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# REGULATION CROWDFUNDING – FUNDING PORTALS AND OTHER CROWDFUNDING INTERMEDIARIES

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Title III of the Jumpstart Our Business Startups Act (JOBS Act) created a new securities registration exemption for crowdfunding<sup>[1]</sup> offerings by adding Section 4(a)(6) to the Securities Act of 1933 (the Securities Act). In late October of 2015, the Securities and Exchange Commission (SEC) adopted Regulation Crowdfunding, a new regulatory framework that implements this crowdfunding exemption. In an earlier **Alert**, we outlined the requirements for issuers to conduct an offering under Section 4(a)(6) and Regulation Crowdfunding. Today's Alert provides an overview of the regulatory requirements for the crowdfunding intermediaries that are required to facilitate such offerings, particularly the newly-created entity called a funding portal.

Each crowdfunding offering and associated activities must occur over the Internet or other similar electronic medium that is accessible to the public, through a single crowdfunding intermediary. In the SEC's view, registered intermediaries are necessary to bring the issuer and potential investors together and to provide safeguards to potential investors. A crowdfunding intermediary must be either: (1) a broker registered under Section 15(b) of the Securities Exchange Act of 1934 (the Exchange Act) or (2) a funding portal registered with the SEC. Funding portals are Internet-based platforms that may facilitate Section 4(a)(6) crowdfunding offerings. The JOBS Act directed the SEC to create an exemption that allows such funding portals to avoid the more fulsome registration requirements imposed on a broker-dealer under the Exchange Act that may otherwise be required based on the character of their activities. The funding-portal registration provisions under Regulation Crowdfunding and the SEC's Form Funding Portal discussed in this Alert became effective on January 29, 2016. Companies can commence offerings under Regulation Crowdfunding on May 16, 2016.

## Overview of SEC Funding Portal Registration and Conditions

**Registration.** Funding portals must register with the SEC by filing a Form Funding Portal that will be publicly available on EDGAR. Form Funding Portal requires information that is similar to the information required for registered broker-dealers on Form BD, but is less extensive in its requirements.

**Conditions on the Exemption.** In order to qualify for the funding portal exemption under Regulation Crowdfunding, a funding portal may not:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy securities displayed on the platform;
- Compensate employees, agents or other persons for solicitation or based on sales; or

- Hold, manage, possess or otherwise handle investor funds or securities.

The SEC created a “safe harbor” in Rule 402 of Regulation Crowdfunding to provide some clarity to the conditions listed above. Under the safe harbor, a funding portal is permitted to undertake and participate in the following limited activities, consistent with the general conditions of the exemption, and still qualify for the exemption from the requirement to register as a broker-dealer:

- Determine whether and under what terms to allow issuers to offer and sell securities through their platforms;
- Highlight specific offerings displayed on its platform based on objective criteria;
- Provide search functions and similar tools to allow investors to search and sort offerings available through its platform;
- Provide communication channels by which investors can communicate with one another and representatives of the issuer about the offering through the platforms;
- Advise issuers regarding the structure or content of an offering including assisting in preparing offering documentation;
- Compensate third parties for referrals under certain circumstances;
- Pay, or offer to pay, compensation to registered broker-dealers for services, including referrals, and receive compensation from registered broker-dealers for services provided by the funding portals in connection with the offer or sale of securities;
- Advertise the existence of the funding portal and objectively identify issuers or available offerings;
- Deny access to the platform or cancel offerings if the funding portal has a reasonable basis for believing that the issuer or offering presents a potential for fraud or otherwise raises concerns regarding investor protection; or
- Accept investment commitments for securities on behalf of issuers, direct investors where to transmit funds or remit payment in connection with their securities purchases, and direct qualified third parties to release proceeds to issuers upon completion of offerings.

## Requirements for Crowdfunding Intermediaries

Regulation Crowdfunding also imposes certain obligations on crowdfunding intermediaries (whether they are registered broker-dealers or funding portals) in connection with facilitating crowdfunding offerings, including requiring that crowdfunding intermediaries:

- Prohibit their directors, officers and partners, and the intermediary itself, from having any financial interest in an issuer using their services;
- Take specified measures to reduce the risk of fraud in crowdfunding offerings;
- Make available information about the issuer and the offering, such as the issuer’s Form C (and related amendments and updates) at certain times;
- Require each investor to open an account with the funding portal before making an investment commitment and to provide prospective investors with educational materials in Plain English in connection with establishing an account;

- Ensure that no investor exceeds the investment limits;
- Obtain from investors a representation and questionnaire acknowledging the risks posed by investing in the issuer;
- Allow investors the unconditional right to cancel their investment commitments until 48 hours before the deadline identified in the issuer's offering materials;
- Provide communication channels that meet certain requirements to permit discussions among investors and between investors and the issuer about offerings on the platform; and
- Provide prompt notice (1) after receiving an investment commitment and (2) at or before the completion of the crowdfunding offering, in each case containing certain specified information.

## FINRA Funding Portal Rules

Crowdfunding intermediaries are required to be a member of a national securities association. Currently, the Financial Industry Regulatory Authority (FINRA) is the only national securities association. On January 28, 2016 (and effective as of the following day), the SEC approved rules and forms for SEC-registered funding portals to become FINRA members that were originally proposed by FINRA in October of 2015. These new Funding Portal Rules include (among other things):

- A streamlined membership application process for funding portals, which is designed to be a limited version of the process for broker-dealers;
- A set of rules establishing the standard of conduct for funding portal members;
- A requirement for a system of supervision of associated persons for funding portal members, an agreement to report to FINRA regulatory proceedings, disciplinary and other events, and an obligation to report and promptly update contact information required by FINRA; and
- A rule applying the FINRA investigations and sanctions rules to funding portal members.

## Practical Considerations for Issuers Choosing a Crowdfunding Intermediary

As the rules under Regulation Crowdfunding take effect, the field of crowdfunding intermediaries is likely to greatly expand. Provided below is a non-exclusive list of questions that issuers should consider when choosing the appropriate intermediary for their financing:

1. Is the intermediary a registered broker-dealer or funding portal? This distinction has numerous practical implications for the offering (such as whether the intermediary can directly handle the securities and payment).
2. What is the fee structure? When will the issuer be charged for hosting the offering on the intermediary's platform?
3. What due diligence will the intermediary handle? Does the third party contract with outside vendors? How does that impact costs?
4. How will deal terms and transaction documents be prepared and negotiated?
5. Does the intermediary assist in preparing the issuer's disclosure documents with the SEC?

6. How is the issuer's relationship with the intermediary documented? What is the extent of the relationship—will the intermediary require the issuer to give it first refusal over future offerings?
7. What kind of indemnification will the issuer be asked to provide to the intermediary? Will the intermediary indemnify issuers for its activities?

Not all crowdfunding intermediaries will be created equal and, with time and as best practices develop, it should become easier to identify the intermediary that suits your objectives. It is important to note that, in certain cases, actions taken by the intermediary could jeopardize the issuer's securities registration exemption, causing the issuer to unlawfully sell unregistered securities. We recommend you assess your options carefully before commencing an offering with a particular intermediary. We are available to assist you in vetting your options—now is the time to begin to make your assessment so you can take advantage of Regulation Crowdfunding this spring.

**Please contact us if you have any questions or would like to learn more about the new rules covered in this Alert and for further guidance if you are considering a crowdfunding offering.**

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[1] Although the meaning for the term varies with context, "crowdfunding" as used in this Alert refers solely to securities offerings made in reliance on Section 4(a)(6) of the Securities Act.

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