August 30, 2012

Marcia E. Asquith
Senior Vice President and Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 12-34

Submitted via: *pubcom@finra.org*

Dear Ms. Asquith:

NSBA is pleased to submit these comments in response to Regulatory Notice 12-34 (FINRA Requests Comment on Proposed Regulation of Crowdfunding Activities). As it is not clear to the public at this juncture what the division of effective regulatory authority and responsibility will be between the Securities and Exchange Commission (the SEC or the "Commission") and the Financial Industry Regulatory Authority (FINRA), in some instances these comments may extend beyond those matters that will be of concern to FINRA to those that will ultimately fall within the scope of the regulatory authority assumed by the SEC.

The National Small Business Association

The National Small Business Association (NSBA) was founded in 1937 to advocate for the interests of small businesses in the U.S. It is the oldest small business organization in the U.S. The NSBA represents more than 65,000 small businesses throughout the country in virtually all industries and of widely varying sizes.

The JOBS Act

On Apr. 5, 2012, the President signed into law the Jumpstart Our Business Startups Act [Public Law 112–106] (the "JOBS Act"). The NSBA strongly supported this legislation. This bi-partisan legislation is designed to substantially reduce the regulatory impediments to small firms' access to capital markets. Properly implemented by the SEC and FINRA, it will dramatically improve small companies' access to capital and reduce their cost of capital. It will reduce the legal, accounting and other administrative cost of small businesses and reduce the need to pay substantial fees to investment bankers and other broker-dealers to access capital markets. The passage of the JOBS Act demonstrates a broad bi-partisan understanding that existing securities

laws pose an unreasonable burden on the ability of small firms to access the capital markets, harming economic growth and job creation.

The SEC must adopt a number of rules to implement the JOBS Act. The basis for FINRA's involvement in the regulation of crowdfunding is new section 4A(a)(2) which requires funding portals to register with any applicable self-regulatory organization (SRO) as defined in section 3(a)(26) of the Securities Exchange Act of 1934. There is every indication that the SEC will designate FINRA to act as this SRO.

Both the Commission and FINRA must guard against regulations that will undermine the purpose of the Act by imposing such complexity, opaqueness and regulatory risk that small firms and funding portals must either incur exorbitant legal and accounting fees and other compliance costs or fail to take advantage of the new means of raising capital offered by the Act. The regulatory framework should be straight-forward and streamlined, imposing the minimum necessary cost and regulatory risk on small firms seeking to raise capital.

Crowdfunding

Title III of the Act provides a crowdfunding exception to the registration requirements of the Securities Act of 1933. The crowdfunding exception will allow issuers to raise, subject to substantial regulation, up to $1 million a year in small increments from ordinary investors through a registered funding portal (or broker-dealers). State Blue Sky laws regarding registration and qualification are preempted.[1] This aspect of the Act has the potential to transform small firms' access to capital provided that the regulatory framework adopted by the Commission and FINRA does not unnecessarily impede either issuers or funding portals.

There is a serious risk that over-regulation will impose such high costs on both funding portals and crowdfunding issuers that the crowdfunding exception will become a dead letter just as Regulation A has rendered virtually unused the small issues exception under section 3(b) of the Securities Act.[2] This clearly would be contrary to the intention of Congress.

Funding Portals

New section 3(a)(80) defines the term "funding portal" to mean:

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[1] Companies using web portals would not know in which state potential investors would reside. In the absence of this preemption provision, the cost of complying with 50 state (plus DC) securities laws regarding registration and qualification would be prohibitive for small offerings. This provision, however, has generated ire from state regulators who are unhappy about the loss of regulatory power over crowdfunding offerings. They are attempting to accomplish through FINRA and the SEC what they were unable to accomplish in Congress, namely to impose such a high regulatory burden on web portals and crowdfunding issuers that the exemption is of little or no value to small firms seeking to raise needed capital. FINRA and the SEC, however, have a duty to honor Congressional (and Presidential) intent particularly given the bi-partisan consensus that change is needed.

[2] Prior to the enactment of the JOBS Act, Regulation A offerings could not exceed $5 million. In 2011, only one Regulation A offering was completed. See "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office (GAO-12-839), July 2012, a study mandated by the JOBS Act.

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, 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;
(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.

New section 4A(a) sets forth the basic requirement for crowdfunding intermediaries. In addition, it is possible that regulations will require crowdfunding intermediaries to exercise some level of due diligence to ensure that issuers using the intermediary comply with the requirements of new section 4A(b) (relating to crowdfunding issuer requirements).

New section 3(h) and new section 4A(a)(1), among other provisions, make it clear that funding portals are to be regulated differently and less intensely than broker-dealers.

Self-Regulatory Organizations and Registration as a Broker

New section 4A(a)(2) requires funding portals to register with any applicable self-regulatory organization (as defined in section 3(a)(26) of the Securities Exchange Act of 1934). Section 304(a) of the Act provides that [t]he Commission shall, by rule, exempt, conditionally or unconditionally, a registered funding portal from the requirement to register as a broker or dealer.

The Act makes it manifestly clear that a funding portal is distinct from a broker or dealer from a regulatory standpoint. The difficulty is that the current stance of the Commission is, effectively, that almost anyone no matter how tangentially involved in a securities transaction may be a broker-dealer required to register as such (see, e.g., the SEC's Guide to Broker-Dealer Registration).[3] It is clear that the state of SEC "guidance" in this area is not clear.

For example, the SEC "Guide to Broker-Dealer Registration" states that (1) "[f]inding investors for "issuers" (entities issuing securities), even in a "consultant" capacity," (2) "[e]ngaging in, or finding investors for, venture capital or "angel" financings, including private placements" or (3) "persons that operate or control electronic or other platforms to trade securities" can trigger registration. That, of course, is what funding portals will be doing and what both Congress and the President intend for them to do.

[3] http://www.sec.gov/divisions/marketreg/bdguide.htm#II

Given the highly expansive interpretation of current SEC guidance, **any** funding portal would presumably be required to register as a dealer. Yet this clearly is not consistent with Congressional intent and would impose an unreasonable burden on funding portals. In fact, it would defeat the primary purpose of the legislation, to wit, to allow investors to invest and small issuers to raise capital without being required to cut Wall Street in for a large piece of the company.

NSBA does not believe that registration as a dealer should generally be required of organizations that are only funding portals for crowdfunding and/or Regulation D offerings. It is imperative that the rules adopted by the Commission and FINRA clearly adopt this position. It is important that the rules make it clear that the fact that funding portal fees are set, in whole or in part, as a percentage of the amount raised do not trigger dealer registration requirements.

Disclosure

New section 4A(a)(3) requires an intermediary "to provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate." To eliminate uncertainty and ensure that the information deemed by the Commission to be necessary is conveyed to prospective investors, we strongly urge the Commission or FINRA to provide model language that is wanted in the disclosures and educational materials or to provide detailed templates.

Background Checks

New section 4A(a)(5) requires an intermediary to "take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person."

We would urge the Commission and FINRA to indicate what behavior uncovered by a background check is disqualifying, which needs to be disclosed and which does not. For example, is a 15 year old DUI or marijuana possession felony conviction disqualifying? Does it need to be disclosed? Are the requirements limited to crimes of moral turpitude? Is the background check requirement limited to a *criminal* background check and, if not, what other types of background check will be required? For example, is it mandatory to disclose tax liens, judgments, bad debts or similar issues and if so, how is such a background check to be conducted? Liens and judgments, for example, are often not on a central database. Guidance on the parameters of this requirement is very important.

Section 15(b)(4) of the Securities Exchange Act could be used as the template for a rule regarding disqualification but would not necessarily be appropriate for a mandatory disclosure standard.

We would also advise FINRA of the recent EEOC revised "Enforcement Guidance on the Consideration of Arrest and Conviction Records in Employment Decisions under Title VII of the Civil Rights Act of 1964." It is clear that the EEOC and the securities laws are pursuing very different policy agendas in this area and we would ask that SEC, FINRA and EEOC guidance be consistent since our membership cannot comply with conflicting legal requirements issued by two different agencies. The EEOC has made it clear that complying with state law requirements with respect to background checks will not prevent EEOC enforcement action. The EEOC does allow in their guidance that they will not pursue enforcement action against a business that conducts *federally* mandated background checks. It is whether the EEOC will disregard any FINRA requirements unless they are also SEC mandated requirements since FINRA is not a federal agency.

Aggregation

New section 4A(a)(8) of the Act requires intermediaries to ensure that no investor in a twelve-month period has purchased crowdfunding securities that, in the aggregate, from all issuers, exceed the Section 4(6) investment limits. It is unclear how an intermediary will be able to verify whether an investor had exceeded these limits unless it is entitled to rely upon the representation of an investor regarding prior investments in such securities.

Rescission

New section 4A(b)(1)(G) requires an issuer to offer investors a reasonable opportunity to rescind the commitment to purchase the securities. Dovetailing this provision with the Truth in Lending Act (TILA) provisions contained in 15 USC §1635 and many state consumer protection statutes seems appropriate since the policy goals are substantially similar and it is less likely to lead to consumer confusion. The TILA statute provides consumers the "right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this subchapter, whichever is later." The period should commence upon the investor entering into a binding initial commitment.

It should also recommence if the issuer makes a change in the investment terms or provides a new material adverse disclosure before the offer is closed (and should not terminate until substantially after the issuer provides actual notice of the change or adverse disclosure). In our judgment, in these two cases, the period should be much longer than three days.

Offering Notices or Announcements

New section 4A(b)(2) provides that an issuer shall "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker." The Commission and FINRA should provide guidance as to what information is permitted in the notice and what role the intermediary has in enforcing this provision. At a minimum, the issuer should be allowed to provide the following information in the notice:

(1) The name of the issuer;
(2) The name and web site of the funding portal or portals;
(3) The type of security being offering;
(4) The offering amount;
(5) The opening and closing date of the offering; and
(6) The line of business that the issuer is in (or will be in if the offering will fund a new line of business).

Issuer and Intermediary Liability

New section 4A(c) provides a cause of action to an investor in a crowdfunding offering against the issuer, a director or partner of the issuer, the principal executive officer or officers of the issuer, or the principal financial officer, controller or principal accounting officer of the issuer to recover damages for material misstatements and omissions by the issuer. Although it is Congressional intent that the issuer and its executives be legally responsible for material misstatements and omissions in the offering documents, the Commission or FINRA or both should provide guidance as to whether an intermediary will be required to confirm any information presented by the issuer during the course of the offering (and if so, which information and to what extent) or will be subject to liability for any violations by the issuer of its Section 4(6) obligations. Guidance is needed as to whether intermediaries will be permitted to request issuers to provide greater disclosure of information to the public than required by the Act and whether this additional disclosure would result in any liability to the intermediary in the event of fraud or negligent misrepresentation by the issuer.

Given the combination of a large number of potential investors making small investments and potentially risky investments, class action or shareholder derivative lawsuits (both warranted and unwarranted) are likely to be reasonably common. In order for this risk not to pose a major barrier to those wishing to maintain funding portals, it is important that the scope of intermediary duties be set forth with reasonable specificity. Moreover, it is our belief that a funding portal attempting to impose stricter standards than the minimum required by the Commission should not give rise to liability. Finally, a funding portal that complies with Commission and FINRA requirements should not be co-liable for material misstatements and omissions by an issuer – otherwise, they are, in effect, being asked to become an insurer and the costs and risk of maintaining a portal will become prohibitive.

Investment Advice

Section 3(a) of the Securities Exchange Act as amended by new subsection 80 defining a "funding portal" prohibits an intermediary from offering investment advice or recommendations. However, the Act does not provide a definition of what constitutes investment advice or a recommendation. The commission should clarify whether the following actions would constitute either investment advice or a recommendation: (1) removing an offering before its offering period has expired for lack of sufficient investor commitments; (2) preventing an issuer from offering its securities on the funding portal's website because of failure to provide documents

responsive to a the portal due diligence/disclosure standard; (3) establishing disclosure standards or qualification standards (e.g. prohibiting felons from being in issuer management) that are higher than the standards specified by the Commission (4) assuming a funding portal allows investors to comment or submit questions to an issuer on the funding portal's website, deleting a third party's statements that are false, obscene, defamatory or irrelevant; (5) defining the layout, format or positioning of the offering on the funding portal's website; (6) providing market and news updates; and (7) declining to post an offering due to the offering not fitting into the type of offering that the funding portal seeks to limit itself to offering (e.g. small businesses, businesses in a specific geographical area, prohibiting certain lines of business (e.g. gambling establishments), etc.)

Customer Funds

A funding portal may not "hold, manage, possess, or otherwise handle investor funds or securities" (new section 3(a)(80)) but must ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest, as the Commission shall, by rule, determine appropriate; (new section (4A(a)(7)). Thus, a funding portal must effectively ensure that funds are held in escrow but may not do so itself. The Commission should provide guidance as to what sort of institutions may provide this service, what the funding portal's responsibilities regarding this requirement are, who should bear the cost of this service, who should bear the risks associated with providing this service and what the escrow agent's duties are and to whom.

Money Laundering

The burden imposed on financial institutions because of various "Know Your Customer" requirements and other anti-money laundering provisions is huge (well over $5 billion annually).[4] To impose the full panoply of these requirements on web portals would, quite simply, prevent crowdfunding portals from being operated by anyone other than broker-dealers.

Of course, for purposes of the money laundering laws financial institutions are not necessarily actual financial institutions. Most would be surprised to find that travel agencies, jewelers, pawnbroker, car dealers, and persons involved in real estate closings and settlements are "financial institutions."[5] Broker-dealers are, of course, subject to these laws. In addition, "any business or agency which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity which is similar to, related to, or a substitute for any activity in which any business described in this paragraph is authorized to engage" may be subject to these rules.

Handling large sums of money is the one thing all of the subject business have in common. As noted above, portals are prohibited from holding customer funds. Thus, anti-money laundering provisions should simply not apply and the law does not require it.

[4] See, e.g., "Trends in Anti-Money Laundering 2011," July 2011, Celent.
[5] 31 USC 5312(a)(2).

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Fraud

The JOBS Act does not change federal fraud laws and does not preempt state fraud laws. You would never know this from the various pronouncements being made by state regulators and other opponents of the JOBS Act.

The law imposes a myriad of requirements on funding portals. It also gives the SEC and FINRA tremendous authority to impose additional requirements. We do not believe that imposing additional requirements beyond those actually required by the JOBS Act are warranted. It is highly unlikely that such additional requirements would materially reduce fraud. It is highly likely that additional requirements will impede the ability of small companies to use crowdfunding to raise needed capital and to create jobs. If it becomes evident in the future that some particular revision to the regulations governing crowdfunding is appropriate, they those revisions can be made by the Commission or FINRA to address the problem.

Sincerely,

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