



NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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November 19, 2015

Via electronic submission to rule-comments@sec.gov

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington DC 20549-1090

RE: *Notice of Filing of a Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4518; Release No. 34-76239; File No. SR-FINRA-2015-040*

Dear Mr. Fields:

The North American Securities Administrators Association, Inc. (“NASAA”) appreciates the opportunity to provide further comment on the Financial Industry Regulatory Authority’s (FINRA) proposed regulation of funding portals (“the proposal” or “the funding portals proposal”).¹ Section 305 of the Jumpstart Our Business Startups (“JOBS Act”) preserves the examination and enforcement authority of a state over funding portals whose principal place of business is located within that particular state while simultaneously limiting such authority to the extent that state regulation does not exceed or conflict with federal law. Given this limitation on state regulatory authority, the regulations applicable to funding portals are of particular importance to state regulators as they are charged with protecting the investors that will invest in federal crowdfunding offerings on the portals. Accordingly, we would appreciate the fullest consideration of our comments as the Commission reviews FINRA’s proposed funding portal rules.

Given the rise and popularity of intrastate crowdfunding² and the various regulatory models states have utilized in implementing their own local crowdfunding exemptions, NASAA encourages the Commission and FINRA to work together with NASAA and its members to address potential issues that may present themselves in the registration of funding portals or other intermediaries that, depending on

¹ Notice of Filing of a Proposed Rule Change to Adopt the Funding Portal Rules and Related Form and FINRA Rule 4518, Exchange Act Release No. 34-76239, FINRA Release No. SR-FINRA-2015-040; 80 Fed. Reg. 66,348 (proposed Oct. 22, 2015).

² Currently 30 jurisdictions have adopted intrastate crowdfunding exemptions. *See* <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Crowdfunding-Index-11-10-2015.pdf>.

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their registration status or business models, may be precluded from acting as an intermediary in an interstate or intrastate crowdfunded offering.³

NASAA initially provided feedback to FINRA's proposed funding portal regulation⁴ in February 2014,⁵ and reviewed with interest this second iteration of the funding portals proposal. As the SEC has since promulgated the final crowdfunding rules, "Regulation Crowdfunding",⁶ it is appropriate to revisit our prior comments and to highlight new recommendations. Although funding portals are designed to be a simplified version of a broker-dealer, their role in facilitating crowdfunding transactions creates an important responsibility in combatting fraud and abuse. The potential \$1 million cap on capital raised under the exemption presents ample incentive for a fraudster looking to prey on vulnerable investors. While we appreciate FINRA's willingness to address potential issues through future rulemaking efforts, we, however, encourage FINRA to address potential shortfalls now before any investors lose money. Thus, we reiterate our call on FINRA to incorporate the following changes to its proposed funding portal rules, as outlined below.

Funding Portals Should be Required to Use the Central Registration Depository To Register and Make Ongoing Disclosures.

The Central Registration Depository ("CRD") was designed to provide an efficient process for firms and individuals to apply for federal and state licenses in one coordinated filing system. To maximize the effectiveness of the system, FINRA Rule 1010(a) requires a broker-dealer to file all forms through the CRD.

NASAA is mindful that funding portals represent a novel approach towards facilitating securities transactions, and FINRA aims to reduce the regulatory burden as much as possible to enhance the proliferation of this type of intermediary. However, it is because funding portals are new that we must ensure ample protections are in place to prevent abuse from the inception of this regulatory framework. Mandating the use of the CRD to file the proposed forms and related updates and disclosures represents a reasonable expense for the funding portals, while providing a central location for regulators to easily access information regarding funding portal operators. Mandating the use of CRD would also facilitate the regulatory cooperation necessary to address the potential issues related to intermediary registration and/or qualification based upon their participation in either federal interstate or local intrastate crowdfunding offerings.

Further, FINRA's proposed funding portal rules would require funding portals to provide detailed disclosures if it or any of its associated persons are involved in any number of circumstances involving customer complaints or arbitration proceedings.⁷ NASAA strongly supports the inclusion of these

³ For example, 15 U.S.C § 78c(a)(80) limits the definition of funding portals to only those entities engaging in offerings pursuant to the federal interstate crowdfunding provisions, which may prevent these entities from effectively participating in intrastate crowdfunding.

⁴ FINRA Regulatory Notice 13-34 (Oct. 2013), available at <http://www.finra.org/sites/default/files/NoticeDocument/p370743.pdf>.

⁵ Letter from Andrea Seidt, NASAA President and Ohio Sec. Comm'r to Elizabeth M. Murphy, Sec'y, SEC (Feb. 3, 2014), available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-to-FINRA-on-Proposed-Funding-Portal-Rules.pdf>.

⁶ 17 C.F.R. § 227.100 to 227.503 (2015).

⁷ See Attachment A: Proposed Funding Portal Rules (Oct. 23, 2013), available at <http://www.finra.org/sites/default/files/NoticeAttachment/p369763.pdf>.

important disclosures. It is, however, unclear whether this information will be made available to the public or to other regulators. In NASAA's view, funding portals' disclosure information should be publicly available through BrokerCheck and be available to state regulators through CRD. Mandating the use of the CRD would facilitate this important disclosure.

An Associated Person of a Funding Portal Should be Required to Obtain a License

FINRA continues to highlight the youthful nature of funding portals, with a constant focus on the limited scope of activities to be performed by funding portals. While it is true that funding portals will never directly handle cash, funding portals will directly interact with investors in important ways. The SEC's final rules allow funding portals to highlight particular offerings on their platform, advise issuers on the structure or content of proposed offerings, and advertise the offerings and services available on their platform.⁸ While funding portals may not be full service broker-dealers, these limited platforms play a critical role in facilitating the most basic of functions that we otherwise require associated persons of a broker-dealer to obtain a license to perform.

Investors need the protection that a licensure requirement of associated persons provides. The scaled back nature of funding portals and the related pared down regulatory costs will likely lead to lower costs to issuers to use their platform, and potential investors will likely benefit from this efficiency through reduced costs to purchase securities through a funding portal. While licensure would add a limited cost to funding portals, this limited cost would be greatly outweighed by the benefits provided by licensure, as it provides a layer of protection to investors and issuers that ensures individuals operate in a professional manner and are individually accountable for misconduct. Furthermore, subjecting associated persons to licensure and disclosure requirements will also help state regulators better police bad actors who may otherwise move across funding portals preying on investors. A licensure requirement for associated persons will only enhance the integrity and credibility of these new intermediaries. This benefits everyone – the funding portal, issuers, and investors – by providing an opportunity for the portal to market itself as fully registered and licensed thereby providing an opportunity to distinguish itself from the illegitimate investment opportunities already residing on the internet and social media.

At a minimum, FINRA should consider a licensure requirement for any person who is in a position with specific responsibilities under the funding portal rules, such as supervisory or compliance. Requiring these individuals to show a minimum level of competency in the securities field by passing a qualification examination has the potential to provide a huge payoff while creating only a minimal hurdle.

The Funding Portal Conduct Rule Should be Enhanced to More Closely Align with the Conduct Rules for Broker-Dealers

NASAA recognizes that not all of the existing rules for broker-dealers are appropriate for funding portals given their limited scope of activity. We further recognize that FINRA will be enforcing the SEC's funding portal rules. However, certain conduct rules may bear repeating given their investor protection significance, particularly given the overall limited approach to regulating funding portals and their associated persons.

⁸ See 17 C.F.R. § 227.402(b) (2015).

Specifically, FINRA Rule 2150 (Prohibition Against Guarantees and Sharing in Accounts), Rule 2210 (Communications with the Public), Rule 3220 (Influencing or Rewarding Employees of Others), Rule 3240 (Borrowing From or Lending to Customers), Rule 5230 (Payments Involving Publications that Influence the Market Price of a Security), and Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) all guard against conflicts of interest that place the investor at a significant disadvantage.

Reiterating important rules is not unduly burdensome, but instead provides multiple avenues for funding portals to understand their expectations when interacting with the public. Given that no associated person of the funding portals will be licensed in any way, providing multiple iterations of important requirements will help ensure that certain activities that create a conflict of interest are avoided.

Funding Portals Should be Prohibited from Placing Mandatory Pre-dispute Arbitration Agreements in their Customer Agreements

While NASAA has no objection to the use of voluntary arbitration clauses in customer agreements, we strongly oppose the imposition of mandatory pre-dispute arbitration agreements (“PDAAs”). In the context of crowdfunding, these agreements are particularly troubling because the small investment amounts may diminish an investor’s bargaining power. Moreover, a crowdfunding investor may wish to bring claims against both the funding portal and the issuer, and it appears the investor could be forced to bring the related claims in separate forums if the funding portal uses a PDAA requiring FINRA Dispute Resolution to be the arbitration forum.

FINRA contends that our initial comment on this topic was outside the scope of the proposed rule.⁹ Addressing this important investor protection issue is not beyond the scope of the portal rules. NASAA continues to believe that mandatory PDAAs are especially inappropriate in the agreements between funding portals and investors. Investors utilizing the services of a funding portal should not be prohibited from choosing the forum in which they can pursue their claims, especially as many investors will be investing less than \$5,000.¹⁰ Given the well-established and oftentimes simplified processes available to investors in small claims courts across the country, the arbitration forum and its related costs and complications are particularly burdensome. In addition to the small investment amounts involved, the ease of investing online and the expansive reach of crowdfunding throughout the country makes arbitration a less feasible means of settling disputes for far too many investors. Allowing aggrieved clients to file in their local courthouse is a more viable means to resolve these disputes, given that the impracticality of the FINRA Dispute Resolution fee structure will likely lead to many investors abandoning meritorious claims due to increased costs. Allowing a remedy in small claims court will provide investors with a more cost-effective forum to realize their claims.

Funding Portals Should be Required to Maintain Books and Records to Demonstrate Compliance with FINRA Rules.

The SEC adopted a recordkeeping rule for funding portals within Rule 404 of Regulation Crowdfunding. The rule requires funding portals to retain records for five years regarding an array of

⁹ See Attachment A: Proposed Funding Portal Rules, *supra* note 7.

¹⁰ See 17 C.F.R. § 227.100(a)(2)(i) (2015) (investor with either annual income or net worth below \$100,000 is limited to investing the greater of \$2,000 or 5% of the lesser of annual income or net worth over the 12 month period preceding the current transaction).

activity conducted by investors, issuers, including communications conducted on its platform. While we understand that FINRA does not want to duplicate SEC rules, it may be worth reiterating the importance of sound recordkeeping practices given the early stage of development of these funding portals and their potential unfamiliarity with the current regulatory environment.

Funding Portals Should be Required to Maintain a Fidelity Bond

NASAA disagrees with both the SEC and FINRA in not adopting a fidelity bond requirement for funding portals. As FINRA highlights, fidelity bonds protect against intentional fraudulent and dishonest acts committed by employees.¹¹ Given the minimal regulation of the associated persons working for funding portals, a fidelity bond provides necessary protection to funding portals for losses that may occur due to acts of their employees. Given the maximum investment amount of any single investor is \$100,000¹², the potential for fraudulent conduct on a lightly regulated platform does exist. Further necessitating a fidelity bond requirement is the fact that funding portals will not be members of the Securities Investor Protection Corporation (“SIPC”), which means customers of a funding portal will not receive SIPC protection.¹³ A streamlined fidelity bond requirement that accounts for a funding portal’s limited scope of activity is an economically feasible alternative given the risk that will otherwise exist for these portals.

NASAA is Concerned that Funding Portals are Not Subject to Suspicious Activity Report Filing Requirements

NASAA fully understands that the limited scope of funding portals includes a statutory mandate that such intermediaries have no ability to hold, manage, or possess investor funds. However, funding portals do interact directly with investors in a variety of capacities which places them in a keen position to report the type of suspicious activity required of the Bank Secrecy Act (“BSA”). While the SEC’s final crowdfunding rules do not require funding portals to comply with the BSA, the portals are required to engage in recordkeeping efforts related to BSA requirements.¹⁴ Adding a requirement for funding portals to provide suspicious activity reports (“SARs”) is a limited additional burden given the potential benefit in stopping money laundering or other forms of illegal activity. While the potential for future rulemaking is encouraging, preventing the loss of investor dollars and damage to our local businesses who are the likely crowdfunding issuers is paramount.

Conclusion

NASAA supports FINRA’s efforts to establish a rational regulatory framework that is workable for funding portals but is concerned that, as proposed, the regulations fail to provide adequate levels of protection for issuers and investors. We believe the comments we have noted if incorporated into the final rules would be a significant improvement and would serve the interests of our main street investors and local businesses.

¹¹ FINRA Fidelity Bond FAQs, available at: <https://www.personal-plans.com/finra/lite/faqs/category.do;itg?id=3976&planID=3921>

¹² See 17 C.F.R. § 227.100(a)(2)(ii) (2015).

¹³ See 15 U.S.C. § 78ccc(a)(2) (2000).

¹⁴ See 17 C.F.R. § 227.404(f) (2015).

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If you would like further information or clarification, please contact me or NASAA's General Counsel, A. Valerie Mirko, at (202) 737-0900.

Sincerely,



Judith Shaw
NASAA President
Maine Securities Commissioner