

ROCKETHUB

REGULATION OF CROWDFUNDING

BUILDING ON THE JUMPSTART OUR BUSINESS STARTUPS ACT

WHITEPAPER

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CROWDFUNDING – WHAT IT IS AND WHERE IT WILL GO

Crowdfunding describes Internet based, social media enabled, community powered fundraising. It is characterized by a low cost, low commitment structure with frequent communication, between fundraiser and funders, through status update and feedback mechanisms.

While the term “crowdfunding” is relatively new, having been coined within the last decade, the rituals behind it are deeply rooted in community based social behaviors. Communities have been funding business endeavors and social initiatives for centuries, and “friends & family” often fund seed-stage businesses. The growth of the Internet has allowed this community based funding process to move online, reducing transaction costs and broadening the potential audience. The success of this approach has been transformative, with hundreds of millions of dollars raised for creative, entrepreneurial, social, and scientific ventures through online crowdfunding.

This success is a testament to the advantages of a social media based funding platform over traditional funding models, specifically lower start-up costs, lower marketing costs and lower transactional costs. In turn, these advantages have driven smaller entrepreneurs, and those without high-finance contacts or backgrounds, towards fundraising through crowdfunding platforms.

Start-ups and small-business play a key role in the economic growth of the United States. The Kauffman Foundation reported, “*Without startups, there would be no net job growth in the U.S. economy.*”¹ Furthermore, 65% of all new jobs in the United States are created by small businesses, thus with new startup companies come employment opportunities. A healthy crowdfunding marketplace will create a ten percent increase in new business startups and 170,000 jobs over the next 5 years.² The development of this industry, however, has been limited by restrictions on the public sale of securities. Instead, the U.S. crowdfunding industry has been “perks based,” where users seeking funds (fundraisers) offer tangible goods or experiences to friends, family and the Internet as a whole, in exchange for funds.

Congress has recognized the benefits and potential of the crowdfunding approach to finance, and Title III of the JOBS Act (the CROWDFUND Act), greatly expands the role of crowdfunding in financing small businesses by permitting issuers to sell securities to their communities via licensed crowdfunding portals.

While the expansion of the industry will result in a multitude of changes for issuers and crowdfunding portals, we feel certain industry drivers will remain constant and should be kept in mind when developing or responding to industry regulation.

¹ <http://www.kauffman.org/research-and-policy/the-importance-of-startups-in-job-creation-and-job-destruction.aspx>,

² <http://mchenry.house.gov/News/DocumentSingle.aspx?DocumentID=283867>

- **Crowdfunding is Internet enabled.** Communication, education and payment are processed through and over the Internet, with little or no physical delivery of documents.
- **Crowdfunding is community based.** Fundraisers must reach out to the members of their communities, which in the age of social media are expansive and evolving concepts, to market and discuss their campaigns and engage their contributors/investors. In turn, those communities provide feedback that is shared among community members. This feedback can act to promote a good campaign or a reliable fundraiser, but it also acts to police campaigns and punish bad actors. Regulations should acknowledge the increasing role that social media plays in interactions, and the increasing reliance the people place on social media for information and interaction with others.
- **Crowdfunding grows with social media.** A fundraiser's success depends not only on the merits of their campaign, but also on convincing others of those merits. To reach the widest audience, a fundraiser must convince not only their social network to support the campaign, but convince members of that network to leverage their own social networks and communities to spread the word about the campaign. Seamless integration with social media platforms (e.g. Facebook, Twitter), and the ability to adapt and integrate new technologies into the funding portal, promotes the growth and success of crowdfunding campaigns. Without the ability to communicate with social networks, fundraisers will be unable to obtain necessary support.
- **Crowdfunding is low-cost.** Existing crowdfunding portals, such as RocketHub.com, use success based fees that average between 4%-6% of funds raised, plus credit card merchant fees, which are passed along to the fundraiser. This not only allows fundraisers with limited funds to begin campaigns, but also puts pressure on crowdfunding portals to avoid up-front costs. Regulations that add costs to crowdfunding will reduce the ability of start-ups to use crowdfunding to raise funds.

This paper explores the CROWDFUND Act and likely rulemaking, and suggests approaches to rules that will permit the crowdfunding industry to play an important role in financing entrepreneurs, while adequately regulating activities for the protection of investors.

COMPARISON WITH TRADITIONAL FUNDING PATHS

Traditional mechanisms for attaining growth capital in the United States include high interest debt products, bank loans, individual angel investors, intermediary organizations (investment banks, broker-dealers), and institutional investors. Although they provide billions of dollars of investment capital annually, these funding sources all possess a combination of three notable flaws that render them incompatible with most small businesses and startups:

1. Lack of transparency
2. Systemic discrimination against many types of entrepreneurs/businesses
3. Systemic discrimination against many types of investors

These drawbacks prevent thousands of entrepreneurs and businesses from attaining necessary growth capital. Crowdfunding directly addresses these failings by increasing transparency and providing an unbiased platform. Crowdfunding portals will provide a vital avenue for funding, and thereby create new sources of innovation, job growth, and overall economic activity.

High Interest Debt

High interest debt products such as credit card financing and peer-to-peer lending are generally the most costly forms of growth capital, and expose the individual entrepreneur to high levels of personal risk on defaults. Annual percentage rates (APR) for credit cards in the United States now average 13% and 14% for business and personal accounts respectively.³ Peer-to-peer lending platforms (e.g. Prosper.com, LendingClub.com) offer loans with an average 20% APR.⁴ Creditworthiness is determined by completing a financial credit check – an automated process through one of the three major credit bureaus: Transunion, Experian, and Equifax. This type of analysis is often not understood by the general public, and is susceptible to inaccurate and/or outdated data, increasing the probability of inaccurate estimates of creditworthiness.

Bank Loans

Banks generally offer business loans of under \$100,000 with a 7% - 8% APR and loans above \$100,000 with a 6% - 7% APR.⁵ While creditworthiness is determined by a more holistic approach (via an analysis of factors including an entrepreneur's and/or business' current financial standing, equity investment, earnings, working capital, collateral, and business plan),⁶ the process is not standardized. Transparency in the marketplace is diminished by these inconsistencies, and new entrepreneurs and businesses are penalized for having little-to-no track record or collateral, which eliminates bank loans as a realistic option for many start-ups.

Individual Investors

Leveraging individual investors (including friends & family, or angel investors) is one of the most popular funding mechanisms for new and emerging growth companies. However, each investor is legally required to be accredited, or exempted. This definition establishes significant income and/or net worth requirements, thus preventing more than 90% of the U.S. population from individually investing in new and emerging growth businesses.⁷

These stringent legal requirements have resulted in minority and women angel investors representing only 4% and 12% respectively of the overall angel population.⁸ Solicitation beyond an entrepreneur's and/or business' immediate network is highly regulated,⁹ decreasing the overall pool of investors available to the entrepreneur.

³ <http://www.creditcards.com/credit-card-news/credit-card-interest-rate-report-022212-1276.php>

⁴ <http://www.prosper.com/welcome/marketplace.aspx>

⁵ <http://smallbusiness.chron.com/average-interest-rate-small-business-loans-15342.html>

⁶ <http://www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/application-process/credit-factors>

⁷ http://www.census.gov/hhes/www/cpstables/032011/perinc/new01_001.htm

⁸ http://wsbe.unh.edu/sites/default/files/2011_analysis_report.pdf

⁹ <http://www.tollefsenlaw.com/answers/The-Law/Securities/General-Solicitation.asp>

Intermediary Organizations

Intermediary organizations such as investment banks and broker-dealers serve to connect emerging growth businesses with accredited investors. These intermediary organizations often possess a carefully guarded pre-existing portfolio of accredited investors, and charge significant fees (both flat fees upfront, and commission/equity fees on the back end) that often prove complex and prohibitively expensive for new and emerging growth businesses.

Institutional Investors

Institutional investors are defined by having a pre-existing pool of funds for investing in new and emerging growth businesses. These organizations seek high-growth businesses in highly scaleable industries, in order to generate large returns (20x - 100x) in short periods of time (3 - 10 years). These stringent requirements immediately eliminate many business categories, including most “brick and mortar” businesses, from consideration. Those that are selected run the risk of being pushed down the path of unsustainable growth in order to meet the institutional investor’s milestone requirements.

Crowdfunding portals open a new pathway to funding for a diverse group of businesses and investors. It is likely that a more diverse investor pool will lead to a higher incidence of investment in, and growth of, traditionally underfunded sectors of the start-up market – including women and minority-owned businesses.

TITLE III – CROWDFUNDING – ANALYSIS OF THE ACT

Congress established a number of important safety measures within the Act designed to maximize transparency, and minimize the possibility of fraud. Furthermore, the Act empowers the Commission with wide latitude to establish additional regulations in order to safeguard the new investor pool. However, over-regulation could stagnate this nascent market, making it difficult for either issuers or investors to participate. In order to assure proper implementation, clear and simple regulation is essential. RocketHub looks to provide feedback on specific provisions and their potential impact from the perspective of an established market leader within the Crowdfunding space.

SECTION 302

SEC.302.(a)/(6)(B) – ANNUAL INVESTMENT CAP

(B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction does not exceed –

(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;

Sec.302.(a)/(6)(B) contains a gap in logic that may expose regulation to creative interpretation. As written it is possible for an investor to find him/herself categorized under the authority of both subsections (i) and (ii). If that investor has an annual income greater than \$100,000 but a net worth less than \$100,000, it is unclear whether the investor should be limited to an annual investment cap of 5% or 10% of the annual income. If the situation is reversed, and annual income is less than \$100,000, but net worth is greater than \$100,000, the same ambiguity arises.

RocketHub Solution: In order to avoid confusion, the Commission should further clarify that if conditions under both subsections (i) and (ii) are true, the greater of income or net worth will be used to determine the restriction.

SEC.302(b)/SEC4A.(a)(4) – REQUIREMENTS ON INTERMEDIARIES

(4) ensure that each investor—

(A) reviews investor-education information, in accordance with standards established by the Commission, by rule;

(B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and

(C) answers questions demonstrating—

- (i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;
- (ii) an understanding of the risk of illiquidity; and
- (iii) an understanding of such other matters as the Commission determines appropriate, by rule;

It is critical to acknowledge the various mediums through which educational information can be delivered, and how the acknowledgement components can be gathered. These regulations will apply equally to broker-dealers and funding portals. As it is possible that Web-based funding portals will not have any off-line communication with users, funding portals must be allowed to complete these components via electronic communication. Electronic delivery will simplify the experience for both issuer and investor, and allow for proper oversight, as the portal will be able to track the delivery of required materials to each user and any required response.

SEC.302(b)/SEC4A.(a)(5) – FRAUD REDUCTION MEASURES

- (5) 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;

Background checks are useful in identifying issuers with a history of undesirable behavior, and may reduce the risk of fraud. However, blanket disqualifications based on certain information could result in discrimination against groups of people. For example, recent graduates often have poor credit scores due to limited credit history, but this demographic has also created some of this country's largest and most successful companies. Limiting an issuer's ability to crowdfund based solely on credit score would be inappropriate and against the spirit of the Act.

RocketHub Solution: Background and securities enforcement checks should be performed on all issuers as described in Sec.302(b)/Sec4A.(a)(5). Intermediaries should query commonly used databases for criminal background, bankruptcy filings, and tax liens, as well as cross check against Office of Foreign Assets Control (OFAC) sanctions lists, and Specially Designated Nationals (SDN) and Blocked Persons lists. The Commission will need to list specific disqualifiers as well as specific items that may not disqualify the issuer from participation, but the portal will be required to disclose to perspective investors. Portals will need to obtain liability waivers from prospective issuers before posting Commission mandated disclosures.

SEC.302(b)/SEC4A.(a)(6) – CAPITAL AND COMMITMENT WAITING PERIOD

(6) Not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the Commission may establish), make available to the Commission and to potential investors any information provided by the issuer pursuant to subsection (b);

RocketHub Solution: When establishing a crowdfunding offering via an accredited portal or broker-dealer, a minimum offering period of 21 days is required. This explanation is the most transparent and simple solution, as long as, per Sec.302(b)/Sec4A.(b)(1)(g), the issuer determines the price to the public and discloses such price at the start of the offering. For an in depth discussion of share price disclosure, please refer to the comments on Sec.302(b)/Sec4A.(b)(1)(g) below.

SEC.302(b)/SEC4A.(a)(7) – INVESTORS’ RIGHT TO RESCIND

(7) 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...

It is important that investors have the ability to cancel their commitments within a reasonable time limit. However, the right to rescind, as written, exposes both the investor and issuer to specific types of fraud and risk.

Pump & Dump:

An unscrupulous issuer could have fake investors “pump up” the campaign by committing large dollar amounts up-front, in order to create the appearance of momentum, thereby attracting other investors. If the rescission period is too long, those initial investors could slowly “dump” those investments, rescinding their commitments as new investors join. This amounts to fraudulent promotion through faux-investing, and should not be permitted.

Short Fall:

Investors who are allowed to rescind their commitments to invest, after the campaign has reached the target amount, may cause the campaign to fall short of the target amount. This short fall may jeopardize the entire offering if the issuer does not have enough time to replace the lost investors before the campaign expires.

RocketHub Solution: RocketHub believes that once an investor expresses intent to invest, his/her investment should be placed in a “pending” state for 24-hours. After that 24-hour rescission period expires, the investor’s funds should transition from “pending” to “committed,” and be held in escrow until transferred to the issuer. However, if the offering does not reach its funding target before the campaign deadline, investor funds should be released from escrow and returned to the investor. A short rescission period will protect investors from “pump & dump”

schemes, and minimize an issuer's exposure to the risk of "short fall." As Sec.302(b)/Sec4A.(a)(6) requires a minimum offering period of 21 days, the investor should have enough time to review the investment opportunity before investing. A longer rescission period is unnecessary.

As the act specifically allows for issuers to raise funds "greater than a target offering amount," the issuer must also establish an offering cap at campaign inception. This will protect the issuer by limiting over subscription.

As part of its portal, RocketHub plans to offer a new countdown mechanism. Once an offering reaches its cap amount, the "count down" to the offering deadline will be paused, awaiting the expiration of the last investor's rescission period. During the pause, RocketHub will continue accepting "investment pledges" and placing those who invest during the pause on a "wait list." If, during the pause, a pending investor exercises his/her right to cancel his/her investment, investors will be added from the wait list, until the cap is reached again, and the pause will continue. If the entire wait list is exhausted, without reaching the cap, the "count down" will resume.

SEC.302(b)/SEC4A.(a)(8) – INVESTOR RISK REDUCTION

(8) make such efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to section 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in section 4(6)(B);

Any regulation that requires the sharing of private investor information between platforms raises the potential of liability to platforms and risk to investors due to inconsistent security and communication standards between various intermediaries.

RocketHub Solution: Congress places the responsibility of enforcing annual investment caps with the intermediary. As an intermediary, RocketHub believes the most efficient, secure and responsible method for accomplishing compliance with the above section, while maximizing investor security, is to require each intermediary to monitor investor activity on its own platform and communicate directly with the Commission. Investors should be required to make representations to the intermediary of any investments made via another intermediary within the last year, before completing an investment, leading to a solution of on-site management. The Commission should also consider the necessity of this provision with respect to investors who are accredited investors and have generally been viewed as sophisticated.

SEC.302(b)/SEC4A.(a)(9) – DATA STORAGE SOLUTIONS

(9) take such steps to protect the privacy of information collected from investors as the Commission shall, by rule, determine appropriate;

The responsibility for storing confidential information should rest with the intermediary, and as such, data should not be shared with or stored by any other organization. Intermediaries should be required to store information in a secure fashion on a dedicated secure server. The Commission should indicate by rule or otherwise an appropriate industry standard for protection of this data. We suggest the Commission look to standards adopted in the legal and banking industries.

SEC.302(b)/SEC4A.(a)(10) – INTERMEDIARY COMPENSATION OF PROMOTERS

(10) not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investors.

“Personal identifying information” must be clearly defined. Currently, funding portals frequently promote top trending campaigns, and also compensate sites such as Facebook, and Twitter for placing the promotions on their platforms. Those sites in turn provide the portal with specific personal information on users whom express interest in the promotion, with the consent of the users. In addition, RocketHub is currently engaged in numerous partnerships with well-known academic institutions, not-for-profit organizations, creative organizations, and large corporations. In certain instances, funding portals may also engage in revenue sharing arrangements with third-parties that refer issuers (not investors) to the funding portal. Additionally, funding portals may engage in user sharing agreements with third-parties in order to provide access and educational materials to its partners.

RocketHub Solution: Funding portals should not be permitted to compensate promoters, finders, or lead generators for providing personal information such as social security number, mailing address, or phone/fax number of potential investors. However, funding portals must be allowed to compensate promoters, finders, or lead generators for directing potential issuers or investors to the funding portal to view either the portal itself or specific offerings. This allowance should not apply to broker-dealers working on individual offerings, but funding portals only. It is critical that new regulations do not restrict currently acceptable marketing practices. Furthermore, revenue sharing arrangements should not be restricted by new regulation where these relationships are not promoter, lead generator, or finder based. These relationships generally leverage the partner’s pre-existing user base and/or community to drive issuers to the funding portal, or allow advertising partnerships with issuers (where an established brand may promote an issuer’s project), which attract investors through greater exposure. RocketHub’s partnership structure allows for the partner to refer and/or direct it’s users to RocketHub’s portal through various avenues including, but not limited to, live events, conferences, digital placements, and links.

SEC.302(b)/SEC4A.(a)(11) – INTERMEDIARY’S FINANCIAL INTEREST IN ISSUER

(11) prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in issuer using its services...

RocketHub recognizes the concern that an intermediary with a financial interest in a specific issuer may be incentivized to display favoritism toward, or promote, that issuer’s campaign. We read this section with the intent of preventing the executive staff of funding portals from directly investing in offerings.

RocketHub Comment: The commission must clarify this section further, specifically with respect to how this rule may affect a registered investment company that shares ownership with a funding portal. Additionally, while officers, directors, or partners may not be able to invest directly, there is some ambiguity as to whether or not the intermediary as a company may establish a financial interest, and the status of trade loans or the extension of credit by a platform to an issuer using the platform.

SEC.302(b)/SEC4A.(a)(12) – OTHER REQUIREMENTS

(12) meet such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.

RocketHub Solution: RocketHub recognizes the Commission’s interest in establishing regulations to prevent fraudulent behavior of both funding portals and brokers. The following are suggested best-practices:

Escrow of Funds:

Given the nature of the relationship between intermediary (funding portal or broker), issuer and investor, the intermediary should be authorized by the issuer and investors to operate as an escrow agent to facilitate the transaction. The intermediary should be required to hold investor funds in a separate escrow account, segregated from the operating funds of the intermediary. The intermediary must establish policies that allow withdrawals from the escrow account, only for:

1. Payments to offerings that have successfully closed (having reached or exceeded their funding goals),
2. Payments to investors requesting refunds of uncommitted funds, or
3. Payment of established intermediary fees.

RocketHub, has already established banking policies governing its “holding account” that only allow withdrawals as described above.

The crowdfunding transaction requires the use of a third party (accredited funding portal, or broker-dealer). It is logistically impossible for the funds to transfer directly from a large number of investors to issuer in a timely fashion, without error.

Payment Methods:

Funding of investor accounts must be made via ACH, wire-transfer, or other secure funding method that allows capital to safely clear into the escrow account. Electronic Wallet systems that do not allow any form of debt-based payments should also be permitted.

Deposits should not be accepted via Credit Card. Credit Cards could cause investors to overextend themselves financially. Furthermore, credit cards permit investors to claim chargebacks on charges made, well after an issuance period.

SEC.302(b)/SEC4A.(b) –REQUIREMENTS FOR ISSUERS

(b) REQUIREMENTS FOR ISSUERS.— For purposes of section 4(6), an issuer who offers or sells securities shall —

The commission should not employ too narrow a focus when implementing these regulations. For example, a focus on small business only could exclude not-for-profit endeavors, as well as many other businesses, that might benefit from crowdfunded capital. RocketHub believes that letting the market evolve is a better practice than limiting the issuers by size, type, or other criteria.

SEC.302(b)/SEC4A.(b)(1)(D) – FINANCIAL CONDITION OF ISSUER

(D) a description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under section 4(6) within the preceding 12-month period, have, in the aggregate, target offering amounts of—

(i) \$100,000 or less—

(I) the income tax returns filed by the issuer for the most recently completed year (if any); and

(II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects;

(ii) more than \$100,000, but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the Commission, by rule, for such purpose; and

(iii) more than \$500,000 (or such other amount as the Commission may establish, by rule), audited financial statements;

Sec.302(b)/Sec4A.(b)(1)(D): As written, it is possible for an issuer to find him/herself subject to overlapping disclosure requirements. *Sec.302(b)/Sec4A(a)(7)* specifically refers to the possibility of raising capital “equal to or greater than a target offering amount.” It is possible that the target amount established falls under the jurisdiction of subsection (i) above, but the aggregate capital raised from all investors pushes the offering into the jurisdiction of subsection (ii). Additionally, while subsection D(i)(II) above requires issuers to provide certified financial statements, it is possible that an early stage company does not have historical financial statements to provide.

RocketHub Solution: In order to define the disclosures an issuer is required to make, the issuer must establish both a “target offering amount” and a “cap offering amount” at campaign inception. If the target and cap offering amounts straddle the divide between the subsections of *Sec4a.(b)(1)(D)*, the issuer must be subject to the higher standard of applicable disclosures.

Under subsection D(i)(I), income tax returns should not be required to be made public, even with omitted information. Selectively black-lining documentation increases the risk of error and exposure of confidential information. However, information can be taken from the issuer’s tax return and entered digitally, by the issuer, for inclusion in the offering.

The Commission should define what information from the tax returns is required, and the intermediaries can relay the information as entered by the issuer. The select information from the income tax returns can be filed with the Commission for oversight purposes. The Commission should provide some form of protection, as the portals cannot be held liable for verifying the information provided by issuers. Instead portals should provide disclosure that the information is unverified.

Financial statements should be interpreted to mean “historical financial statements” only for periods that the issuer has been in existence.

Sec.302(b)/Sec4A.(b)(1)(D)(ii) & (iii): These subsections specifically refer to the use of public accountants to certify or audit the financial statements produced by the issuer. Without oversight, it is possible that an issuer could accidentally or purposefully leverage the services of an unlicensed or unscrupulous accountant.

RocketHub Solution: The issuer must be required to provide information regarding the accountant used to certify or audit the financial statements, in order to allow investors to perform due diligence on the accountant, permit the intermediary to track accountant activities and block the use of accountants who produce poor quality/fraudulent work. The Public Company Accounting Oversight Board (PCAOB) has already determined certain statutory rulings to ensure protection of investors and the public interest. Commission requirements should leverage these standards for regulation, and the portal should receive a representation from the issuer that the accountant meets those standards.

Sec.302(b)/Sec4A.(b)(1)(D)(iii): Not all issuers will have historical financial information that can be audited. Furthermore, audits can be prohibitively expensive, counteracting the spirit of the Act when applied to offerings less than \$1,000,000.

RocketHub Solution: The Commission must acknowledge the expense of producing audited financial statements. *Sec.302(b)/Sec4A.(b)(1)(D)(iii)* specifically allows the Commission to adjust the target offering amount where audited financials are required. As audited financials are not generally a requirement of angel investments or venture capital investments of this size, RocketHub believes this amount should be raised to an amount in excess of \$1,000,000. RocketHub, recognizes that this will place the audit requirement outside of the exemptions laid out by Congress, but does not believe this contradicts the Act, rather it is consistent with the intent of the Act, and within the powers delegated to the Commission.

RocketHub also believes that audited financial statements should only be required for issuers that have been in operation for more than two years, and that the issuer should be required to provide audited financial statements only for the prior fiscal year.

SEC.302(b)/SEC4A.(b)(1)(F) – CAMPAIGN REQUIREMENTS

(F) the target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount;

Without a cap on the offering amount, investors and issuers are exposed to potential liabilities and complications, as the issuer could inadvertently sell more equity than intended, or is available. Additionally, the term “regular updates” is ambiguous.

RocketHub Solution: The issuer must set a “cap offering amount” at campaign inception, which is greater than or equal to the “target offering amount.” This will allow for oversubscription within a defined range. Issuers should be exempted from issuing status updates and/or reports so long as the funding portal publicly displays progress of the issuer in meeting the target offering amount. Given the nature of crowdfunding, it is likely that issuers will seek to frequently contact and encourage their supporters in any event. The intermediary should also provide a mechanism for investors and issuers to communicate with each other, but not require them to do so. If regular updates are mandated, the Commission should not mandate a particular format of update.

SEC.302(b)/SEC4A.(b)(1)(G) & (H) – METHOD FOR DETERMINING PRICE OF SECURITIES

(G) the price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities

(H) a description of the ownership and capital structure of the issuer, including—

The section above allows for campaigns to be structured in multiple ways, including a variable share price that may not be defined until the close of the campaign. As such, it also allows for an investor rescission period, after the campaign closes, to evaluate the final terms. Complex deal structures will invariably lead to the confusion of some investors, and an investor rescission period, which extends beyond the close of a campaign, exposes both the investor and issuer to specific types of fraud and risk.

RocketHub Solution: For a discussion of the investor’s right to rescind his/her commitment, please refer to the comments on Sec.302(b)/Sec4A.(a)(7) above.

Issuers must be able to issue various types of securities and classes. The burden of education lies with the issuer and intermediary. The Commission should establish a minimum required disclosure for issuers and intermediaries to use when communicating the price and structure of offered securities. The Commission should not, however, prescribe acceptable types of securities, as markets and securities may evolve.

RocketHub believes that for ease of understanding by the investor public, offerings will generally be limited to the following structures:

1. Convertible and non-convertible debt, or
2. Equity with a fixed share volume, fixed share price, and of a specific stock class.

As a responsible funding portal, RocketHub believes that equity structures are generally a better solution than debt. A fixed return on debt may be more damaging to startups than parting with equity. However, RocketHub does not believe the Commission should restrict offerings to equity vehicles only, but rather allow the market to evolve.

SEC.302(b)/SEC4A.(b)(2) – ADVERTISEMENT

(2) not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;

Depending on how this legislation is interpreted, issuers that leverage social media may be in violation. Given the nature of social media and how many people may view comments and postings at any given time, it is not clear what practical restrictions can or should be made. As written, RocketHub believes this clause should not apply to advertisement through social media and search platforms (e.g. Google, Yahoo) that does not give the actual price per share (i.e., the terms of the offering). Advertisements or notices on search platforms or through social media that (i) alert the public to the issuer’s project/company, (ii) state that the public may participate in the fundraising, and (iii) direct the public to the funding platform should be permitted. The

Commission should focus investor protection at the point of funding, where it can mandate disclosure by issuers.

RocketHub Solution: This clause should not restrict general postings on social media, partner sites, or search portals by issuer, investor, and/or the funding platform, even where the advertisements mention an investment opportunity. This rule is specific to advertising the terms of the offering. Therefore, simply advertising the fact that an offering is occurring, and directing investors to the funding portal should be permitted.

SEC.302(b)/SEC4A.(b)(3) – ISSUER COMPENSATION OF PROMOTERS

(3) not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the Commission shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication;

The subsection above, if read broadly, could unintentionally subject many standard practices to regulation. In its rulemaking, the Commission should be mindful of the interconnectedness of social media and cross-posting, as well as the fact that many issuers and their supporters may be more familiar with social media communications than the regulations under the securities laws. For example, read literally, issuer employees that invest in their employer could be regulated if they make a supportive post on the funding portal.

Additionally, many issuers hire consultants to help them manage a campaign on a funding portal. These consultants offer services including structuring the campaign, and paying for promotion on the funding portal and/or social media channels to draw attention to the project. In many of these cases, the consultant's services will be "behind the scenes" such that the consultant is not identified as a promoter of the issuer. In other instances, entities will promote issuers on their own websites, to drive traffic.

Finally, funding portals regularly have revenue sharing partnerships, with both for-profit and not-for-profit entities, that leverage shared user bases and communication channels. These partnerships may be used to attract either issuers or investors to the funding portal. As part of these relationships, the funding portal may pay the referring partner a fee, and advertise on or link to the referring partner's website.

RocketHub Solution: RocketHub perceives a distinction between an issuer hiring an individual or entity for promotion, where investors may not be aware of the commercial relationship between the parties, and more standard web-based advertising, including through search engines or trending topics. The Commission should not enact rules that may interfere with promotional compensation, but rather require simple disclosure of a commercial relationship where it would not otherwise be apparent.

Some partnership arrangements that RocketHub currently maintains are designed to promote active campaigns as well as raise interest and awareness of the RocketHub portal. At no point should portals be restricted in regards to their partnerships, as long as promotions of campaigns do not disclose or feature offering details. Portals must be allowed to compensate individuals or organizations for promotional services so long as those promotions are conducted in such a way that investors and issuers are directed to the portal for offering specifics.

If the Commission sets up registration processes for consultants, the issuer should be required to represent to the funding portal that all involved consults are appropriately registered. If advisory persons are not registered through the portal, they should not be able to receive compensation.

SEC.302(b)/SEC4A.(b)(4) – ANNUAL ISSUER REPORTS

(4) not less than annually, 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, subject to such exceptions and termination;

Issuers may not have the skills or resources to directly report to commission, due to lack of knowledge regarding channels, format, and means.

RocketHub Solution: Portals should be permitted to assist the issuer in meeting their filing obligations. The portals should not be required to do so, however, nor should they be liable for ensuring issuers file. Portals that provide this service should be allowed to charge a fee for the service. The Commission should provide a means for electronic filings to reduce filing errors and costs. The Act directs that the filing be made to the Commission and we believe providing this information to any other entity, such as a Self-Regulatory Organization (SRO), would be inconsistent with the Act's intent.

SEC.302(b)/SEC4A.(d) – STATE INFORMATION SHARING

(d) INFORMATION AVAILABLE TO STATES.—The Commission shall make, or shall cause to be made by the relevant broker or funding portal, the information described in subsection (b) and such other information as the Commission, by rule, determines appropriate, available to the securities commission (or any agency or office performing like functions) of each State and territory of the United States and the District of Columbia.

The Commission should not mandate that intermediaries use a third party to relay information to the States. Nor should any SRO be allowed to impose such requirements. Portals and broker-dealers should be allowed to communicate directly with the Commission and the States, or chose to use a third party API system to do so.

RocketHub Solution: From the perspective of an intermediary, RocketHub believes providing information to the States should be a passive obligation, only required if the State requests information in excess of what is provided to the Commission. The Commission should make the information it receives available to the various State agencies as needed. The Act directs that the information be provided to the Commission directly, and RocketHub believes providing this information to any other entity, such as a SRO, would be inconsistent with the Act.

SEC.302(b)/SEC4A.(e)(1) – RESTRICTIONS ON SALES

(e) RESTRICTIONS ON SALES.—Securities issued pursuant to a transaction described in section 4(6)—

(1) may not be transferred by the purchaser of such securities during the 1-year period beginning on the date of purchase, unless such securities are transferred—

(A) to the issuer of the securities;

(B) to an accredited investor;

(C) as part of an offering registered with the Commission;

or

(D) to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the Commission; and

RocketHub Solution: We believe a direct registration system, as discussed in “Regulation of Other Services” in this paper provides the best solution for policing transfers at a low cost. To the extent physical certificates are issued, however, they should be legended in a similar fashion as the Commission generally provides for restricted securities.

SEC.302(b)/SEC4A.(h)(2) – INCOME AND NET WORTH

(2) INCOME AND NET WORTH.—The income and net worth of a natural person under section 4(6)(B) shall be calculated in accordance with any rules of the Commission under this title regarding the calculation of the income and net worth, respectively, of an accredited investor.

An investor’s income and net worth should be calculated based on information the investor provides to the intermediary. Each funding portal must monitor investor activity on its platform, and enforce regulations based upon the representations made by investors. However, portals cannot, be held liable for any misrepresentation by issuers or investors. Under this standard, portals and brokers should be capable of achieving compliance with Commission regulations on their own. Third party involvement will slow the compliance process and create unnecessary bureaucracy.

SECTION 304

SEC.304(a)(1)/SEC3(h)(1)(B)

(B) is a member of a national securities association registered under section 15A;

The National Security Associations (NSAs) could circumvent Commission ruling by requiring all members to obtain licenses as broker-dealers.

RocketHub Solution: The NSAs should not be able to demand that a funding portal become a broker-dealer. It would be inconsistent with Congressional intent and language for NSAs to have this ability as well as create additional requirements and procedures outside the scope of the Act.

SEC.304(b)/SEC3(a)(80) – FUNDING PORTALS

(80) FUNDING PORTAL.—The term ‘funding portal’ means 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 (15 U.S.C.77d(6)), 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.*

3(a)(80)(A): RocketHub and other crowdfunding platforms frequently feature and advertise specific campaigns. RocketHub provides educational materials as well as consulting services in order to increase the campaign success rate, and also provides technical support. Furthermore, current funding portals such as RocketHub send out newsletters to their user bases highlighting specific campaigns. Through this practice, a funding portal may be perceived as indirectly offering investment advice or recommendations in violation of subsection (A) above.

RocketHub Solution: Funding portals should be allowed to continue to feature trending campaigns as promotional tools for the portal. In essence, a portal should be permitted to advertise to draw interest to its site and encourage other issuers to fund through it, or investors to participate. Portals should be barred from language that implies the risk level or quality of investment opportunity. However, if portals feature/highlight certain offerings based on discretion or specific metrics (e.g. topic, press, momentum) this should not be viewed as investment advice, recommendation, or solicitation. Nor should regulation interfere with a

portals ability to use its discretion to reject certain campaigns, and accept others. This practice should not be interpreted as endorsement of individual campaigns or investment advice.

3(a)(80)(B): Due to the public nature of a funding portal, the funding portal may be seen as indirectly soliciting investments by promotion of campaigns.

RocketHub Solution: Funding portals should be barred from soliciting investment for any specific campaign by providing offering details outside of the portal, but must be allowed to advertise more generally, as well as highlight offerings that are ongoing through various communication channels. Portals may also feature individual campaigns in advertisements, so long as those advertisements do not offer investment advice as discussed in subsection (A) above.

3(a)(80)(c): In the regular course of business a funding portal may have staff directed to handle business development and marketing initiatives. Subsection (C) above should not limit those standard business practices. Furthermore, crowdfunding portals such as RocketHub currently engage in revenue sharing agreements with large organizations, communities, institutions, and groups, often due to a shared customer base, interest, or activity. These forms of revenue arrangements should not be seen as violating the language or intent of the Act.

RocketHub Solution: Business development activities should be explicitly permitted by regulation.

3(a)(80)(D): RocketHub currently allows fundraisers to create perks-based campaigns online. During the term of the campaign, RocketHub collects the contributed funds and maintains those funds in an “segregated account,” insulated from its operating funds, maintained at a third party financial institution. When the campaign reaches its deadline, RocketHub transfers the collected funds to the fundraiser.

RocketHub Solution: Portals should be barred from managing an investor’s funds, with the exception of allowing those funds to be deposited in a segregated account, delivering those funds to successfully funded campaigns, and returning uncommitted funds to investors. RocketHub recommends adopting a policy that does not allow intermediaries to access the funds directly, except for the collection of fees for services rendered at rates agreed to by the issuer, investor, or other type of user. Intermediaries must not commingle funds in their own accounts but can use a separate designated account held by a third party, such as a bank.

3(a)(80)(E): The Commission must acknowledge that portals, in the regular course of business, may offer other revenue generating services, and cultivate revenue sharing partnerships. RocketHub is well positioned to be a beneficial service provider to issuers and investors by facilitating the crowdfunding process, and providing necessary educational tools. As such, RocketHub is considering offering several additional services. The Commission should not prevent portals such as RocketHub from perusing these corollary business endeavors.

REGULATION OF OTHER SERVICES

HOLDING AND TRANSFER OF SECURITIES

The JOBS act does not explicitly cover the practical issuance, and transfer of securities at the end of a successful crowdfunding campaign, when per SEC.304(b)/SEC3(a)(80)(D) portals are not permitted to “hold, manage, possess, or otherwise handle investor funds or securities.”

RocketHub Solution: The above cited subsection does not bar portals from assigning and/or transferring securities. Portals should be permitted to assist issuers with ministerial corporate duties and by keeping corporate stock ledgers. RocketHub believes that in the interest of oversight, security, and cost reduction, portals should be able to facilitate direct registration. Under this system the security is registered in the investor’s name on the issuer’s books, and the portal tracks the security for the investor as a book-entry. This will also allow investors to transfer securities in this way. The portal can act as a simplified transfer agent keeping the issuer’s records on file. RocketHub believes this method allows the portal to facilitate the registration and transfer of securities, without holding or managing the securities.

Direct registration will also allow portals to assist issuers by forwarding any correspondence from the issuer to the investor, including the annual reports discussed in SEC.302(b)/SEC4A.(b)(4). In addition, once permitted under SEC.302(b)/SEC4A.(e)(1), investors can more easily transfer securities through the portal. Since the portals hold a record of securities owned by various investors, on request the portals are able to print and provide paper certificates. This will allow portals to enforce transfer restriction by physically printing requirements on certificates.

It is important to note, that portals should be restricted to recording securities purchased on their portal, or securities transferred from one portal to another. Portals should not be permitted to act as full-fledged brokerage firms or transfer agents as that would violate SEC.304(b)/SEC3(a)(80).

The Commission should note that crowdfunding platforms are capable of providing additional services SEC304(b)/SEC3(a)(80)(E) that are necessary and beneficial to issuers and investors. The Commission should consider the efficiencies of having the portal provide those services, and should not restrict the portal as a service provider.

HOLDING AND DISBURSEMENT OF FUNDS

RocketHub is built on a virtual currency system that allows contributors to purchase RocketHub credits. Those credits are then allocated to support a particular campaign. Once regulations are put into effect, investors will be able to use RocketHub credits and allocate them as they see fit, including purchasing securities. RocketHub does not handle contributor/investor funds. When credits are purchased, contributor/investor funds are maintained in the segregated account throughout the life of those credits. All contributor/investor activity is registered through movement of virtual currency. RocketHub’s ledger states how many credits of virtual currency each contributor/investor has purchased, or has available, and how they have committed those

credits. If a contributor/investor has a balance of uncommitted credits they are entitled to a full refund of the value of those credits. Figure 1 is a visual representation of the flow of money on RocketHub's platform.

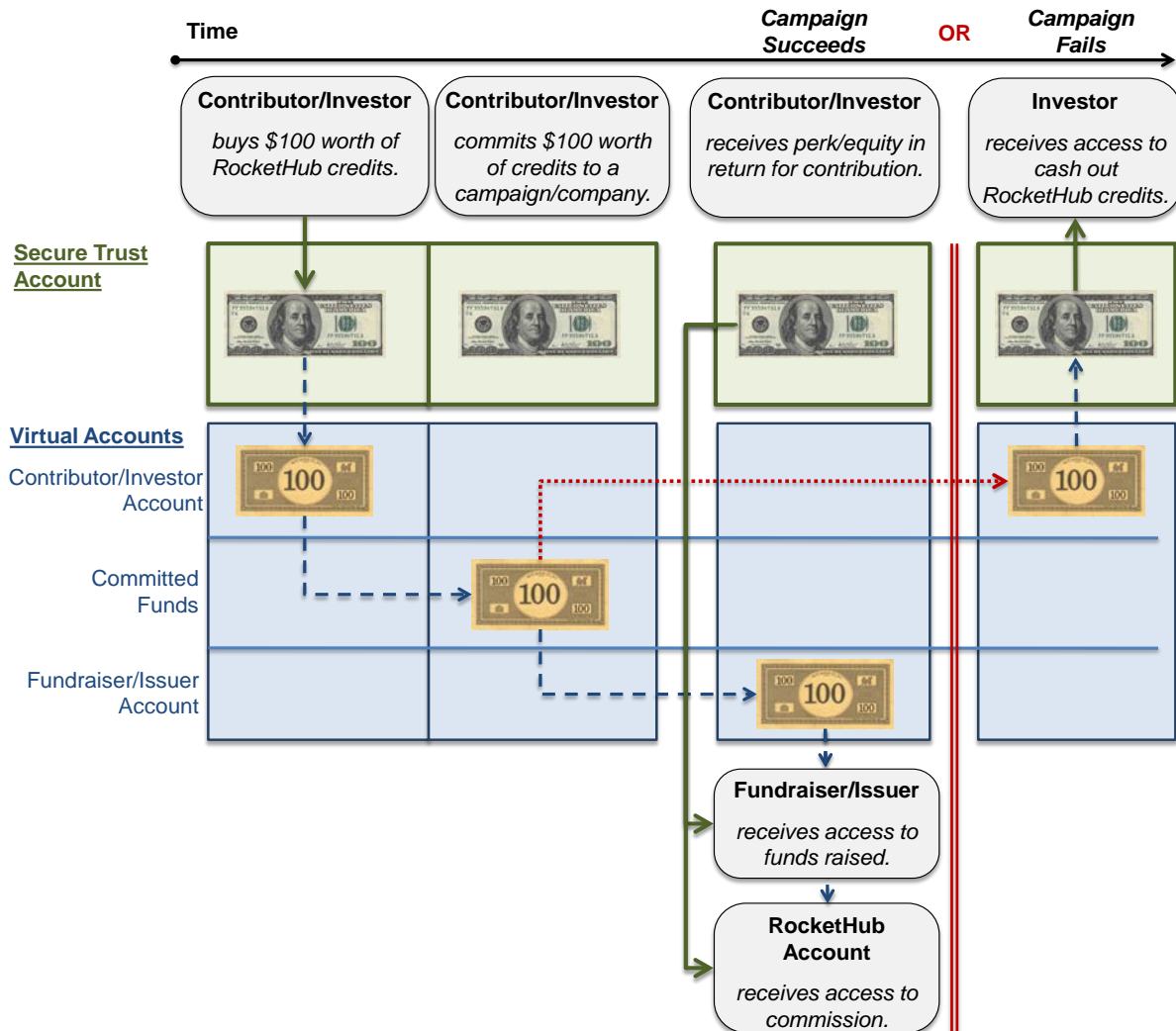


Figure 1

Throughout the life of a campaign, funds are maintained in a segregated account. They remain untouched until the offering ends, at which point the investor is either committed, or receives a credit to his/her account balance with the option to withdraw funds. RocketHub believes this system provides full oversight on flow of funds while providing a high-level of security for the issuer, investor, and portal. Furthermore, the investor has the flexibility to allocate funds as they see fit, and withdraw funds when they deem necessary.

* * *

Thank you for your attention. If you have any questions regarding the contents of this paper, or would like to contact us, you may do so at:

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DEFINITIONS:

- 1) Commission – The term “Commission” shall mean the Securities and Exchange Commission.
- 2) Portals – The term “Portals” shall mean any Crowdfunding Portal or platform.
- 3) Seed Funding – The term “Seed funding” shall mean any form of funding, including but not limited to debt and equity based methods, up-to and including \$1,000,000.
- 4) CROWDFUND act – The term “CROWDFUND act” means the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” as defined in Sec.301 of H.R. 3606, also known as being part of the JOBS Act.
- 5) Issuer – The term “issuer” shall mean as any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4(6) of the 1933 Securities Act, and any person who offers or sells the security in such offering.
- 6) NSA – The term “NSA” shall mean National Securities Association registered under section 15A.
- 7) Emerging Growth Company – The term “Emerging Growth Company” is defined by the Title I Section 2(a) of the Securities Act of 1933 amendment defining ‘emerging growth company’ as an issuer that had total gross revenues of less than \$1,000,000,000¹⁰.
- 8) SRO – The term “SRO” shall mean a Self-Regulatory Organization that exercises some degree of regulatory authority over an industry or profession.
- 9) OFAC – The term “OFAC” shall mean Office of Foreign Assets Control of the US department of Treasury.

¹⁰ Indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumer published by the Bureau of Labor Statistics.