

SEC Adopts Crowdfunding Rules

November 19, 2015

On October 30, the SEC voted 3-1 to adopt **final rules** to permit eligible companies to offer and sell securities through crowdfunding—a relatively new and evolving Internet-based method of raising capital through limited investments from a broad group of investors. The culmination of an extensive two-year rulemaking process, Regulation Crowdfunding attempts to achieve a balance between creating a viable crowdfunding model for startups and small businesses while providing adequate protections for investors. It is the last of the SEC's significant rulemakings under the 2012 JOBS Act.

While substantially similar to the **October 2013 rule proposal**, which we discussed in an earlier **client memorandum**, the final rules reflect a number of notable changes designed to minimize the burdens and costs for issuers and intermediaries (particularly smaller entities) while preserving sufficient investor protection measures. The new crowdfunding rules will be effective May 16, 2016. The forms enabling funding portals to register with the SEC will be effective January 29, 2016.

While crowdfunding presents a compelling new financial option for many small issuers that currently have difficulty raising capital, compliance with the rules may prove disproportionately costly relative to the low maximum amount of capital that can be raised. As the discussion below makes clear, issuers will face substantial compliance costs and potential liabilities associated with the significant disclosure and reporting obligations the rules impose and the required use of a registered intermediary.

Other deterrents to crowdfunding include the \$1 million aggregate offering limit (which may not be sufficient for issuers to make their businesses viable); the relatively low individual investment limits (which, by restricting potential upside, may discourage investor participation and make it harder for issuers to reach their funding targets); the advertising restrictions on crowdfunding transactions (which may limit issuers' ability to attract a wide range of investors); and the potentially high degree of illiquidity associated with crowdfunding securities (which will complicate investor exit strategies). These costs and restrictions and others we address below will limit the utility of crowdfunding as a capital-raising alternative for startups and small businesses.

Regulation Crowdfunding

Regulation Crowdfunding implements the requirements of Title III of the JOBS Act. Title III added a new Section 4(a)(6) of the Securities Act, which provides an exemption from the Securities Act registration requirements to permit securities-based crowdfunding transactions, and established the foundation for a comprehensive, yet scaled, crowdfunding regulatory regime.

As an overview, Regulation Crowdfunding:

- enables companies to raise investment capital through crowdfunding offerings, subject to offering-size limitations;
- enables investors (whether accredited or non-accredited) to purchase securities in crowdfunding offerings, subject to investment limitations;
- requires companies to disclose information about their business and their securities being offered in crowdfunding offerings; and
- creates a regulatory framework for the registered funding portals and broker-dealers that companies are required to use as intermediaries in crowdfunding transactions.

Crowdfunding Exemption

Issuer Offering Limits

Issuers are permitted to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period. In calculating the amount sold, securities sold by entities controlled by, or under common control with, the issuer, as well as any securities sold by any predecessor of the issuer, will be aggregated with the securities sold by the issuer. Capital raised through other exempt transactions during the 12-month period would not count toward the threshold.

Individual Investment Limits

Individual investors (including non-accredited investors) are permitted to invest in the aggregate across all crowdfunding offerings over a 12-month period up to:

- if either their annual income or net worth is less than \$100,000, the greater of \$2,000 or 5% of the lesser of their annual income or net worth; or
- if both their annual income and net worth are equal to or greater than \$100,000, 10% of the lesser of their annual income or net worth, subject to an investment cap of \$100,000.

For investors who are natural persons, annual income and net worth are to be calculated as those values are calculated for purposes of determining accredited investor status under Rule 501(a) of Regulation D. The value of an individual's primary residence is not counted as an asset in the net worth calculation. Spouses may calculate their annual income and net worth jointly, but if they elect to do so, their aggregate investment cannot exceed the limit applicable to an individual investor at the same income or net worth level.

As discussed below, an issuer is allowed to rely on the efforts that the intermediary is required to undertake to ensure investor compliance with the investment limitations, provided the issuer does not have knowledge to the contrary.

Offering through a Single Intermediary

Crowdfunding transactions must be conducted *exclusively* online through platforms operated by an SEC-registered intermediary, either a broker-dealer or a new type of SEC registrant called a "funding portal," the business activities of which are of limited scope relative to entities that register as broker-dealers.

An issuer relying on the crowdfunding exemption is required to conduct its offering (or concurrent offerings) exclusively through one intermediary platform at a time. The adopting release notes that use of a single intermediary helps to foster the creation of a "crowd," strengthens the ability of the crowd to communicate and makes it easier for the intermediary to monitor the issuer's compliance with the \$1 million aggregate offering limitation.

Issuer Eligibility

Certain categories of issuers are not eligible to use the crowdfunding exemption. Specifically, the exemption is not available to:

- non-U.S. companies;
- Exchange Act reporting companies;
- investment companies (as defined in the Investment Company Act) and companies that are excluded from the investment company definition under Section 3(b) or 3(c) of the Investment Company Act;
- companies that are disqualified under Regulation Crowdfunding's disqualification provisions (modeled on, and substantially similar to, the "bad actor" disqualification criteria under Rule 262 of Regulation A and Rule 506 of Regulation D);

- companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the crowdfunding offering; and
- blank check companies.

Types of Securities Offered

The adopting release explicitly notes that the final rules do not limit the types of securities that may be offered in reliance on the crowdfunding exemption, and thus debt securities may be offered and sold in crowdfunding transactions.

Resale Restrictions

Securities purchased in a crowdfunding transaction generally cannot be resold for one year, unless they are transferred to the issuer, an accredited investor, as part of a registered offering, or to certain members of the purchaser's family, to the purchaser's trust (or a family trust) or in connection with the purchaser's death or divorce.

The resale restrictions apply to any purchaser during the one-year period beginning when the securities were first issued and not only to the initial purchaser.

As a practical matter, liquidity may be constrained even after the one-year restricted period ends absent the development of an active secondary trading market, which may limit the attractiveness of crowdfunding offerings.

Exemption from Exchange Act Section 12(g)

The final rules permanently exempt crowdfunding securities from the Exchange Act "holder of record" count for the purposes of determining if registration of a class of equity securities is required under Section 12(g), provided that the issuer is current in its annual reporting obligations, has engaged the services of a registered transfer agent and has total assets as of the end of its last fiscal year not in excess of \$25 million.

Advertising Restrictions

The final rules prohibit an issuer (or person acting on behalf of the issuer) from advertising the terms of the crowdfunding offering, except for limited notices (similar to "tombstone ads" permitted under Securities Act Rule 134) that direct investors to the intermediary's platform. Information in advertising notices is limited to:

- a statement that the issuer is conducting a crowdfunding offering, the name of the intermediary through which the offering is being conducted and a link to the intermediary's platform;
- the terms of the offering (the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period); and
- limited factual information about the issuer: the name, address, phone number and website of the issuer; the email address of a representative of the issuer; and a brief description of the issuer's business.

The final rules do not impose limits on how the issuer distributes the advertising notices. For example, an issuer could place notices in newspapers or post notices on social media sites or the issuer's own website.

In addition, issuers may communicate with investors about the terms of the offering through communication channels provided on the intermediary's platform, provided an issuer identifies itself as the issuer in all communications.

The final rules also do not restrict an issuer's ability to communicate other information that might occur in the ordinary course of its operations and that does not refer to the terms of the offering. While the final rules do not provide a safe harbor for regularly released factual business information so long as it does not refer to the terms of the offering, the adopting release notes that issuers may generally look to the

provisions of Securities Act Rule 169 (which permits non-reporting issuers engaged in an initial public offering to continue to publish regularly released factual business information) for guidance in making this determination in the Regulation Crowdfunding context.

Promoter Compensation

An issuer is prohibited from compensating anyone to promote its offering through communication channels provided on the intermediary's platform, unless the issuer takes reasonable steps to ensure the person clearly discloses the receipt (past or prospective) of compensation with any such promotional communication.

The adopting release sets forth a number of "reasonable steps" an issuer can take to ensure that promoters disclose the receipt of compensation, including contractually mandating that promoters include the required disclosure about receipt of compensation and monitoring the promoters' communications.

An issuer is prohibited from compensating anyone to promote its offerings outside of the communication channels provided by the intermediary, unless the promotional communication is limited to notices that comply with the advertising restrictions discussed above.

No Integration

A crowdfunding offering will not be integrated with another exempt offering made by the issuer, provided that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering. Accordingly, an issuer conducting a contemporaneous exempt offering for which general solicitation is not permitted (for example, under Securities Act Rule 506(b)) would need to conclude that purchasers in the Rule 506(b) offering were not solicited by means of the crowdfunding offering. Otherwise, the solicitation conducted in connection with the crowdfunding offering might preclude reliance on Rule 506(b).

Alternatively, an issuer conducting a concurrent exempt offering for which general solicitation is permitted (for example, under Securities Act Rule 506(c)) could not include in its solicitation an advertisement of the terms of the crowdfunding offering unless the solicitation otherwise complies with Regulation Crowdfunding. As such, a concurrent offering would be bound by the more restrictive advertising rules of Regulation Crowdfunding, unless the issuer can conclude that purchasers in the crowdfunding offering were not solicited by means of the Rule 506(c) offering.

Insignificant Deviations

The final rules contain a safe harbor, which provides that insignificant deviations from a term, condition or requirement of Regulation Crowdfunding will not result in a loss of the exemption so long as the issuer, in good faith, reasonably attempted to comply with the rules, the failure to comply was insignificant to the offering as a whole and certain other conditions apply.

State Preemption

Crowdfunding offerings are not subject to state registration or "blue sky" requirements.

Disclosure Requirements

Form C and Filing Requirements

A new Form C will be used for all filings under Regulation Crowdfunding, including the initial offering statement, any updates and the ongoing annual reports.

Offering Statement Disclosure Requirements

Issuers that conduct crowdfunding offerings must file information with the SEC via EDGAR on Form C and provide this information to investors and the intermediary facilitating the offering. The final rules do not prescribe the specific content or format for this information, but instead set forth general principles for making the required disclosures, which are generally less expansive than are required in registered offerings and include:

- information about officers, directors and 20% owners;
- a description of the issuer's business, current number of employees and the stated purpose and intended use of the offering proceeds;
- the offering price of the securities or the method for determining the price (provided that the final price and required disclosures are provided to each investor prior to any sales);
- the terms of the securities and the valuation method;
- the target offering amount, the deadline to reach the target offering amount, regular updates about the issuer's progress in meeting the target offering amount and whether the issuer will accept investments in excess of the target offering amount;
- related-party transactions;
- a description of the issuer's ownership and capital structure;
- material indebtedness;
- risk factors tailored to the issuer's business and the offering;
- transfer restrictions;
- information about exempt offerings conducted within the past three years;
- all compensation paid or to be paid to the intermediary for conducting the offering (which may be disclosed as a dollar amount or as a percentage of the offering amount), as well as any other direct or indirect interest in the issuer held by the intermediary (including an intermediary's financial interest in the issuer conducting offerings on its platform);
- a narrative discussion of the issuer's financial condition (including, to the extent material, liquidity, capital resources and the issuer's historical results of operations, as well as any material changes or trends known to management subsequent to the period for which financial statements are provided);
- financial statements, the required level of review for which is scaled based on the aggregate amount of crowdfunding securities offered and sold in the prior 12 months, as discussed in greater detail below; and
- any material information necessary in order to make the disclosures, in light of the circumstances under which they were made, not misleading.

The final rules also require an issuer to disclose in its offering statement and annual report if it, or any of its predecessors, previously failed to comply with the ongoing reporting requirements of Regulation Crowdfunding.

Financial Statement Requirements

Financial statements (to comprise balance sheets, income statements, cash flow statements, statements of changes in owners' equity and notes to the financial statements) must be prepared in accordance with U.S. GAAP, and are required for the issuer's two most recently completed fiscal years or the period since inception, whichever is shorter. Interim financial statements are not required.

An issuer may use financial statements for the fiscal year prior to the most recently completed fiscal year, provided that not more than 120 days have passed since the end of the issuer's most recently completed fiscal year (and financial statements for the most recently completed fiscal year are not otherwise available).

The final rules establish a framework of tiered financial statement review requirements based on the aggregate amount of crowdfunding securities offered and sold during the preceding 12-month period (inclusive of the offering amount in the offering for which disclosure is being provided):

- for offerings of \$100,000 or less, the financial statements must be certified by the issuer's principal executive officer to be true and complete in all material respects and be accompanied by certain information from the issuer's federal income tax return for the most recently completed year and certified by the issuer's principal executive officer as reflecting accurately the amounts reported on the tax return. In a nod to privacy concerns, the final rules do not require issuers to file a copy of the underlying tax return. If reviewed or audited financial statements are otherwise available, those must be provided, along with a signed review or audit report, in lieu of the foregoing.
- for offerings of more than \$100,000 but less than \$500,000, the financial statements must be reviewed by an independent public accountant and include a signed review report. If audited financial statements are otherwise available, those must be provided, along with a signed audit report, in lieu of the reviewed financial statements.
- for offerings of more than \$500,000 but less than \$1 million, the financial statements must be audited by an independent public accountant and include a signed audit report. However, in a significant accommodation relative to the original proposal, first-time crowdfunding issuers are permitted to provide reviewed rather than audited financial statements (along with a signed review report), unless audited financial statements are otherwise available. The adopting release indicates that this accommodation was added for issuers relying on the crowdfunding exemption for the first time in response to critics' concerns about the expense of obtaining audited financial statements, especially for startup issuers without a track record of successfully raising capital that are likely be more financially constrained.

An issuer will not be in compliance with the requirement to provide audited financial statements if the audit report includes an adverse opinion, a disclaimer of opinion or (in a modification from the proposal) a qualified opinion. A going concern opinion is acceptable.

An independent public accountant's signed review report or audit report on the issuer's financial statements must be filed with the offering materials. The adopting release notes that in contrast to audit reports in a registered offering, the final rules do not require that review or audit reports be accompanied by a formal consent. Rather, the review and audit reports must be signed, and issuers must notify the public accountants of their intended use in a crowdfunding offering.

To qualify as independent of the issuer, a public accountant must meet the independence standards of Rule 2-01 of Regulation S-X or (in an addition to the proposed rules) those of the American Institute of Certified Public Accountants.

The independent public accountant does not have to be registered with the PCAOB.

Amendments to the Offering Statement

An issuer is required to amend its Form C disclosures to report material changes in the offer terms or disclosures previously provided to investors. Material changes require reconfirmation by investors of their investment commitments within five business days. If an investor does not reconfirm her investment commitment after the occurrence of a material change, the investment commitment will be canceled and the committed funds will be returned.

The adopting release notes that what constitutes a material change is a facts-and-circumstances determination. Consistent with U.S. Supreme Court precedent, information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether or not to purchase the securities. The adopting release provides several examples of material changes that would require amended disclosure, including a material change in the issuer's financial condition or intended

use of proceeds. In addition, in those instances in which an issuer has previously disclosed in its offering materials only the method for determining the price (and not the final price) of the securities offered, determination of the final price would be a material change to the terms of the offer and must be disclosed.

Progress Updates

An issuer also is required to file progress updates with the SEC to disclose its progress in meeting the target offering amount. Updates are required within five business days after any of the following milestones: commitments for 50% of the deal are received; commitments for the full deal are received; subscriptions will be accepted in excess of the initial offering amount; or the issuer closes the offering.

The final rules permit issuers to satisfy the 50% and 100% progress update requirements by relying on the relevant intermediary to make publicly available on its platform frequent updates about the issuer's progress toward meeting the target offering amount. However, the issuer must still file a Form C at the end of the offering to disclose the total amount of securities sold in the offering.

Ongoing Annual Reporting Requirement

Following the completion of a crowdfunding offering, issuers become subject to limited ongoing reporting requirements. Issuers must file with the SEC, within 120 days after fiscal year-end, and post on their website annual reports on Form C, which contain disclosure substantially similar to the disclosure provided in the offering statement, with the exception of the offering-specific information. The ongoing reporting obligation is annual only; issuers are not required to provide quarterly reports or current reports.

Instead of requiring that the financial statements in the annual report meet the highest standard previously provided by the issuer (reviewed or audited), the final rules require financial statements certified by the issuer's principal executive officer to be true and complete in all material respects, unless reviewed or audited financial statements are otherwise available. The adopting release notes that reducing the required level of public accountant involvement is intended to minimize the costs and burdens for crowdfunding issuers associated with preparing and reviewing audited financial statements on an ongoing basis.

Issuers will be required to file annual reports until the earliest of the following events occurs: the issuer becomes an SEC reporting company; all of the issuer's securities issued pursuant to the crowdfunding exemption are redeemed or repurchased; the issuer liquidates or dissolves; the issuer has filed at least one annual report and has fewer than 300 holders of record; or the issuer has filed at least three annual reports and has total assets not exceeding \$10 million.

Any issuer terminating its annual reporting obligation is required to file with the SEC a termination notice on Form C, within five business days from the date on which it becomes eligible to do so, a notice that it will no longer file and provide annual reports pursuant to the requirements of Regulation Crowdfunding.

The final rules clarify that the availability of the crowdfunding exemption is not conditioned on compliance with the annual reporting, progress update or termination of reporting obligations (although crowdfunding issuers remain obligated to comply with these reporting requirements, and must disclose in the offering statement and annual report if they, or any of their predecessors, previously failed to comply with such requirements). However, issuers are denied the benefit of relying on the crowdfunding exemption for future offerings until they file, to the extent required, the two most recently required annual reports.

Crowdfunding Intermediaries

Registration Requirements

As noted above, crowdfunding transactions must be conducted exclusively online through platforms operated by an SEC-registered intermediary. A crowdfunding intermediary is required to register with the SEC either as a broker-dealer or as a funding portal, which is a new type of intermediary created under Title III of the JOBS Act. The registration requirements for funding portals are tailored to the more limited

nature and scope of funding portal activities and, accordingly, are less extensive and less costly than those that accompany broker-dealer registration.

A funding portal is required to register with the SEC by filing a new Form Funding Portal and become a member of a registered national securities association (currently, FINRA).

Non-U.S. funding portals are allowed to register with the SEC and operate as funding portals in the U.S. crowdfunding market.

Financial Interest in the Issuer

In a notable departure from the rules as proposed, the final rules allow an intermediary to have a financial interest in an issuer that is offering or selling securities on its platform, provided that the intermediary receives the financial interest as compensation for its services, and 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. Intermediaries will not otherwise be permitted to invest in the offering. The intermediary must clearly disclose any financial interest in an issuer on the portal. The adopting release notes that permitting intermediaries to have such a financial interest allows for more flexibility in the payment arrangements between issuers and intermediaries and may also help to align the interests of intermediaries and investors, as well as provide an additional incentive to screen for fraud.

An intermediary's directors, officers or partners, however, are prohibited from having any financial interest in an issuer using the intermediary's services and from receiving a financial interest in the issuer as compensation for such services.

A "financial interest in the issuer" is defined to mean a direct or indirect ownership of, or economic interest in, any class of the issuer's securities.

Measures to Reduce Risk of Fraud

Consistent with their intended role as "gatekeepers," intermediaries are required to take certain measures to reduce the risk of fraud, including:

- having a reasonable basis for believing that an issuer complies with Regulation Crowdfunding and has established means to keep accurate records of securities holders; and
- denying access by an issuer to their platform if they have a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises investor protection concerns, or that the issuer or any of its officers, directors or 20% owners is subject to "bad actor" disqualification under the final rules.

Significantly, an intermediary may reasonably rely on an issuer's representations about compliance and recordkeeping unless it has reason to question the reliability of those representations. In a modification from the proposal, the final rules provide a safe harbor whereby an intermediary is deemed to have met the recordkeeping requirement if the issuer has retained a registered transfer agent.

An intermediary must, at a minimum, conduct a background and securities enforcement regulatory history check on each issuer and each officer, director and 20% owner of the issuer to determine whether the issuer or such person is subject to a disqualifying event. The final rules do not establish specific requirements for background checks, but rather allow intermediaries the discretion to design their own screening systems and procedures.

Account Opening

Accounts and Electronic Delivery. Intermediaries may not accept an investment commitment from an investor until that investor has opened an account and consented to electronic delivery of documents.

Educational Materials. In connection with establishing an account, intermediaries are required to deliver to investors educational materials in plain English that explain, among other things, the process for investing on the platform, the types of securities being offered, the risks and costs associated with

investing in the securities, resale restrictions, investment limits and investor cancellation rights. The final rules do not prescribe the overall format and manner of presentation of the materials, but rather allow intermediaries the flexibility to prepare and present educational materials reasonably tailored to their offerings and investors (provided they contain the minimum specified information required under the final rules). The educational materials can be in any electronic format.

Intermediaries are required to update their educational materials as needed to keep them current. In addition, intermediaries must obtain a representation that an investor has reviewed the most recent educational materials each time before accepting an investment commitment from the investor.

Promoters. Intermediaries are required to inform investors, at the time of account opening, that promoters (or founders or employees of an issuer who engage in promotional activities on the issuer's behalf) must clearly disclose in all communications on the platform the receipt (past or prospective) of compensation and the fact that they are engaging in promotional activities on behalf of the issuer.

Compensation. When establishing an account for an investor, intermediaries are required to clearly disclose the compensation they will receive in connection with crowdfunding offerings (including any financial interest in an issuer as compensation for their services, as discussed above).

Issuer Information

An intermediary is required to make information that an issuer is required to disclose publicly available on its platform throughout the offering period and for a minimum of 21 days before any securities are sold in the offering (during which time the intermediary may accept investment commitments).

Investor Qualification

Each time before accepting an investment commitment, intermediaries are required to:

- have a reasonable basis for believing that the investor satisfies the investment limitations; and
- obtain from the investor acknowledgment of certain risks, including (i) a representation that the investor has reviewed the intermediary's educational materials, understands that the entire amount of her investment may be lost and is in a financial condition to bear the loss of the investment; and (ii) a questionnaire completed by the investor demonstrating her understanding of the risks of any potential investment (specifically, that there are restrictions on the investor's ability to cancel an investment commitment and obtain a return of her investment; that it may be difficult for the investor to resell the securities; and that the investor should not invest any funds in a crowdfunding offering unless she can afford to lose the entire amount of her investment).

Significantly, an intermediary may reasonably rely on investor representations concerning compliance with the investment limitation requirements unless it has reason to question the reliability of those representations. An issuer, in turn, is allowed to rely on the efforts that the intermediary is required to undertake to ensure investor compliance with the investment limitations, provided the issuer does not have knowledge to the contrary.

The final rules do not prescribe sample content or a model form of acknowledgment or questionnaire but rather, as with the educational material requirements, give intermediaries the flexibility to determine the most effective format in which to present the required materials.

Communication Channels

Intermediaries are required to provide communication channels on the platform to permit discussions about offerings. Consistent with the statutory prohibition on a funding portal offering investment advice or recommendations, as discussed below, intermediaries that are funding portals are prohibited from participating in communications in these channels, other than to establish guidelines about communication and to remove abusive or potentially fraudulent communications.

Notice of Investment Commitment; Confirmation of Transactions

Intermediaries are required to promptly provide investors notices once they have made investment commitments (which must include, among other information, the date and time by which the investor may cancel the investment commitment), and confirmations at or before completion of a transaction.

Completion of Offerings, Cancellations and Reconfirmations

Intermediaries are required to comply with completion, cancellation and reconfirmation of offering requirements. Among the most noteworthy of these requirements, crowdfunding investors have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer's offering materials. In addition, investor reconfirmations must be obtained within five business days following the occurrence of a material change. If an investor does not reconfirm, her investment commitment will be canceled and the committed funds will be returned.

Maintenance and Transmission of Funds

Intermediaries are required to comply with requirements governing the maintenance and transmission of investor funds.

Additional Funding Portal Requirements

Statutory Prohibitions and Safe Harbor for Certain Activities. Regulation Crowdfunding contains certain rules that are specific to registered funding portals consistent with their more limited activities relative to those of registered broker-dealers. For example, funding portals are prohibited from engaging in a variety of activities, including:

- offering investment advice or recommendations;
- soliciting purchases, sales or offers to buy securities;
- compensating promoters and other persons for solicitations or based on the sale of securities; and
- holding, managing, possessing or otherwise handling investor funds or securities.

The final rules contain a non-exclusive conditional safe harbor under which funding portals can engage in certain limited activities deemed consistent with these restrictions. The permissible activities in the safe harbor include, among others, limiting offerings and issuers allowed on the platform; highlighting and displaying offerings on the platform; advising issuers on the structure and content of their offerings, including preparing offering documentation; and denying access to, or canceling, offerings due to fraud or investor protection concerns.

Compliance Requirements. The final rules also impose specific compliance requirements on funding portals, which mandate, among other things, compliance with certain recordkeeping requirements; compliance with certain privacy rules as they apply to brokers; and the implementation of written policies and procedures designed to achieve compliance with applicable federal securities laws. In addition, funding portals, although exempt from broker-dealer registration, remain subject to the full range of the SEC's and FINRA's examination and enforcement authority and are required to permit the SEC and FINRA to examine and inspect their business operations related to their activities as funding portals.

In contrast to the original proposal, the final rules do not impose anti-money laundering obligations for funding portals or require them to maintain fidelity bond coverage. (However, registered broker-dealers that serve as intermediaries in securities-based crowdfunding transactions will continue to have AML obligations.)

Proposed FINRA Framework Applicable to Funding Portals. In October, FINRA filed with the SEC [proposed Funding Portal Rules and Related Forms](#) that would apply to SEC-registered funding portals that become FINRA members. The proposal has not yet been approved by the SEC. Concurrently, FINRA submitted a [companion filing](#) to adopt the fees applicable to funding portal members (which are generally lower than the fees currently charged to broker-dealer members).

The proposed Funding Portal Rules consist of a set of seven rules (Funding Portal Rules 100, 110, 200, 300, 800, 900 and 1200) and related forms (Form FP-NMA (new membership application), Form FP-CMA (continuing membership application), Funding Portal Rule 300(c) Form, and Form FP-Statement of Revenue), which are designed to streamline and simplify FINRA regulations that currently apply to broker-dealers to reflect the comparatively limited nature and scope of funding portal activities. The proposed rules address, among other matters, general standards applicable to funding portals, the membership application process, standards of business conduct, supervisory systems, reporting and recordkeeping requirements, the application of FINRA's investigations and sanctions procedures, code of procedure and arbitration and mediation procedures to funding portals, and eligibility proceedings in connection with statutory disqualifications.

In addition, FINRA is proposing to adopt new FINRA Rule 4518 (Notification to FINRA in Connection with the JOBS Act), which would apply to registered broker-dealer members and require them to notify FINRA prior to engaging in a crowdfunding transaction for the first time or within 30 days of directly or indirectly controlling, or being controlled by or under common control with, a funding portal.

Other Provisions

Disqualification Provisions

The final rules impose "bad actor" disqualification provisions for both issuers and intermediaries:

- for issuers, the disqualification provisions are substantially similar to those imposed under Rule 262 of Regulation A and Rule 506 of Regulation D. The final rules allow for a waiver from, and a reasonable care exception to, the disqualification provisions.
- for intermediaries, the final rules apply the disqualification provisions under Section 3(a)(39) of the Exchange Act, an established standard for broker-dealers.

Scope of Liability

Securities Act Section 4A(c) provides that an issuer will be liable to a purchaser of its securities in a crowdfunding transaction if the issuer, in the offer or sale of the securities, makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of the untruth or omission, and the issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. In the proposing release, the SEC stated that it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of Section 4A(c) liability.

In the adopting release, the SEC specifically declined to exempt intermediaries (including funding portals) from the statutory liability provision of Section 4A(c) or to interpret the provision as categorically excluding such intermediaries, which it said could pose undue risks to investors by providing insufficient incentives for intermediaries to take steps to prevent their platforms from becoming vehicles for fraud. Rather, the determination of "issuer" liability for an intermediary under Section 4A(c) will turn on the facts and circumstances of the particular matter in question. An intermediary has a defense to such liability if it is able to show that it did not know, and in the exercise of reasonable care, could not have known, of the untruth or omission.

SEC Staff Report

The SEC staff is required to submit a report to the SEC no later than three years following the effective date of Regulation Crowdfunding on the impact of the regulation on capital formation and investor protection, which will include an assessment of the development of secondary market trading in crowdfunding securities.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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