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SEC Proposes Onerous Rules to Implement JOBS Act Provision Allowing Crowdfunding

On October 23, 2013, the Securities and Exchange Commission proposed new rules to implement the requirements of Title III of the Jumpstart Our Business Startups Act or "JOBS Act" which creates a "crowdfunding" private placement exemption. The JOBS Act, enacted on April 5, 2012, established a foundation for a regulatory structure for crowdfunding and directs the SEC to adopt several new rules for its use. The SEC has proposed these new rules under a new "Regulation Crowdfunding" under the Securities Act of 1933 and the Securities Exchange Act of 1934. The proposed rules are now subject to a comment period ending February 3, 2014, after which the SEC will adopt final rules.

The JOBS Act creates a new Securities Act exemption from the registration requirements of the Securities Act for crowdfunding transactions. Under this exemption, companies will be able to sell securities without registering with the SEC or state regulators, regardless of whether any of the investors qualify as an "accredited investor." Crowdfunding offerings must be made exclusively through the Internet website or other similar electronic medium of a broker or "funding portal" intermediary.

The new crowdfunding exemption would not be available to foreign companies, public companies, investment companies or companies with no specific business plan or with a business plan that is to

engage in a merger or acquisition with an unidentified company or companies. The exemption would also not be available to any company that, during the preceding two years, has not filed with the SEC or provided to investors the ongoing annual reports described below that will be required with respect to any previous crowdfunding transaction.

The JOBS Act and proposed Regulation Crowdfunding would impose substantial requirements on both the companies making crowdfunding offerings and the intermediaries through which crowdfunding offerings would be made. These requirements include:

- size limitations on the amount companies may raise and on the amount investors may invest;
- extensive disclosure obligations for both companies making crowdfunding offerings and their intermediaries, including the provision of tax returns or, depending on the size of the offering, reviewed or audited financial statements;
- ongoing reporting of the company disclosure and financial information referred to above;
- advertising and compensation restrictions;
- intermediary eligibility standards;

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- intermediary obligations to perform due diligence on companies and investors;
- a 21-day minimum offering period during which investment commitments may be cancelled;
- obligations on intermediaries to provide investor communication channels and restrictions on intermediary communications with investors;
- restrictions on resale of securities purchased through crowdfunding;
- the imposition of prospectus liability on both companies and intermediaries; and
- disqualification provisions for both companies and intermediaries.

The summary below describes these requirements which, in the aggregate, make it unlikely that crowdfunding will become a viable financing mechanism. We will continue to monitor the rulemaking process. Please do not hesitate to contact us with any questions regarding the JOBS Act or Regulation Crowdfunding.

LIMITATIONS ON INVESTMENT AMOUNT

A company would be permitted to rely on the crowdfunding exemption to raise up to \$1 million (including amounts sold by affiliated entities) during any 12-month period.

The aggregate amount that may be sold to any investor by a company, including any amount sold in reliance on this exemption during the previous 12 months, would not be permitted to exceed:

- in the case of an investor with both an annual income and net worth of less than \$100,000, a limit of \$2,000 or 5% of the annual income or net worth of that investor, whichever is greater; or
- in the case of an investor with an annual income or net worth equal to or more than \$100,000, a limit of 10% of the annual income or net worth of that investor, whichever is greater, but not to exceed \$100,000.

A company would be permitted to rely on an intermediary (as described below) to determine whether a purchase of securities by an investor would cause that investor to exceed the above limits, provided that the company does not have knowledge that the investor had exceeded, or would exceed, those limits by that purchase.

The dollar amounts referred to above must be adjusted by the SEC to reflect inflation at least once every five years.

COMPANY REQUIREMENTS

The provisions of the JOBS Act and Regulation Crowdfunding would impose substantial disclosure and ongoing reporting requirements on companies making a crowdfunding offering, as well as restrictions on advertising and compensation.

Disclosure

A company selling securities in a crowdfunding transaction would be required to file a variety of disclosures with the SEC and provide these disclosures to investors and the intermediary that the company would be required to use in connection with

the transaction as described below. These disclosures include:

- the name, legal status, physical address and website address of the company;
- the names of the directors and officers of the company, the positions held by these persons, the period of time in which these persons served in these positions and their business experience during the past three years, including each person's principal occupation and employment and the name and principal business of any other employer of any officer, and the number of employees;
- the names of each person holding more than 20% of the voting equity securities of the company (a "20% beneficial owner");
- a description of the business of the company and its business plan;
- a description of the financial condition of the company taking into account the expected proceeds of the offering and any other pending sources of capital, including the company's historical results of operations in addition to its liquidity and capital resources, a discussion of whether historical earnings and cash flows are representative of what investors should expect in the future (if the company has a prior operating history), a discussion of financial milestones and operational, liquidity and other challenges (if the company does not have a prior operating history), a discussion of how the proceeds from the offering will affect the company's liquidity and whether these funds and any other additional funds are necessary to the

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viability of the company and a description of the other available sources of capital to the company;

- a description of the intended use of the proceeds of the offering sufficient in detail to permit investors to evaluate their potential investment;
- the target offering amount, including whether a company will accept investments in excess of that target offering amount and, if it will, the maximum amount it will accept, and the deadline to reach the target offering amount;
- if an offering is oversubscribed, how securities in the offering will be allocated to investors;
- regular updates regarding the progress of the company in meeting the target offering amount, to be given within five business days of the company reaching 50% of the target offering amount, reaching 100% of the target offering amount and completing the offering;
- the price to the public of the securities being sold or the method for determining the price, and examples of methods for how those securities may be valued by the company in the future;
- a description of the ownership and capital structure of the company, including a description of voting rights, how securities may be modified, a summary of the differences between the securities being offered and each other class of security of the company, how the rights of the securities being offered may

be materially limited, diluted or qualified by the rights of any other class of security of the company, a description of the material terms of any indebtedness of the company and a description of restrictions on transfer of the securities;

- a description of the risks to purchasers of the securities relating to minority ownership, dilution and transactions with related parties, including disclosure of related party transactions since the beginning of the company's last full fiscal year;
- a discussion of the material factors that make an investment in the company speculative or risky;
- a description of exempt offerings conducted by the company within the previous three years;
- the name of the intermediary through which the offering will be conducted and the compensation to be paid to the intermediary; and
- a description of the process to cancel an investment commitment or to complete the transaction once the target amount is met.

Companies would be required to file the above information with the SEC electronically as an offering statement on new Form C. Updates would be made on Form C-U. Companies would be required to amend the above disclosures on Form C-A if any material changes occur prior to the closing of the offering. In the case of an occurrence of a material change, investors would have five business days to reconfirm

their investment commitments, or the investment commitments would be cancelled.

A company would also be required to file with the SEC and provide to investors and the relevant intermediary a complete set of its financial statements (including a balance sheet, income statement, statement of cash flows and statement of changes in owners' equity), prepared in accordance with U.S. generally accepted accounting principles and certified by its principal executive officer, covering the shorter of its two most recently completed fiscal years or the period since its inception. During the first 120 days of the company's fiscal year, financial statements for the fiscal year prior to the most recently completed fiscal year need not be used if those financial statements are not otherwise available or required to be filed. Once more than 120 days have passed since the end of the company's most recently completed fiscal year, the company would be required to include financial statements for its most recent fiscal year. Regardless of the age of the financial statements, a company would be required to include a discussion of any material changes in its financial condition during any time period subsequent to the period for which financial statements are provided. For offerings of more than \$100,000, but not more than \$500,000, these financial statements would be required to be reviewed by a public accountant who is independent of the company, and a copy of the review report must also be provided. For offerings of \$500,000 or more, these financial statements would be required to be audited by a public accountant who is independent of the company, and a copy of the audit report must also be provided.

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For offerings of \$100,000 or less, companies would be required to file with the SEC and provide to investors and the relevant intermediary income tax returns for its most recently completed fiscal year, if any, certified to be true and complete in all material respects by the company's principal executive officer. Companies would be required to redact personally identifiable information, such as social security numbers, from their tax returns before filing. If a company makes a crowdfunding offering before filing its tax returns for the most recently completed fiscal year, that company would be allowed to use its tax return filed for the prior year, provided that the company discloses any material changes since that prior year and, if filed during the crowdfunding offering, the company would be required to provide its tax return for the most recent fiscal year when filed with the Internal Revenue Service.

Ongoing Reporting

Companies that sell securities through a crowdfunding offering would be required to file a report annually with the SEC on Form C-AR no later than 120 days after the end of the most recently completed fiscal year covered by the report. Companies would also be required to post these reports on their websites. These reports would be required to include information similar to that required of offering statements to be filed on Form C described above and the applicable financial statements described above. A company would be required to continue to file these reports until the company becomes a reporting company required to file reports under the Securities Exchange Act, the company or another

party purchases all of the securities issued through crowdfunding or the company liquidates or dissolves. Any company terminating its annual reporting obligations would be required, within five business days from the date of the terminating event, to file with the SEC on Form C-TR a notice to investors and the SEC that it will no longer file and provide annual reports pursuant to the requirements of Regulation Crowdfunding.

Advertising

Companies making a crowdfunding offering would not be permitted to advertise the terms of the offering, except that companies would be permitted to publish notices which include no more than a statement that the company is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the potential investor to the intermediary's platform or portal, the terms of the offering, the name of the company, the address, phone number and website of the company, the e-mail address of a representative of the company and a brief description of the company's business. The "terms of the offering" include the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period.

Compensation

Companies making a crowdfunding offering would be prohibited from compensating, or committing to compensate, directly or indirectly, any person promoting the company's offering through communication channels provided by the intermediary unless the company takes reasonable steps

to ensure that the person clearly discloses the receipt (both past and prospective) of compensation each time the person makes a promotional communication.

Insignificant Failures to Comply

A company's failure to comply with a term, condition or requirement of Regulation Crowdfunding would not result in the loss of the exemption from the requirements of the Securities Act for any particular crowdfunding offering if the company shows that:

- the failure to comply with a term, condition or requirement was insignificant with respect to the offering as a whole;
- the company made a good faith and reasonable attempt to comply with all those terms, conditions and requirements; and
- the company did not know of the failure to comply, where the failure to comply with a term, condition or requirement was the result of the failure of the intermediary to comply with its requirements, or that failure by the intermediary occurred solely in offerings other than the company's offering.

INTERMEDIARY REQUIREMENTS

The provisions of the JOBS Act and Regulation Crowdfunding set forth proposed eligibility standards for intermediaries through which crowdfunding offerings would be made. In addition, these provisions would impose substantial requirements on these intermediaries that, among other things, would obligate them to provide

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education materials to investors, perform due diligence on investors, coordinate the timing and mechanics of closing and facilitate investor communications.

Eligibility

Crowdfunding offerings would be required to be conducted through an intermediary that is either a broker or a “funding portal.” A “broker” includes any person who effects transactions in securities for the account of others. A “funding portal” includes any broker acting as an intermediary solely in crowdfunding transactions who does not offer investment advice or recommendations, solicit purchases, sales or offers to buy the securities offered or displayed on its platform or portal, compensate employees, agents or other person for that solicitation, or based on the sale of securities displayed or referenced on its platform or portal, or hold, manage, possess or otherwise handle investor funds or securities. To act as crowdfunding intermediaries, all brokers and funding portals would be required to be registered with the SEC and be a member of the Financial Industry Regulation Authority (FINRA).

Intermediaries would be prohibited from having any financial interest in a company using its services and would be required to prohibit its directors, officers and partners from having any financial interest in a company using its services. Intermediaries and their directors, officers and partners, would be prohibited from receiving a financial interest in a company (including any interest in the company’s securities) as compensation for services provided to or for the benefit of the company in connection

with the offer and sale of the company’s securities.

Measures to Reduce the Risk of Fraud

Intermediaries would be required to have a reasonable basis for believing that a company making a crowdfunding offering through its platform or portal is in compliance with Regulation Crowdfunding and has established means to keep accurate records of holders of the securities it offers. Intermediaries would be permitted to rely reasonably on representations of companies, absent knowledge or other information or indications that the representations are not true. In order to reduce to the risk of fraud, intermediaries would be required to implement the following measures:

- Intermediaries would be required to deny a company access to its platform or portal if it has a reasonable basis for believing that the company, or any of its officers, directors or 20% beneficial owners, is subject to a disqualification under Regulation Crowdfunding as described below.
- Intermediaries would be required to deny a company access to its platform or portal if it believes, or is unable to adequately or effectively assess, that the company or that company’s offering would present a potential for fraud or otherwise raises concerns regarding investor protection.
- If the potential for fraud or other concerns becomes known to an intermediary after it has granted a company access to its platform or portal, the intermediary

would be required to promptly remove that company’s offering from its platform or portal, cancel that company’s offering and direct the return to investors of any funds they may have committed.

- Intermediaries would be required to conduct a background and securities enforcement regulatory history check on each company whose securities are to be offered by the intermediary, as well as on each of that company’s officers, directors and 20% beneficial owners.

Investor Due Diligence

Before permitting an investor to make an investment commitment on its platform or portal, an intermediary would be required to have a reasonable basis to believe that the investment by that investor will satisfy the investment size limitations described above. In determining an investor’s compliance with the investment size limitations, an intermediary would be permitted to rely on an investor’s representations regarding the investor’s annual income and net worth and the amount of the investor’s other investments in securities sold in crowdfunding offerings through other intermediaries. The intermediary would not be permitted to rely on an investor’s representations if the intermediary had reason to question the reliability of the representations, including as a result of transactions made by that investor through that intermediary or other information about the investor in the intermediary’s possession.

All intermediaries would be required to satisfy existing anti-money laundering and “know your customer” regulations

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applicable to brokers, as well as recordkeeping requirements similar to, though less extensive than, those currently applicable to brokers.

Provision of Investor Education Materials

When an investor opens an account with an intermediary, the intermediary would be required to deliver to the investor educational materials that are in plain language and are otherwise designed to communicate effectively the following information:

- the process for the offer, purchase and issuance of securities through the intermediary;
- the risks associated with investing in securities offered through crowdfunding;
- the types of securities that may be offered on the intermediary's platform and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution;
- the restrictions on the resale of securities offered through crowdfunding;
- the types of information that a company is required to provide in annual reports, the frequency of the delivery of that information and the possibility that the company's obligation to file annual reports may terminate in the future;
- the limitations on the amounts investors may invest;

- the circumstances in which a company or an investor may cancel an investment commitment;
- the need for the investor to consider whether investing in a security offered through crowdfunding is appropriate for the investor;
- the manner in which the intermediary will be compensated in connection with crowdfunding offerings;
- that any person who promotes a company's offering for compensation, or who is a founder or an employee of a company that engages in promotional activities on behalf of the company on the intermediary's platform or portal, must clearly disclose in all communications on the platform or portal the receipt of the compensation and the fact that the person is engaging in promotional activities on behalf of the company; and
- that following completion of a company's offering, there may or may not be any ongoing relationship between that company and the intermediary.

These educational materials would be required to be updated and maintained by intermediaries on their platforms or portals.

Each time before accepting an investment commitment, an intermediary would be required to obtain from an investor a representation that the investor has reviewed the relevant educational materials, understands that the entire amount of the investor's investment may be lost and is in a financial condition to bear the loss of the investment. The intermediary

also would be required to ensure each time before accepting an investment commitment that each investor answers questions demonstrating the investor's understanding that there are restrictions on the investor's ability to cancel an investment commitment and obtain a return of the investor's 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 the investor can afford to lose the entire amount of the investor's investment.

Timing and Closing Mechanics

For the period beginning no less than 21 days before any securities are sold in a crowdfunding offering and until that offering is completed or cancelled, an intermediary would be required to make the offering statement information disclosures provided by a company (as described above) publicly available on the intermediary's platform or portal in a manner that reasonably permits a person accessing the platform or portal to save, download or otherwise store the information. An intermediary would be prohibited from requiring any person to establish an account with, or provide personal information to, the intermediary in order to access this information.

Intermediaries would be required to ensure that all offering proceeds are provided to the relevant company only when the aggregate capital raised from all investors is equal to or greater than the applicable target offering amount. An intermediary that is a broker (and not a funding portal) must comply with Securities Exchange Act rules in respect to the transmission of investor funds. Regulation Crowdfunding would

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include similar rules for intermediaries that are funding portals that would require intermediaries to direct investors to transmit funds directly to a bank that has agreed in writing to hold the funds for the benefit of the investors and the company and to promptly transmit or return the funds to the persons entitled to those funds.

Investors would have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the company's offering materials. If a company reaches its target offering amount prior to that deadline, it would be permitted to close the offering once the target offering amount is reached, provided that the offering will have remained open for a minimum of 21 days, the intermediary provides notice about the new offering deadline at least five business days prior to the new offering deadline, investors are given the opportunity to reconsider their investment decision and to cancel their investment commitment until 48 hours prior to the new offering deadline and, at the time of the new offering deadline, the company continues to meet or exceed its target offering amount.

An intermediary would be required, at or before the closing of a crowdfunding offering, to send to each investor a notification disclosing the following:

- the date of the closing;
- the type of security that the investor is purchasing;
- the identity, price and number of securities purchased by the investor, as well as the number of securities sold by

the company in the offering and the price at which the securities were sold;

- if the security being offered is a debt security, the interest rate, yield to maturity and maturity date of the security;
- if the security being offered is a callable security, the first date that the security can be called; and
- the source and amount of any remuneration received or to be received by the intermediary in connection with the offering.

Investor Communications

Intermediaries would be required to provide, on its platform or portal, channels through which investors can communicate with one another and with representatives of companies about offerings made available on the intermediary's platform. While an intermediary may restrict the ability to communicate through these channels to investors that have opened an account with it, the intermediary would be required to make these communications publicly available for viewing. Intermediaries would be required to require any person posting a comment in these communication channels to clearly and prominently disclose with each posting whether that person is a founder or an employee of a company engaging in promotional activities on behalf of that company, or is otherwise compensated to promote that company's offering. This disclosure would apply to officers, directors and other representatives of the company, and also would be required of an intermediary that is a broker (and not a funding portal) or its associated persons.

Because funding portals are prohibited from providing investment advice or recommendations, an intermediary that is a funding portal would be prohibited from participating in any communications in these channels, apart from establishing guidelines for communication and removing abusive or potentially fraudulent communications. Intermediaries that are brokers (and not funding portals) would be permitted to provide investment advice and recommendations, subject to other applicable laws and regulations applicable to brokers.

Upon receipt of an investment commitment from an investor, an intermediary would be required to give or send promptly to the investor a notification disclosing the dollar amount of the investment commitment, the price of the securities, if known, the name of the company being invested in and the date and time by which the investor may cancel the investment commitment.

If a company does not complete an offering because its target offering amount is not reached or the company decides to terminate the offering, the intermediary would be required, within five business days, to send to each investor who had made an investment commitment a notification disclosing the cancellation of the offering, the reason for the cancellation and the refund amount that the investor should expect to receive, direct the refund of investor funds and prevent investors from making investment commitments on the intermediary's platform or portal with respect to that offering.

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An intermediary would not be permitted to compensate promoters, finders or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor.

Funding portals would be required to maintain a fidelity bond that has a minimum coverage of \$100,000, covers any associated person of the funding portal unless otherwise excepted in the rules set forth by FINRA and meets any other applicable FINRA requirements.

Regulation Crowdfunding would also subject all intermediaries to existing privacy rules applicable to brokers.

RESTRICTIONS ON REALES

Securities issued in crowdfunding offerings would not be permitted to be transferred by the purchaser for one year after the date of purchase, except when transferred (i) to the company that issued the securities, (ii) to an accredited investor, (iii) as part of a registered offering, (iv) to a family member of the purchaser or the equivalent, or (v) in connection with the death or divorce of the purchaser.

LIABILITY

In general, an “issuer” would have liability for its disclosures made in connection with a crowdfunding offering equivalent to that applicable to prospectuses under Section 12 of the Securities Act. An “issuer” would be liable to a purchaser of securities sold pursuant to a crowdfunding offering if that 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. For this purpose, the term “issuer” would include the company issuing the securities, that company’s principal executive, financial and accounting officers and any other person who offers or sells the securities, including the intermediaries.

Under this liability provision, an investor who purchases securities pursuant to a crowdfunding offering would be permitted to bring an action against the issuer to recover the consideration paid for the securities, with interest, or damages if the investor no longer holds the securities.

DISQUALIFICATION PROVISIONS

The provisions of Regulation Crowdfunding would include disqualification rules for both companies wishing to engage in crowdfunding and companies wishing to act as crowdfunding intermediaries.

Company Disqualification Rules

Regulation Crowdfunding would adopt disqualification rules applicable to companies wishing to engage in crowdfunding that are substantially similar to the disqualification rules adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act with respect to securities offerings in reliance on Securities Act Rule 506 that became effective in September, 2013.

Under these rules, a company may not sell securities in a crowdfunding offering if any “covered person” has been subject to any one of a list of certain “disqualifying events.” With respect to any crowdfunding offering by a company, a “covered person”

would include the company itself, any predecessor of that company, any affiliated company, any director, officer, general partner or managing member of that company, any 20% beneficial owner of that company, any promoter connected with the company in any capacity at the time of that sale, any person that has been or will be paid for solicitation of purchasers in connection with that sale or any general partner, director, officer or managing member of that solicitor. A “covered person” would be subject to a “disqualifying event” if that person:

- has been convicted within the ten years prior to filing of the relevant offering statement with the SEC as described above (or five years, in the case of the company or its predecessors or affiliates) of any felony or misdemeanor (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC, or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor of purchasers of securities;
- is subject to any order, judgment or decree of any court of competent jurisdiction entered within the five years prior to filing of the relevant offering statement that continues to restrain or enjoin that person from engaging or continuing to engage in any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC, or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor of purchasers of securities;

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- is subject to a final order of a state securities or insurance commission (or like agency or officer), federal or state banking agency, the U.S. Commodity Futures Trading Commission or the National Credit Union Administration that:
- continues to bar the person from association with an entity regulated by any of those authorities or engaging in the business of securities, insurance or banking; or
- constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within the ten years prior to the filing of the relevant offering statement.
- is subject to an order of the SEC that continues to (i) suspend or revoke that person's registration as a broker, dealer or investment adviser, (ii) place limitations on the activities, functions or operations of that person, or (iii) bar that person from being associated with any entity or from participating in the offering of any penny stock;
- is subject to any order of the SEC entered within the five years prior to the filing of the relevant offering statement that continues to order that person to cease and desist from committing or causing a violation or future violation of the Securities Act or any fraud provision of the federal securities laws;
- is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange

or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

- has filed (as a registrant), or was named as an underwriter in, any registration statement that, within the five years prior to the filing of the relevant offering statement, was the subject of a refusal order, stop order or order suspending that registration statement, or is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or
- is subject to a United States Postal Service false representation order entered within the prior five years prior to the filing of the relevant offering statement, or is subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

No conviction, order, judgment, decree, suspension, expulsion or bar event would constitute a "disqualifying event" if that event occurred or was issued before the effective date of the new disqualifying rules or if the relevant court or authority advises in writing that disqualification should not arise. A company, however, would be required, at a reasonable time prior to the sale, to provide purchasers of its securities with a written description of any event that would have been a "disqualifying event" but for the fact that it occurred prior to the effective date of the new disqualifying rules.

In addition, a company would not be prohibited from making a crowdfunding offering as a result of a "disqualifying event" if the company establishes that it did not know and, in the exercise of reasonable care, could not have known that the disqualification existed. A company would not be able to establish that it has exercised reasonable care unless it has made a factual inquiry into whether any disqualifications exist. A company would need to make that factual inquiry by obtaining representations from its "covered persons" through written questionnaires or other documents and, in cases where there is information suggesting the possible existence of a "disqualifying event," by checking public databases and taking any other appropriate steps.

Intermediary Disqualification Rules

Regulation Crowdfunding would adopt disqualification rules applicable to intermediaries that provide that a crowdfunding offering may not be made through an intermediary that is subject, or is associated with a person who is subject, to a "statutory disqualification" as defined in Section 3(a)(39) of the Securities Exchange Act. A person would be subject to a "statutory disqualification" if that person:

- is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, securities exchange, contract market or futures association;
- is subject to an order of the SEC or other appropriate regulatory agency or authority denying, suspending or revoking

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that person's registration as a broker, dealer or security-based swap participant or barring or suspending that person being associated with a broker, dealer or security-based swap participant;

- by that person's conduct while associated with a broker, dealer or security-based swap participant, or while associated with an entity or person required to be registered under the Commodity Exchange Act, has been found to be a cause of any effective suspension, expulsion or order of the character described above by the SEC, an appropriate regulatory agency or any self-regulatory organization;
- has associated with any other person who is known or, in the exercise of reasonable care, should be known to be a disqualified person described above; or
- has committed or omitted any act that is, or is subject to an order or finding, a violation of securities laws, has been convicted within the previous ten years of any offense involving: the sale of securities; the conduct of the business of a broker, dealer, investment adviser, bank, insurance company, fiduciary, transfer agent or nationally recognized statistical rating organization; fraud; bribery; perjury; burglary; larceny; theft; robbery; extortion; forgery; counterfeiting; embezzlement; or substantially equivalent activity, is enjoined from acting as a

broker, dealer, investment adviser, bank, insurance company, fiduciary, transfer agent or nationally recognized statistical rating organization, has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization or proceeding before a self-regulatory organization any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report or proceeding any material fact which is required to be stated therein.

PREEMPTION

The crowdfunding exemption would preempt state registration, documentation and offering requirements. State filing fees would also be preempted, except from the State of the principal place of business of the company making the crowdfunding offering and the State, if any, in which purchasers of a majority of the securities being issued in a crowdfunding offering are resident. States, however, would retain the ability to bring enforcement actions for fraud, deceit or unlawful conduct against companies engaging in crowdfunding and their broker or funding portal intermediaries.

This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.