



Risk Management Update July 2012

JUMPSTART OUR BUSINESS STARTUPS ACT (JOBS ACT) AND CROWDFUNDING - WHAT DOES IT MEAN?

Last year President Obama unveiled an initiative to increase American jobs and economic growth by providing more small businesses with the ability to raise capital. In April 2012, the President signed the Jumpstart Our Business Startups Act (“JOBS Act”) into law which is geared to help startups have access to a larger pool of potential investors and make it easier for businesses to become publicly traded companies. This month FINRA released Regulatory Notice 12-34, which requests comments on the proposed regulation of Crowdfunding Activities pursuant to the JOBS Act.¹ The comment period, which ends on August 31, 2012, allows the industry an opportunity to provide feedback on the appropriate scope of FINRA rules that should apply to member firms engaging in crowdfunding activities.

Crowdfunding is a major component of the JOBS Act and relates to how securities may now be offered or sold. So, what is crowdfunding? Congress created the acronym CROWDFUND, which stands for Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure, as an abbreviated means to cite provisions of this bill. Crowdfunding involves the practice of funding a project or venture by raising many small amounts of money from a large group of people, typically via the internet. The crowdfunding provisions of the JOBS Act provide an exemption from registration under the Securities Act of 1933 (effectively amending Sections 4 and 5) for securities offered in amounts of up to \$1 million over a 12-month period, provided the amount raised from any single investor adheres to strict limits (ranging from \$2,000 to \$100,000), based on the investor’s annual income or net worth.² The crowdfunding exemption establishes specific eligibility and sales practice standards for issuers and intermediaries that engage in crowdfunding. Intermediaries that would like to engage in crowdfunding will be required to register as a broker-dealer or as a “funding portal.” Under Section 304 of the Act, a new exemption from broker-dealer registration is created for funding portals. The term funding portal means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others solely pursuant to new section 4(a)(6) of the Securities Act.³

¹ See FINRA Regulatory Notice 12-34, issued in July 2012; Jumpstart Our Business Startups Act, available at <http://www.finra.org/Industry/Regulatory/Notices/2012/P131269.pdf>.

² *Id.* Specifically, an issuer relying on the JOBS Act may not raise from an investor an aggregate amount that exceeds: (i) the greater of \$2,000 or 5 percent of the investor’s annual income or net worth (for investors whose annual income or net worth is less than \$100,000); or (ii) 10 percent of the investor’s annual income or net worth, not to exceed \$100,000 (for investors whose annual income or net worth is \$100,000 or more). See Securities Act Section 4(6). These aggregate amounts limit an investor’s total crowdfunding purchases from all issuers in a 12-month period.

³ See page 8: <http://www.crowdfundingofferings.com/wp-content/uploads/2012/03/CROWDFUND-Text.pdf>.

FUNDING PORTAL.--The term “funding portal” means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act of 1933 (15 U.S.C. 77d(6)), that does not--

(A) offer investment advice or recommendations;

(B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;

Notably, a funding portal may not:

- offer investment advice or recommendations;
- solicit purchases, sales or offers to buy securities offered or displayed on its website or portal, compensate employees, agents or other persons for solicitation or sales;
- hold, manage, possess or otherwise handle customer funds or securities; and/or
- engage in any other activities the SEC determines to prohibit in its crowdfunding rules release.

In addition, each funding portal and each crowdfunding broker-dealer is prohibited from:

- compensating promoters, finders, or lead generators for providing them, as intermediary, with the personal identifying information of potential investors without taking such steps as the Commission shall, by rule, require to ensure that each person clearly discloses the receipt of such compensation upon each instance of such promotional communication; and/or
- allowing its directors, officer, or partners to have a financial interest in any issuer using the services of the intermediary.

Regardless of whether a funding portal or broker-dealer, the JOBS Act requires crowdfunding intermediaries to:

- provide disclosures as the SEC will determine appropriate, which may include, among other things, the risks associated with the transaction and investor educational materials;
- receive acknowledgement from each investor to help ensure that investors have reviewed the educational materials provided, understand that they could lose their entire investment, and understand the level of risk associated with investing in startup businesses;
- provide safeguarding protections for the confidential investor information collected;
- provide a background check on each officer, director, or person holding more than 20% of the outstanding equity of the issuer and make available any disclosures provided by the issuer at least 21 days before any sale to investors and the SEC;
- ensure all offering proceeds are only provided to the issuer when aggregate capital raised from investors is equal to or greater than a target offering amount, allow investors the opportunity to cancel their commitment to invest under such circumstances, as the Commission shall, by rule, determine appropriate and make sure no investor in a 12-month period has purchased crowdfunded securities that, in aggregate, from all issuers, exceeds the investment limits; and
- comply with any other requirement the SEC deems appropriate.

Under the new law, intermediaries performing crowdfunding on behalf of issuers must register with the SEC as a “funding portal” or be appropriately registered as a broker-dealer. As the

(C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;

(D) hold, manage, possess, or otherwise handle investor funds or securities; or

(E) engage in such other activities as the Commission, by rule, determines appropriate.

largest self-regulatory organization (“SRO”) of broker-dealers, FINRA is soliciting public comment on the appropriate scope for FINRA rules that should apply to member firms engaging in crowdfunding activities, as either funding portals or as broker-dealer. The SEC is still analyzing how broker-dealers should be regulated if they offer crowdfunding portals. In addition, the SEC still must adopt rules to govern funding portals before permitting anyone to register with the SEC as a funding portal. Funding portals also must become members of a national securities association that is registered under Section 15A of the Exchange Act. Presently, FINRA is the only national securities association that is registered under Section 15A.

The JOBS Act does not limit FINRA with regard to the rules that would be applicable to its member firms that engage in crowdfunding. FINRA is asking for comment from broker-dealers regarding the existing rules to its members’ crowdfunding activities and whether such rules should be relaxed taking into account the extent that broker-dealers would separate its crowdfunding business, make organizational changes, or identify any conflicts that might arise by the broker-dealer recommending a customer visit the firm’s crowdfunding site.

The JOBS Act requires the Commission to adopt rules within 270 days of enactment. Based on this time frame, the rules governing crowdfunding activities are likely to be introduced by the Securities and Exchange Commission early next year. Until then, speculation over rule enactment by the SEC and FINRA shall continue, particularly given the current climate for emerging business and startup companies as a result of the JOBS Act, which will undoubtedly have a tremendous impact to the financial industry.

For more information, including registration considerations for crowdfunding activities, please contact CCLS.

Author: Kris Gruben, Compliance Consultant; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services (“CCLS”). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

This article is for information purposes and does not contain or convey legal or tax advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer and/or tax professional.