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Via e-mail pubcom@finra.org
Attn.: Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 12-34 – Jumpstart Our Business Startups Act

Dear Ms. Asquith:

Our Firm is pleased to respond to the Financial Industry Regulatory Authority's ("FINRA") request for comment regarding the rules to be promulgated by FINRA for the registration of funding portals. Funding portals are intermediaries established by Section 3(a)(80) of the Securities Exchange Act of 1934 ("1934 Act"), as added by Section 304 of the Jumpstart Our Business Startups Act ("JOBS Act"). The JOBS Act's crowdfunding provisions are intended to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.

I. Executive Summary

In order to facilitate FINRA's review of our comments, the salient points of our response are set forth below:

1. The FINRA registration process for funding portals should be significantly less burdensome than the process applicable to broker-dealers.

2. Any rules applicable to funding portals, and the supervision and enforcement of those rules, should be transparent and avoid the opaque supervision and enforcement standards applicable to broker-dealers dealing in microcap securities.

3. Rules applicable to funding portals should be minimal and should focus on investor protection rather than highly technical issues applicable to the financial industry as a whole. Therefore, FINRA's anti-money laundering regulations and just and equitable principles of trade should not apply to funding portals.

4. Net capital requirements should not apply to funding portals because they are prohibited from taking possession of customer funds or securities.

5. Broker-dealers with funding portals should be required to establish legally separate subsidiaries for their crowdfunding activities, and that subsidiary should only be subject to the funding portal rules.

6. Advertising by funding portals of offerings listed on the funding portal should not be limited, except for anti-fraud purposes. Specifically, funding portals should be free to distribute additional information regarding issuers or offerings that is not in the offering materials, as long as the additional information does not contradict the offering materials.

7. Crowdfunding offering proceeds should be held in escrow.

8. FINRA should require funding portals to carry sufficient insurance coverage to cover claims asserted by investors. The amount of insurance should be proportional to the total offering amounts of the offerings in which the funding portal participates.

9. FINRA should allow crowdfunding offerings for an issuer to be conducted through only one funding portal at a time in order to effectively enforce the total investment limitations of Section 4(6)(B) of the Securities Act.

10. Funding portals should be able to rely on the investor's representations regarding their annual income or net worth.

11. Funding portals should be required to disseminate to investors the periodic information required by Section 4A(b)(4) of the Securities Act via e-mail or other electronic means.

II. Comments

1. *The FINRA registration process for funding portals should be significantly less burdensome than the process applicable to broker-dealers*.

   Broker-dealers are required to register with FINRA by submitting a Form BD and an application for FINRA membership.[1] The information in these forms is subject to FINRA review, comment, and follow-up, including an in-person review by staff in the FINRA district office closest to the registrant.[2] In sum, the FINRA membership process for broker-dealers can take up to nine months and cost tens of thousands to hundreds of thousands of dollars.

   We believe that the registration process for funding portals should be greatly streamlined. Section 4(c)(2)(B) of the Securities Act of 1933 ("Securities Act") (added by Section 304 of the JOBS Act) provides that funding portals are prohibited from taking possession of

[1] *See* 1934 Act § 15(b).
[2] *See* FINRA Rule 1013.

customer funds or securities, and as a result, the concerns that would normally apply to a broker-dealer are simply not relevant to a funding portal.[3] This counsels in favor of a more accommodative approach to the registration of funding portals.

In addition, the JOBS Act suggests that the regulations applicable to funding portals are to be less stringent than those applicable to broker-dealers.[4]

2. *Any rules applicable to funding portals, and the supervision and enforcement of those rules, should be transparent and avoid the opaque supervision and enforcement standards applicable to broker-dealers dealing in microcap securities*.

We encourage FINRA to be transparent in its rulemaking for funding portals and its supervision and enforcement of those rules. Our Firm represents many small publicly traded companies (smaller reporting companies) and a constant rejoinder that we hear from our clients' management and shareholders is the difficulty that they have in depositing or trading in securities issued by such companies. This difficulty is caused by standards imposed by broker-dealers, who in turn, have claimed that FINRA is imposing such standards on them during their examinations.[5] These broker-dealers have gone on to claim that FINRA has essentially imposed a strict liability standard on broker-dealers accepting trades in or deposits of microcap issuers' securities. This has greatly reduced liquidity for smaller reporting companies and constrained financing options for these issuers. In those cases in which financing is available, the costs have increased substantially. We believe that FINRA's intent is to protect the public investors of these securities; however, the implementation of these "unwritten rules" has actually led to the opposite effect, with many issuers choosing to abandon their public status, which leads to even worse outcomes for public investors, such as less liquidity, fewer investment options, and more potentially abusive transactions by insiders and manipulators.

We provide the above summary because there will likely be substantial overlap between smaller reporting companies and issuers raising financing through crowdfunding, and as a result, the lessons learned from broker-dealers dealing in microcap securities will also be instructive when dealing with funding portals.

As a result, we urge FINRA to be transparent in its processes toward funding portals, not only in the rules that are ultimately promulgated, but also in the supervision and enforcement of funding portals that are involved in crowdfunding offerings.

3. *Rules applicable to funding portals should be minimal and should focus on investor protection rather than highly technical issues applicable to the financial industry as a whole*.

[3] *See* Securities Act § 4(c)(2)(B) (added by Section 304 of the JOBS Act)
[4] *See* 1934 Act § 3(h)(2) (added by Section 304 of the JOBS Act).
[5] Indeed, these types of complaints led the Securities and Exchange Commission ("SEC" or "Commission") to convene the Roundtable on the Execution, Clearance and Settlement of Microcap Securities to examine these issues. *See* Public Roundtable on Execution, Clearance and Settlement of Microcap Securities, Release No. 34-65511 (Oct. 7, 2011). The Commission's Microcap Fraud Working Group held a public roundtable meeting on October 17, 2011 at the Commission's headquarters to seek comments from participants in the microcap market regarding difficulties in clearing microcap securities. *See id.*

Therefore, FINRA's anti-money laundering regulations and just and equitable principles of trade should not apply to funding portals.

It is important to realize that Congress' intent in the JOBS Act is to encourage capital-raising by small businesses, and this goal is effectuated by encouraging the creation and operation of funding portals. As a result, the amount of regulation that funding portals should be subject to should be minimal and focused on investor protection, rather than technical issues applicable to the financial industry as a whole.

Indeed, the JOBS Act suggests that funding portals are to be regulated with a "light touch", *i.e.*, under lesser standards than those applicable to broker-dealers.[6] Consequently, we believe that FINRA's anti-money laundering rule (Rule 3310) should not apply to funding portals. We believe that the potential for use of funding portals as a device to launder money is minimal because of the small offering amounts imposed by the JOBS Act. A criminal seeking to launder money would likely have access to other, more efficient methods of doing so, and as a result, weighing the benefit to society against the cost to funding portals leads to the conclusion that such regulation is unnecessary.

In addition, we believe that FINRA's Section 5000 rules (Securities Offering and Trading Standards and Practice Rules) should not apply to funding portals due to the novelty of the funding portal concept. Funding portals should be allowed to develop with relatively few rules applicable to their business model for now, so that issuers, investors, and funding portals can determine the business strategies, methods, and procedures that work best. We note that investors who believe that they are being taken advantage of somehow by a funding portal or are being exposed to dubious crowdfunding offerings are free to take their investment business to a different crowdfunding portal, or not invest in a given crowdfunding offering at all.

4. *Net capital requirements should not apply to funding portals because they are prohibited from taking possession of customer funds or securities*.

   Related to the above comment, we believe that net capital requirements should not apply to funding portals, because as stated earlier,[7] funding portals are statutorily prohibited from taking possession of customer funds or securities.[8] [9] However, it may be appropriate for FINRA to ensure that funding portals are in fact complying with this prohibition by undertaking periodic examinations of funding portals.

5. *Broker-dealers with funding portals should be required to establish legally separate subsidiaries for their crowdfunding activities, and that subsidiary should only be subject to the funding portal rules*.

[6] *See* 1934 Act § 3(h)(2) (added by JOBS Act § 304).
[7] *See supra* p. 2.
[8] 1934 Act § 3(a)(80)(D).
[9] We recognize that the net capital rule applicable to broker-dealers is an SEC requirement, rather than a FINRA requirement, *see* Rule 15c3-2; nonetheless, we urge FINRA not to impose a similar requirement on funding portals.

Regulatory Notice 12-34 specifically requests comment regarding "broker-dealers that may engage in crowdfunding concerning the organizational structure through which this activity would occur within the firm (*e.g.*, through the broker-dealer entity or a separately identified department)."[10]

We believe that as a realistic matter, broker-dealers wishing to act as funding portals will establish a separate subsidiary for their crowdfunding activities. As a result, it would not be unreasonable for FINRA to require member firms to establish a separate subsidiary for crowdfunding activities so that these activities are segregated from a broker-dealer's non-crowdfunding securities activities. Taking the limitations on FINRA's authority over funding portals a step further, only the funding portal provisions should apply to this separate subsidiary.[11]

6. *Advertising by funding portals of offerings listed on the funding portal should not be limited, except for anti-fraud purposes. Specifically, funding portals should be free to distribute additional information regarding issuers or offerings that is not in the offering materials, as long as the additional information does not contradict the offering materials*.

   We encourage FINRA not to limit the types of information that can be distributed to customers nor the means in which that information can be disseminated (*i.e.*, social media, etc.). Funding portals should be free to conduct their own research regarding the business models or industries of the issuers whose securities are offered on their platforms and to disseminate this research to their customers. As a result, funding portals should be allowed to provide additional information not included in the issuer's offering materials, so long as this information does not contradict the issuer's offering materials and is truthful. We believe that there will be no erosion of investor protection by such a rule.

7. *Crowdfunding offering proceeds should be held in escrow*.

   Under Section 4A(7), proceeds from crowdfunding offerings can only be released to issuers once a certain target offering amount is reached, similar to a "minimum-maximum offering", in which the issuer sets a minimum amount that must be raised for the offering to proceed.[12]

   Also under Section 4A(7), issuers in crowdfunding offerings must permit investors to cancel their commitment to invest pursuant to SEC rules.[13]

   In order for these obligations to truly be effective, we believe that funding portals should require that the proceeds from their offerings to be deposited in escrow; however, as stated earlier, Section 3(a)(80) of the 1934 Act (added by Section 304(b) of the JOBS Act) prohibits funding portals from taking possession of customer funds.[14] Consequently, offering proceeds should be deposited into escrow with a broker-dealer or an institution insured by the Federal

[10] FINRA Regulatory Notice 12-34 at p.3.
[11] *See* 1934 Act § 3(h)(2) (added by Section 304 of the JOBS Act).
[12] *See* Securities Act § 4A(7) (added by Section 302(b) of the JOBS Act).
[13] *See id.*
[14] *See* 1934 Act § 3(a)(80) (added by Section 304(b) of the JOBS Act).

Deposit Insurance Corporation ("FDIC") and then only be released after (1) the rescission time period has passed, and (2) after taking into account any investor cancellations, the minimum target amount has been met, both as calculated by the funding portal. We note that any cancellations should be processed through the funding portal in order to allow it to apply any cancellations in determining whether the target offering amount has been met.

We believe that this escrow requirement will minimize the risk of an issuer or a funding portal absconding with investor funds or an investor being unable to reclaim his funds in case of insolvency of a funding portal.

We note that the SEC already has a similar rule, Rule 419, which applies to offerings of blank check companies.[15] Rule 419 requires the proceeds of an offering by a blank check company to be deposited in escrow with an FDIC-insured institution or broker-dealer and allows the investor to reclaim his funds upon the issuer's reconfirmation of an acquisition proposed by the blank check company.[16] As a result, it may be useful for FINRA to look to Rule 419 for guidance in drafting this rule.

8. *FINRA should require funding portals to carry sufficient insurance coverage to cover claims asserted by investors. The amount of insurance should be proportional to the total offering amounts of the offerings in which the funding portal participates*.

   One rule that we believe would greatly enhance investor protection is requiring funding portals to hold an insurance policy insuring the funding portal from claims asserted against the funding portal due to alleged violations of the Securities Act, 1934 Act, or common law fraud. The limits of this policy should be proportional to the total offering amounts of the offerings in which the funding portal participates.

   We believe that this rule would offer an important investor protection by providing a financially responsible party that wronged investors can pursue in case of a crowdfunding issuer's violations of the Securities Act or 1934 Act. We note that under Section 4A(c) of the Securities Act (added by Section 302(b) of the JOBS Act), the funding portal will also be liable for these violations (unless it can prove that it did not know of such violations and could not have known about them).[17] This is important because by nature, the companies that would raise funds through crowdfunding will be small companies, and if the funds raised have already been spent (either legitimately or illegitimately), investors could have claims but no way in which to recoup their losses. Therefore, requiring insurance for funding portals would greatly enhance investor protection in crowdfunding offerings.

9. *FINRA should allow crowdfunding offerings for an issuer to be conducted through only one funding portal at a time in order to effectively enforce the total investment limitations of Section 4(6)(B) of the Securities Act*.

[15] *See* Rule 419.
[16] *See generally id*.
[17] *See* Securities Act §§ 4A(c)(1)(B), 12(b), 13.

Section 4(6)(B) of the Securities Act (added by Section 302(b) of the JOBS Act) conditions the crowdfunding exemption upon certain limits on the total amount of the offering and the total amount that can be invested by any one person. The reasoning behind this appears to be to limit the amount that any one individual can lose in a crowdfunding investment.

The investment limitations are:

> (i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and
> (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000…

Securities Act § 4(6)(B).

We believe that the only realistic way to ensure that the per-investor limits are complied with is to prevent more than one funding portal from carrying an offering by the same issuer. Otherwise, the per-investor limits could be circumvented (either intentionally or mistakenly) by an issuer conducting its offering through more than one funding portal; investors could then invest through multiple funding portals and/or broker-dealers and thereby circumvent the limitations. Since FINRA does not have jurisdiction to regulate crowdfunding issuers, the way to achieve this goal is to impose this rule on the funding portals. Since crowdfunding offerings must be conducted through an funding portal in order to qualify for the Section 4(6) exemption from the registration requirements of Section 5 of the Securities Act, we believe that this rule would be effective to enforce the per-investor investment limitations of Section 4(6)(B).[18]

10. *Funding portals should be able to rely on the investor's representations regarding their annual income or net worth.*

Related to the above comment, the per-investor investment limitations of Section 4(6)(B) are determined based upon the investor's annual income or net worth.[19] The question then arises of how a funding portal can determine these figures.

The only possible way that a funding portal could reliably determine an investor's income and thereby limit his participation pursuant to the limits in Section 4(6)(B) would be to obtain income tax returns from the investor. However, this is invasive (from the investor's perspective) and burdensome (from the funding portal's perspective). In addition, even if funding portals did obtain income tax returns, they would not reflect an investor's net worth, and they would therefore provide incomplete information for determining the Section 4(6)(B) limits applicable to that investor.

[18] *See* Securities Act § 4(6)(C) (crowdfunding offering must be conducted through either broker-dealer or funding portal).
[19] *See* Securities Act § 4(6)(B)(i), (ii).

Consequently, we believe that the best method is to allow funding portals to rely upon representations made by the investor to the funding portal regarding their annual income and net worth. Funding portals should not be required to verify these representations and should be exempt from any enforcement action based upon an investor investing beyond the Section 4(6)(B) limits if such overinvestment was due to the investor's misrepresentations to the funding portal regarding his annual income or net worth.

11. *Funding portals should be required to disseminate to investors the periodic information required by Section 4A(b)(4) of the Securities Act via e-mail or other electronic means*.

Section 4A(b)(4) of the Securities Act requires crowdfunding issuers to "file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate…"[20]

We believe that a component of the funding portal rules should require funding portals to distribute the reports required by Section 4A(b)(4) to the investors that invested in the offering through that funding portal. This would not be unduly burdensome, as the funding portal will already have collected the investor's identifying information. In order to further lighten the information distribution requirements on funding portals, the rule should only require funding portals to deliver the information electronically (via e-mail) to investors. This requirement could be met by e-mailing to investors a link to the applicable report; however, it could not be met by simply posting the report on a Web site without otherwise notifying investors individually.

III. Conclusion

We appreciate the opportunity to provide our comments on the proposed FINRA rules applicable to funding portals. We believe that our experience in representing smaller reporting companies provides us with an informed basis for providing these comments and the conclusions expressed herein.

We look forward to reviewing FINRA's proposed funding portal rules and providing further comments once they are formulated.

Thank you.

Very truly yours,

WHITLEY LLP ATTORNEYS AT LAW

By: /s/ *Samuel E. Whitley*
Samuel E. Whitley
Partner, Corporate and Securities Law

[20] Securities Act § 4A(b)(4) (added by Section 302(b) of the JOBS Act).

Cc: Elizabeth M. Murphy, Secretary
Securities and Exchange Commission