

HamiltonClark Securities Company

Response to FINRA request for comment on proposed regulation of crowdfunding activities

Background

Hamilton Clark Securities Company, a FINRA member-firm, was originally organized as McKenna Securities Company in 1991 as a NASD member-firm. We act as a placement agent for Regulation D, Section 4(2) private placements and we advise our clients in corporate finance and M&A transactions; all generally in the range of \$5,000,000 to \$50,000,000 of transaction value. Our private placements are sold to institutional investors only (venture capital or strategic investors). We do not solicit investments from individual accredited investors. We work exclusively for energy technology companies from our offices in Washington, DC and Houston, TX. Most of our clients are privately-held companies and all of our clients are small capitalization companies. Since inception we have completed about 75 advisory, private placement or M&A engagements.

Comment and Recommendation

In general we believe that the concept of crowdfunding under the JOBS Act will be beneficial for the U.S. in order to make it easier for small companies to raise capital. In addition, it conceptually should allow sophisticated investors who do not qualify as accredited investors to have access to wealth-creating start-up company investments.

However, we believe that two investor safeguards should be built into the procedures for crowdfunding:

- ***Investor protection in transaction structuring and pricing.***
 - We believe that each transaction should include a “crowdfunding fairness opinion” issued by a FINRA-member firm that, like a fairness opinion in an M&A transaction, states that “in our opinion the terms and the pricing proposed in this offering are fair to investors from a financial point of view”. Although a fairness opinion from a FINRA-member firm will not guarantee an absence of fraud between the issuer and the funding portal or broker, it will at least bring in a third-party to perform a minimum level of due diligence and opine on the key corporate finance and fairness elements of the placement. The FINRA-member firm offering the opinion could also act as the broker in the placement, and should be entitled to earn a fairness opinion fee.
- ***Investor protection in the offering process.***
 - We believe that funding portals should be regulated by FINRA as the appropriate SRO. In addition, we believe that funding portals should be required to meet the same compliance standards and net capital requirements as a \$5,000 broker, except that only the officers of the firm and supervisory management of the crowdfunding activities would need to be Series 7 licensed.

- We believe that FINRA-member firms should be permitted to act as funding portals as part of their normal business and not be required to segregate crowdfunding activities into a separate unit.
- We believe that investment summaries of crowdfunding transactions where the FINRA-member broker is acting as a portal or as a placement agent should be permitted to appear on the broker's website.
- We believe that if a broker is acting as a placement agent then the broker should be entitled to earn a placement fee.

Investor Protection in Transaction Structuring and Pricing

Although crowdfunding will assist small companies in raising capital, if improperly structured or priced, these transactions will result in a myriad of problems for investors and issuers, including but not limited to the following:

- ***Severe dilution to investors.*** An example would be an offering in which Company X, a start-up, seeks to raise say \$1,000,000. Based on its own “non-arm's length” decision it decides to undertake a crowdfunding offering through a funding portal as follows:
 - It completes all the offering requirements of a crowdfunding offering as outlined in Securities Act Section 4A and SEA Section 3(a)(80) so it can proceed with an offering in compliance with the JOBS Act
 - It decides to offer common stock to investors, the same class as stock issued to its founders
 - It arbitrarily decides that its technology is worth say \$10,000,000 even though the founders might have only invested, say \$1,000 to get organized and incorporated. And let's suppose the company has not filed any patent application on its technology and that any reasonable corporate finance professional might conclude that in the absence of a third party review, the technology could potentially be bogus. After the offering, investors would only own 10% of the company (having invested 99.9% of its capitalization) and have no senior position if the company decides to liquidate after the offering
 - Use of proceeds is vague with the likelihood that most of the money will be used to pay for salaries of the founders

So in this simple example the company would have fully complied with the issuing requirements of crowdfunding but the offering would have violated the basic terms of early-stage financing, namely that new investors should be senior to existing investors, that the valuation should be comparable to other companies and similar offerings in the sector, and that the proceeds should generally be used to build and sell products or commercialize technology.

In our opinion if the company were required to obtain a “crowdfunding fairness opinion” from a FINRA-member firm then the terms and pricing would likely be more

in line with the company's industry sector comparables and fair and reasonable with respect to the maturity of the company.

- ***Future problems for issuers.*** An example would be a situation, say Company X above, that closes a crowdfunding offering as outlined above, say for \$1,000,000 based on a pre-money valuation of \$10,000,000. For its follow-on offering Company X seeks to raise \$10,000,000 from venture capital firms in order to complete the commercialization its technology. In due diligence the venture capital firm looks at the offering documents for the \$1,000,000 crowdfunding offering and figures out that the documents did not disclose the inept structuring and valuation, and that they would likely be inheriting a lawsuit when the true valuation is understood and the resulting dilution impacts the crowdfunding investors.

In our opinion traditional venture capital firms and strategic investors will be leery of investing in companies that have undertaken crowdfunding transactions without the equivalent of a “crowdfunding fairness opinion”.

Conclusion

Although we are conceptually in favor of the goals of crowdfunding (namely to make it easier for small companies to raise capital), we believe that FINRA can assist the SEC in regulating the effort, for the benefit of investors, by:

- Requiring a “crowdfunding fairness opinion”, offered only by a FINRA-member firm, as a condition of every crowdfunding transaction.
- Requiring that FINRA be the SRO of all funding portals.
- Requiring funding portals to be FINRA-compliant in the same manner as \$5,000 brokers, but with fewer employees having to be Series 7 licensed.