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So You Want to Be a Crowdfunding Portal? Top 10 Traps for the Unwary

While both startups seeking capital and investors on the prowl for the next big thing have been quick to endorse equity crowdfunding, there's a third group that sees exciting opportunities in this new capital fundraising scheme: prospective funding portals. This year, we'll witness the creation of entirely new regulated entities[1][1] that will facilitate the sale of crowdfunded securities?- without being subject to the extensive regulatory framework governing broker-dealers. Thinking of launching a website to offer crowdfunded securities? Based on the rules proposed by the Securities and Exchange Commission ("SEC"), here are some things to keep in mind before you rush out to register some variant of www.iLuvCrowdfunding.com.

1. You're Not a Broker-Dealer?- So Don't Act Like One

Funding portals have extremely limited functions. Their sole purpose is to act as intermediaries in transactions involving the offer or sale of crowdfunded securities. Without registering as a broker-dealer or an investment adviser, a funding portal cannot offer investment advice or recommendations. For example, a funding portal is not permitted to highlight "recommended" offerings, describe interesting or novel offerings, or even decide which companies can make offerings on its website based on other than objective criteria, such as offerings in a particular industry. Focusing on an "offering of the day" or simply placing a particular offering in a prominent position on a webpage could appear to be an implicit endorsement of the offering or issuer, thereby constituting investment advice. Also, unlike a broker-dealer, a funding portal does not play the role of a securities salesperson; a portal is not permitted to solicit purchases, sales or offers to buy the securities offered or displayed on its website.

How are you going to entice potential investors to visit your website and sign up for accounts with you? The portal may compensate a person for directing issuers or potential investors to the platform (a "finder") through hyperlinks or search terms or otherwise?- if the finder does not provide the portal with the potential investor's personally identifiable information. This proposed rule would prohibit portals from purchasing lists of potential investors. Moreover, the portal may not compensate the finder (directly or indirectly) based on the purchase or sale of a crowdfunded security offered on the portal (unless the finder is a registered broker-dealer). Funding portals are limited to compensating finders with a flat fixed fee.

How are you planning to compensate your employees? People associated with a funding portal are not subject to the licensing and qualification requirements applicable to people associated with broker-dealers, and they cannot be compensated based on sales of crowdfunded securities or for soliciting purchases of crowdfunded securities.

Finally, keep in mind that funding portals are limited to facilitating primary issuances of securities; investors cannot use funding portals to resell crowdfunded securities.[2][2]

2. No Handling the Merchandise

How are you planning to compensate yourself? Funding portals may earn commissions based on the amount of money that is raised for issuers, but beyond that, their options for making money on crowdfunded offerings are limited. If you thought that your funding portal (or its directors, officers and partners) would take an equity stake in the issuer as compensation for the services the portal is providing in connection with the offer and sale of securities, think again. While some have argued that a

portal's receipt of the issuer's securities as compensation would align the interests of the portal and the investor, it is the SEC's view that the promise of a financial stake in the outcome could give a portal an incentive to ensure the success of its own investment in the issuer, to the disadvantage of investors and other issuers on the platform, especially if the portal receives securities on different terms than do other investors. Moreover, the funding portal and its directors, officers and partners are prohibited from having any financial interest in an issuer using its services. This proposed rule, which would prohibit the director of a portal from investing in the companies on the portal, is intended to eliminate cherry-picking by advancing one issuer's fundraising efforts over those of another issuer. And to ensure complete transparency, when establishing an account for an investor, the portal is required to disclose the manner in which it will be compensated in connection with offerings and sales of securities.

3. Not Just Anyone Can Play on Your Field

Funding portals are required to conduct certain diligence on prospective issuers seeking to list their offerings on the portal's website. The funding portal must have a reasonable basis for believing that an issuer seeking to offer and sell securities through the portal (1) complies with the requirements in Securities Act Section 4(A)(b) and the requirements in Regulation Crowdfunding; and (2) has established means to keep accurate records of its security holders. The portal may reasonably rely on the issuer's representations as to its compliance, unless the portal knows or has reason to know that the representations are false. Portals dealing with unsophisticated issuers may need to take steps to confirm the issuer's representations.

Portals play a gatekeeper role. If the portal believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection, the portal must deny access to its platform. The portal must conduct a background and securities enforcement regulatory history check on each issuer as well as each of its officers, directors or 20 percent beneficial owners, but beyond this requirement, the proposed rules do not specify actions that a portal must take to reduce the risk of fraud. If the portal is unable to assess the risk of fraud?- for example, if it cannot obtain background check information on certain officers of an issuer?- the portal is required to deny access. Similarly, if the portal has a reasonable basis for believing that an issuer (or any of its officers, directors or 20 percent beneficial owners) is subject to a disqualification under the proposed rules, the portal must deny access to its platform. If the portal learns of the potential for fraud after the offering is already posted to the website, the portal must promptly remove the offering from the site, cancel the offering and return to investors any funds they may have committed.

The proposed rules would prohibit a portal from accepting an investment commitment unless the investor has opened an account with the portal and consented to electronic delivery of materials. Since portals are subject to anti-money laundering obligations, including customer identification, when opening an account for an investor, the portal would be advised to check the investor against the OFAC list as well as conduct a background check. Before permitting an investor to make an investment commitment, the portal must have a reasonable basis to believe that the investor satisfies the investment limitations under Securities Act Section 4(a)(6)(B) and Regulation Crowdfunding. In the absence of a centralized database about particular investors, the proposed rules provide that a portal may rely on an investor's representations concerning compliance with the investment limitation requirements based on the investor's annual income and net worth and the amount of crowdfunded securities the investor has acquired through other portals or broker-dealers. If the portal has reason to question the reliability of the investor's representations, it cannot rely on such representations.

4. It's Your Responsibility to Educate Your Investors

The proposed rules require the portal to provide educational materials about crowdfunding to every potential investor opening an account with the portal. Among other things, the materials must contain basic terms about crowdfunding transactions, including limitations on investment amounts, the circumstances under which an investor can cancel an investment commitment and obtain a refund, and the restrictions on the resale of crowdfunded securities. The materials must also contain information about the crowdfunding process, the risks associated with purchasing crowdfunded securities, the types of securities that may be offered by the portal, the risks associated with each type of security and the risk of having limited voting power as a result of dilution. In addition, the materials should inform investors about the types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information and the possibility that the issuer's obligation to file annual reports may terminate in the future.

These materials must also be posted on the portal's website. Before an investor makes an investment commitment, the portal is required to provide updated materials to ensure that each investor has information about key aspects of investing through the portal that may have changed. It is likely that the industry will develop a set of standardized educational materials for investors.

But don't think that you can send the materials and consider the potential investor educated. The portal must ensure that each investor reviews the educational materials. And yes, there will be a quiz! The potential investor is required to answer questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses and small issuers, as well as the risk of illiquidity. As a substitute for watching the investor actually read the materials, the proposed rules require the portal to ensure that the investor affirms that he/she understands that he/she is risking the loss of the entire investment and that he/she could bear such a loss. The portal is required to collect the investor representation and completed questionnaire each time before accepting any investment commitment. This requirement is intended to help ensure that investors engaging in crowdfunded transactions are fully informed and reminded of the risks associated with their particular investment before making any investment commitment.

5. Don't Breach Crowdfunding Chat Room Etiquette

The portal is like a big chat room for potential investors and issuers. The proposed rules require the portal to provide channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the portal's platform. These communications, in which the "wisdom of the crowd" is presumably revealed, are intended to help potential investors assess the issuer and the investment opportunity. To promote transparency and accountability, all communications between investors and the issuer about the terms of the offering are required to flow through the portal. Portals themselves can't join in the discussions?- apart from establishing guidelines for communication and removing abusive or potentially fraudulent communications. Only those people who have opened accounts with the portal may post comments, although the communications should be viewable to the public. To keep the discussion honest, any commenter who is a founder, officer, director or employee of the issuer or is being compensated (directly or indirectly) to promote the issuer's offering is required to identify himself/herself as such and disclose the receipt of compensation each time the commentator makes a promotional communication. Portals are well placed to ensure that promoters are clearly identified in postings.

6. You Could Be Liable for the Issuer's Misrepresentations

An issuer will be liable to a purchaser of crowdfunded securities if the issuer, in the offer or sale of 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?- unless the purchaser knew of the untruth or omission or the issuer did not know, and in the exercise of reasonable care could not have known, about the untruth or omission. The SEC has stated that it appears likely that funding portals would be considered issuers for purposes of this liability provision. In order to address this potential liability, funding portals will need to establish due diligence policies and procedures and consider reviewing the issuer's offering documents to evaluate whether they contain materially false or misleading information.

7. Beware of Fickle Investors

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. This flexibility is intended to allow investors to have the full benefit of the views of other potential investors regarding a crowdfunded offering, even after the investor has made a commitment.

If an issuer fails to complete an offering because the target is not reached or the issuer decides to terminate the offering, the portal must, within five business days, give each investor who had made an investment commitment a notification disclosing the cancellation of the offering, the reason and the refund amount that the investor should expect to receive; direct the refund; and prevent investors from making investment commitments with respect to that offering on its platform.

Also, if the issuer makes a material change in the terms of the offering, the portal is required to send a notification of the changes to investors, stating that their investment commitment will be canceled if not reconfirmed within five business days.

8. Don't Jump the Gun on Transmitting Funds to the Issuer

Pursuant to the proposed rules, funding portals would be required to direct investors to transmit money or other consideration directly to a bank that has agreed in writing to either hold the funds in escrow for the benefit of the investors and the issuer, and to promptly transmit or return the funds to the persons entitled to such funds, or to establish a bank account for the exclusive benefit of investors and the issuer.

When the aggregate amount of investment commitments from all investors is equal to or greater than the target amount of the offering, and the cancellation period for each investor has expired, the portal must promptly direct transmission of funds from the bank to the issuer. However, keep in mind that issuer information must be available to investors for at least 21 days prior to the first day on which securities are sold and that investors must be allowed a reasonable opportunity to rescind their investment commitment. Accordingly, the transmission of funds can take place no earlier than 21 days after the date on which the portal makes publicly available on the website the information required to be provided by the issuer, such as information about the issuer and the offering.

An issuer may close an offering "early" (i.e., before the deadline in the offering materials) if the issuer reaches its target offering amount, the offering has remained open for at least 21 days, the portal provides notice of the new deadline at least five business days prior to the new deadline, investors are given the opportunity to cancel until 48 hours before the new deadline, and the issuer continues to meet or exceed the target offering amount as of the new deadline.

9. Remember the Receipt

Upon receipt of an investment commitment from an investor, the portal is required to promptly provide the investor with a notification disclosing the dollar amount of the investment, the price of the securities, the name of the issuer, and the date and time by which the investor may cancel the investment commitment.

At or before the completion of the transaction, the proposed rules require the portal to provide each investor with a confirmation of the transaction that includes, among other things, the transaction date, the type of security, the price and number of securities purchased, the number of securities sold by the issuer in the transaction, the price at which the securities were sold, and certain specified terms of the security. The confirmation must include the source and amount of any remuneration received or to be received by the portal in connection with the transaction, whether from the issuer or any other person. This requirement is intended to highlight potential conflicts of interest the funding portal may have.

10. Registration and Ongoing Requirements

While the proposed SEC rules and proposed FINRA rules governing the registration and compliance obligations of funding portals are certainly less extensive than the rules pertaining to broker-dealers, these new entities are still heavily regulated. The proposed SEC rules require a prospective funding portal to file a "Form Funding Portal" with the SEC. The information sought is consistent with, but less extensive than, the information required for broker-dealers on Form BD. For example, Form Funding Portal would require information regarding the portal's ownership and management, including disciplinary history. The portal would also need to register with FINRA, pursuant to the FINRA proposed rules, and would be subject to FINRA conduct requirements for funding portals. A funding portal could operate multiple website addresses under a single funding portal registration, thereby permitting the portal to customize each address to appeal to different investors or industries.

Among other proposed requirements, a funding portal must have in place as a condition of registration, and maintain for the duration of registration, a fidelity bond with minimum coverage of $100,000. This bond is intended to help insure against any loss of investor funds. Also, the proposed rules would require a funding portal to implement written policies and procedures reasonably designed to achieve compliance with the federal securities laws and regulations thereunder, relating to its business as a funding portal, as well as certain anti-money laundering provisions. Funding portals would be subject to the same privacy rules as brokers, including providing notices to investors about their privacy policies and practices. Like broker-dealers, funding portals are subject to inspection by the SEC and FINRA. The proposed rules would require a funding portal to make and preserve certain records for five years, with the records retained in a readily accessible place for at least the first two years.

Conclusion

Do the benefits of acting as a funding portal outweigh the compliance costs and the risk of potential liability? Even though funding portals may earn transaction-based compensation, the proposed limit of $1 million on the amount that an issuer may raise in a 12-month period by issuing crowdfunded securities will require a successful funding portal to feature a large number of offerings. As a consequence, the funding portals that make a strong impression with issuers and investors in the early days of crowdfunding?- and that have the sophistication to avoid regulatory pitfalls?- will have a significant advantage in the race to become the portal of choice.

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[1] A funding portal must register with the SEC pursuant to Securities Act Section 4A(a)(1) and proposed Rule 400 of Regulation Crowdfunding. In addition, a funding portal must register with FINRA and is subject to FINRA's proposed funding portal rules. See Regulatory Notice 13-34 (Funding Portal Rules). The comment period on both the SEC's and FINRA's proposed rules closes on February 3, 2014.

[2] Funding portals also cannot hold, possess or handle investor funds or securities. But you didn't want to do that anyway, did you?