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Crowdfunding Intermediaries

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Introduction

On April 5, 2012, the Jumpstart Our Business Startups Act (the JOBS Act) was enacted. Consistent with its name, the JOBS Act sought to help small businesses and start-ups get off the ground and on a path toward success. Among the means employed to achieve its purposes was a provision that created an exemption from the Securities and Exchange Commission's (SEC) registration requirements for offerings of securities made using a process called "crowdfunding." See Jobs Act, Title III (112 P.L. 106, 126 Stat. 306); see also Section 4(a)(6) (15 USCS § 77d) of the Securities Act of 1933, as amended (the Securities Act). Crowdfunding is the process of raising capital over the Internet by collecting a large number of low-dollar investments from numerous individuals (i.e., a crowd of investors). Although certain forms of crowdfunding have gained increasing popularity in recent years, the JOBS Act was (and is) only concerned with the type of crowdfunding in which investors are offered some form of equity in return for their investment, which implicates securities laws. For an overview of the crowdfunding provisions of the JOBS Act, see [An Overview of the SEC's Crowdfunding Regulations](#).

The JOBS Act added a new Section 4(a)(6) to the Securities Act that provides an exemption from registration for crowdfunding transactions that meet specified conditions and required the SEC to implement a regulatory framework to achieve its crowdfunding objectives. In response, the SEC adopted Regulation Crowdfunding (17 C.F.R. §§ 227.100–503), which became effective on May 16, 2016 (except that forms allowing funding portals to register with the SEC became effective on January 29, 2016). Given that it emanates from the JOBS Act, it should come as no surprise that the SEC's implementation of a crowdfunding regulation is seen as a coup for small and medium-sized businesses. Historically, such businesses struggled to raise capital through securities offerings for a variety of reasons, including the high transaction costs associated with such offerings. For example, intermediaries offering securities, such as broker-dealers (BDs), generally seek to manage offerings involving higher-dollar amounts so that they can shift some, if not all, of the transaction costs onto investors. Regulation Crowdfunding opens the door for smaller businesses to capitalize on securities offerings by eliminating many of the transaction costs associated with such offerings and creating a new exemption in Section 4(a)(6) from the Securities Act registration requirements. However, the SEC remains cognizant of the need to protect investors. Regulation Crowdfunding represents the result of a balancing test, in which the SEC sought to protect investors while minimizing the transaction costs associated with such measures. This practice note provides an overview of the regulation of intermediaries and funding portals under Regulation Crowdfunding, including their obligations to investors and their required registration with a national securities association such as the Financial Industry Regulatory Authority (FINRA).

The Contours of Crowdfunding

The crowdfunding exemption is limited in numerous ways. Most notably, under Rule 100(a) (17 C.F.R. § 227.100) of Regulation Crowdfunding, an issuer may only raise \$1 million in any 12-month period utilizing crowdfunding. The amount will be aggregated with

any crowdfunding activities undertaken by entities that share common control with the issuer, or any entity that was a predecessor of the issuer. However, the amount does not include non-crowdfunding offerings, such as private placements.

Certain companies are also barred from participating in crowdfunding. For example, any person who is statutorily disqualified under Section 3(a)(39) (15 U.S.C.S. § 78c) of the Securities Exchange Act of 1934, as amended (the Exchange Act), is barred from participating in crowdfunding, or associating with a company wishing to undertake crowdfunding activities. Additional ineligible companies include non-U.S. companies, certain investment companies, Exchange Act reporting companies, companies without a specific business plan, and companies that failed to comply with annual reporting requirements under Regulation Crowdfunding. See Rule 100(b) (17 C.F.R. § 227.100) of Regulation Crowdfunding.

Crowdfunding investors are similarly limited in the amount they may invest. An investor may not purchase more than \$100,000 of securities through crowdfunding offerings over any 12-month period. This general limitation is subject to further exceptions based on whether the investor's annual income or net worth is above or below \$100,000. Specifically, if either annual income or net worth is less than \$100,000, then the investor is limited to the greater of \$2,000 or 5% of their annual income or net worth (whichever is less). If both annual income and net worth are \$100,000 or more, then the investor is limited to 10% of the lesser of the investor's annual income or net worth, with a cap of \$100,000.

Also of note, any securities that are purchased through crowdfunding cannot be transferred for one year. Issuers, however, are not limited in the type of stock (e.g., common vs. preferred) that they may offer.

For a more detailed discussion of the scope of the crowdfunding exemption, see [An Overview of the SEC's Crowdfunding Regulations](#).

Disclosure Requirements of Issuers

Rule 201 (17 C.F.R. § 227.201) of Regulation Crowdfunding subjects issuers to specific disclosure requirements. Issuers must disclose certain information to the SEC, the intermediary facilitating the offering, and the investors. See SEC Release 2015-249 (Oct. 30, 2015). The information that is subject to disclosure includes, among other things, the price of the securities, the company's financial condition, risk factors related to the offering, and a description of the business plan underlying the offering.

For a more detailed discussion of disclosure requirements of issuers, see [An Overview of the SEC's Crowdfunding Regulations](#).

Regulation Crowdfunding Intermediaries

Under Section 4(a)(6), a company wishing to raise capital using crowdfunding must do so through an intermediary such as a BD. Notably, Regulation Crowdfunding creates a new intermediary called a "funding portal" to allow Internet-based intermediaries to conduct securities offerings without having to register with the SEC as brokers. See Rule 300(c)(2)(17) (17 C.F.R. § 227.300) of Regulation Crowdfunding. The main role of an intermediary in a crowdfunding offering is to provide the Internet funding portal or platform for the offering. In connection with operating a crowdfunding platform, intermediaries are required to provide educational materials and other disclosures about the offering on their platforms.

BDs generally tend to work on high-dollar offerings in order to shift some of their transaction and compliance costs to the wealthy investors who can afford to invest in such offerings. By operating through funding portals, crowdfunding issuers are able to access a larger swath of the investing population without incurring the higher costs of traditional underwritten securities offerings. Also, because crowdfunding offerings can be made to nonaccredited investors, issuers are able to access smaller investors who have been historically left out of the securities market.

In order to protect investors, Regulation Crowdfunding still requires intermediaries to register with the SEC, although they do not have to register as a BD and are not subject to the onerous broker-related rules. Regulation Crowdfunding also requires an intermediary to become a member of a registered national securities association such as FINRA, which is discussed below in greater detail.

General Obligations of Intermediaries

Those crowdfunding intermediaries that are not BDs (i.e., funding portals) are prohibited from engaging in broker-dealer activities and cannot:

- Offer investment advice or recommendations
- Solicit purchases, sales, or offers to buy the securities offered or displayed on its platform

- Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform
- Hold, manage, possess, or otherwise handle investor funds or securities

Moreover, Rules 300-305 of Regulation Crowdfunding impose certain affirmative obligations on intermediaries (whether funding portals or BDs) by requiring them to:

- Provide investors with the most current and up-to-date educational materials on, inter alia, the process for investing on the platform, the types of securities being offered, the risks inherent in each security, resale restrictions, investment limits, and cancellation
- Have a reasonable basis for believing that an issuer meets the requirements for a crowdfunding offering and Regulation Crowdfunding and has the ability to keep accurate records of securities holders
- Make required disclosure available to the public on its platform for the duration of the offering period and at least 21 days before any security may be sold in the offering
- Provide communication channels on their platforms that will allow investors who have opened accounts with the intermediaries and representatives of the issuer to interact and discuss the issuer's offering
- Require any person who posts a comment on communication channels to disclose with every posting whether such person is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer or a compensated promoter
- Provide disclosures to investors regarding intermediary compensation
- Only accept investment commitments after the investor has opened an account and consented to electronic delivery
- Obtain investor representations that the investor has reviewed and understands educational materials, understands the risks of engaging in securities investments, and is in a financial position to deal with such risks
- Obtain from the investor a completed questionnaire indicating the investor's understanding of the restrictions on investment cancellations, potential challenges for resales, and the inherent investment risks
- Reasonably believe that each investor complies with Regulation Crowdfunding
- Provide investors with certain notices and confirmations during the various steps of the investment process
- Comply with requirements for the maintenance and transmission of funds
- Follow completion, cancellation, and reconfirmation of offerings requirements

See "Regulation Crowdfunding: A Small Entity Compliance Guide for Crowdfunding Intermediaries," which can be found at <https://www.sec.gov/divisions/marketreg/tmcompliance/cfintermediaryguide.htm>.

In addition to the above duties, Rules 403 (17 C.F.R. § 227.403) and 404 (17 C.F.R. § 227.404) of Regulation Crowdfunding impose the following duties and obligations on funding portals only:

- Implement written policies and procedures that are reasonably designed to achieve compliance with the federal securities laws and their related rules and regulations pertaining to their businesses as funding portals
- Comply with privacy rules that are applicable to BDs, such as Regulation S-P (Privacy of Consumer Financial Information and Safeguarding Personal Information), Regulation S-ID (Identity Theft Red Flags), and Regulation S-AM (Limitations on Affiliate Marketing)
- Permit examinations and inspections by representatives of the SEC and the relevant registered national securities associations
- Maintain and preserve certain books and records relating to their businesses for at least five years, of which the first two years must be in an easily accessible place

Registration with the SEC

As noted above, funding portals must also register with the SEC. To do this, funding portals must file Form Funding Portal (Form FP)

on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. 17 C.F.R. § 249.2000. Access to EDGAR is available at <https://www.filermanagement.edgarfiling.sec.gov/Welcome/EDGARFilerMgmtMain.htm>.

As an initial matter, before registering with the SEC, a potential funding portal should request and reserve a proposed name from FINRA to ensure that an existing member firm does not already have the desired name. This can be done by completing FINRA's Firm Name Reservation Request Form.

A funding portal's registration becomes effective on the later of: (1) 30 calendar days after the date that the registration is received by the Commission; or (2) the date the funding portal is approved for membership in a national securities association registered under Section 15A of the Exchange Act (i.e., FINRA). To ensure a smooth transition, funding portals should coordinate the filing of Form FP and their registration with FINRA, a topic which is discussed further below.

Form FP requires a vast array of information from a funding portal. In this regard, Form FP requires information covering seven subject areas, referred to as items. The seven items and the corresponding type of information each item seeks are:

- Item 1—**Identifying information.** Name, principal business address, mailing address, and contact information of the funding portal
- Item 2—**Form of organization.** The legal organization of the funding portal (e.g., corporation, partnership, LLC, etc.)
- Item 3—**Successions.** Only applicable if the applicant is succeeding to the business of a currently registered funding portal
- Item 4—**Control relationships.** Every person that directly or indirectly controls the applicant, controls management or policies of the applicant, or that the applicant directly or indirectly controls
- Item 5—**Disclosure information.** Information about the applicant's disciplinary history and the disciplinary history of all associated persons or control affiliates of the applicant (If disciplinary action exists, additional disclosure pages providing details of the underlying incident must be submitted)
- Item 6—**Non-securities-related business.** Non-securities-related business the applicant engages in
- Item 7—**Qualified third-party arrangements; compensation arrangements.** Any third-party arrangements for persons who will hold investor funds in escrow as well as any compensation arrangements the funding portal has with issuers

In addition, Schedule A to Form FP requires applicants to identify and provide information about the applicant's direct owners and executive officers. This includes identification of any shareholder that owns 5% or more of the applicant's stock. For each qualifying owner or executive, the applicant must identify that person's status and indicate whether they occupy a control position, which is defined as the power, directly or indirectly, to direct the management or policies of the funding portal, whether through contract or otherwise. As Form FP states, most executive officers and all 25% owners, general partners, elected managers, and trustees are control persons.

Funding portals must also ensure that the information provided in the initial Form FP is kept accurate. Should any information that was initially submitted become inaccurate, the funding portal must file an amendment within 30 days. 17 C.F.R. § 227.400(b).

Nonresident funding portals must also fill out Schedule C to Form FP. A nonresident funding portal is one that is incorporated in or organized under the laws of a jurisdiction outside of the United States or its territories, or having its principal place of business in any place not in the United States or its territories. 17 C.F.R. § 227.400(f)(1). Schedule C requires a nonresident funding portal to identify its U.S. agent for service of process and certify that it can, and will:

- Provide the SEC and FINRA or any national securities association of which it is a member with prompt access to its books and records
- Submit to onsite inspection and examination by the Commission and any registered national securities association of which it becomes a member

In addition, the nonresident funding portal must attach an opinion of counsel stating that it can, as a matter of law, comply with these two provisions of its certification.

Should a funding portal cease operating as such, it must file a withdrawal of registration on Form FP, which will be effective on the later of: (1) 30 days after receipt by the Commission, or (2) such longer period of time as to which the funding portal consents or the SEC deems necessary to protect investors and the public interest.

How Funding Portals Become FINRA Members

In addition to registration with the SEC, Regulation Crowdfunding requires funding portals to become members of a registered national securities association. Regulation Crowdfunding specifically references FINRA as one such organization, although it leaves the door open for other organizations to qualify. Nevertheless, FINRA membership is the only path for now to complying with this registration requirement of Regulation Crowdfunding. FINRA Rule 110 details the process that a funding portal must undertake to become a FINRA member.

To start, a funding portal applicant must first submit Form FP-NMA, together with an application fee, and indicate whether the funding portal is subject to an event described in Section 3(a)(39) of the Exchange Act, which prohibits certain entities from serving as intermediaries if they engage in prohibited disqualifying acts. See FINRA Rule 110(a)(3).

The application will then be processed for a preliminary 14-day period. During this period, an applicant can withdraw and receive a refund of its application fee. Within 14 days, FINRA may make a written request for further information and/or documentation or reject the application as incomplete. If FINRA seeks further information, the applicant must respond within 14 days (to the first request) or seven days to any subsequent request.

Within 30 days after the filing of an application, or within 14 days after the responding to a request for additional information (whichever is later), the applicant's representative will have a membership interview with FINRA. Per the terms of FINRA Rule 110, the membership interview must be conducted before a final decision is delivered by FINRA. See FINRA Rule 110(a)(9). The applicant will be notified of the date and time of the interview at least five days before the interview takes place.

In making the final decision, FINRA will consider a number of factors, including the following:

- Whether the applicant is capable of complying with applicable federal securities laws and their rules and regulations, and FINRA's rules relating to funding portals; relevant considerations under this inquiry include whether the applicant is subject to a Section 3(a)(39) event or is (or was) subject to an SEC investigation
- Whether the applicant has established all contractual and business relationships necessary to initiate the operation described in its application, such as relationships with banks, BDs, and clearing corporations
- Whether the applicant has a supervisory system that is reasonably designed to achieve compliance with applicable federal securities laws
- Whether the applicant has fully disclosed and established all direct and indirect sources of funding
- Whether the applicant has a recordkeeping system that enables the applicant to comply with all relevant recordkeeping requirements

See FINRA Rule 110(a)(10). Within 60 days of the application, FINRA will deliver its written decision to the applicant and the applicant has 14 days to file a written request for review with the National Adjudicatory Council. See FINRA Rule 110(a)(13). Thereafter, the National Adjudicatory Council will appoint a subcommittee, which will be responsible for conducting a hearing if requested. The applicant may be represented by counsel at a hearing. The applicant and FINRA will exchange copies of their proposed hearing exhibits and witness lists five days before the hearing. However, formal rules of evidence do not apply to the hearing. Additionally, the subcommittee may direct additional briefing. After the hearing and all necessary briefing is complete, the subcommittee must present a recommendation to the National Adjudicatory Council within 60 days of the hearing date. The National Adjudicatory Council may affirm, modify, or reverse FINRA's decision or remand with additional instructions.

Furthermore, after a final decision has been issued, an applicant may apply for review of the decision by the SEC pursuant to Section 19(d)(2) of the Exchange Act. However, seeking such review does not stay the effectiveness of FINRA's decision unless otherwise ordered by the SEC.

After becoming a member, a funding portal has a continuing obligation to keep the information in its application current. For example, a funding portal must update information relating to compliance with Section 3(a)(39) of the Exchange Act within 10 days of any change in status. See FINRA Rule 110 (a)(3)(B).

Officers, Directors, or Partners of an Intermediary

Pursuant to Rule 300, any director, officer, or partner of an intermediary, or any person occupying a similar status or performing a

similar function, may not have a financial interest in an issuer that is offering or selling securities under Regulation Crowdfunding through the intermediary's platform. 17 C.F.R. § 227.300. Additionally, any director, officer, or partner may not receive a financial interest in an issuer as compensation for the services provided to, or for the benefit of, the issuer in connection with the offer or sale of such securities. Id.

Note that it is possible for the intermediary itself to have a financial interest in an issuer if: (1) the intermediary receives the financial interest from the issuer as compensation for the services provided to the issuer in connection with the issuer's offer or sale of securities through the intermediaries 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 through the funding portal. 17 C.F.R. § 227.300.

Permissible Activities of Funding Portals

Given that a funding portal cannot engage in BD-type activities, there is some confusion about what activities a funding portal can engage in without running afoul of this regulation. To clarify what activities a funding portal can undertake in order to still be entitled to the crowdfunding exemption, the SEC issued Rule 402's "safe harbor." 17 C.F.R. § 227.402. Pursuant to the safe harbor, a funding portal is permitted to engage in the following activities:

- **Selecting issuers.** A funding portal may select which entities are permitted to make offerings on its platform. However, the funding portal must not advertise or otherwise provide investment advice or recommendations.
- **Highlight offerings.** A funding portal may apply objective criteria to highlight offerings on the funding portals platform provided that the criteria are reasonably designed to highlight a broad selection of issuers utilizing the platform, are applied consistently to all issuers and offerings, and are clearly displayed on the funding portal's platform. Rule 402 makes clear that a funding portal may not receive compensation for highlighting offerings. Rule 402 also provides examples of objective criteria, such as the type of securities being offered, the geographic location of the issuer, and the industry or business segment of the issuer.
- **Advertising.** A funding portal may advertise the existence of the funding portal and identify one or more issuers or offerings available on the portal on the basis of objective criteria similar to that applicable to highlighting offerings.
- **Search functions.** A funding portal can provide search functions that allow users to search and categorize offerings according to objective criteria. However, search criteria may not include the advisability of investing in the issuer or its offering, or an assessment of any characteristic of the issuer, its business plan, its key management, or risks associated with an investment.
- **Communication channels.** Under certain conditions, a funding portal can provide communication channels by which investors can communicate with one another and with representatives of the issuer through the funding portals platform. However, a funding portal and its associated persons may not participate in these communications. Additionally, a funding portal must (1) permit public access to view any communications; (2) restrict posting of comments to those persons who have opened an account on the funding portal; and (3) require any person posting a comment to disclose with every posting whether they are a founder or an employee of an issuer promoting an issuer or otherwise being compensated for promoting an issuer.
- **Advising the issuer.** A funding portal may advise an issuer about the structure or content of the issuer's offering, including assisting the issuer in preparing offering documentation.
- **Referrals.** A finding portal can compensate a third party for referring a person to the funding portal so long as (1) the party does not provide the funding portal with information on potential investors, and (2) the compensation is not based, directly or indirectly, on the purchase or sale of a security offered through the funding portal.
- **Utilizing BDs.** A funding portal may compensate a BD for BD services, including referring a person to the funding portal, so long as the agreement is written and otherwise complies with all applicable rules. Similarly, a funding portal may provide services to a BD in exchange for compensation so long as the agreement is written and otherwise complies with all applicable rules.
- **Denying access to the funding portal.** A funding portal may deny access or cancel an offering of an issuer if the funding portal has a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection.
- **Accepting investment commitments.** A funding portal may accept an investment commitment on behalf of the issuer for securities offered by that issuer on the funding portal's platform.

- **Directing fund transmissions.** A funding portal may direct investors where to transmit funds or remit payment in connection with the purchase of securities offered and sold. Similarly, a funding portal may direct a qualified third party, such as an escrow agent, to release funds to an issuer upon completion of the offering or, alternatively, to return funds to investors upon the cancellation of an offering. However, a funding portal may not actually handle customer funds.

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