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Equity Crowdfunding under the JOBS Act and SEC Proposed Rules: an Ineffective Compromise

Kevin Hogan

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by

Kevin Hogan

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EQUITY CROWDFUNDING UNDER THE JOBS ACT AND SEC PROPOSED RULES: AN INEFFECTIVE COMPROMISE

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INTRODUCTION

Marin Morrison was a world-class swimmer with dreams of competing in the Olympics, but in January 2009, she lost her four year battle against brain cancer.[1] Desperate to preserve his daughter's legacy and share her inspirational experience with others, Marin's father, Matt Morrison, sought to detail Marin's touching story in an independently published book that he wrote himself.[2] Faced with the myriad of costs associated with getting his project off the ground, Mr. Morrison created an account on kickstarter.com, made a 4 minute video describing his daughter and the project she inspired, and asked for backers to contribute to his goal amount of $45,000.[3] Incredibly, the project was completely funded—actually raising $49,181—within the thirty day funding period.[4] The money was donated by 379 backers, many of whom were strangers, from locations across the country in amounts varying from $1 to more than $5,000.[5]

Although this anecdote of a man raising a sizeable quantity of money to finance a new project is a tremendous feat, it is no longer unique.[6] Since kickstarter, one of the biggest —but certainly not the only—online crowdfunding platforms, launched its website in 2009, it has raised more than $962,000,000 for over 55,000 successfully financed independent projects.[7] With modern technology proving capable of changing the landscape of fundraising, many advocated to modify the longstanding securities laws in order to allow small businesses to utilize

[1] Matt Morrison, *Touch—The Marin Morrison Story*, Kickstarter (Jun. 18, 2013), available at https://www.kickstarter.com/projects/68829029/touch-the-marin-morrison-story

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] Kickstarter.com alone has successfully financed more than 55,000 projects. https://www.kickstarter.com/help/stats. Additionally, there are other crowdfunding sites, such as www.gofundme.com, www.indiegogo.com, and www.upstart.com, that similarly display the ability to effectively raise funds via the internet.

[7] https://www.kickstarter.com/help/stats

this fast and cost-effective method of raising money to support their budding enterprise.[8] The call for crowdfunding appeared to be answered by Congress through the passage of the Jumpstart Our Business Startups Act ("JOBS Act") in 2012, which, among other things, authorized the Securities and Exchange Commission ("SEC") to promulgate rules that would allow companies to engage in crowdfunding to raise funds from investors without registering under the securities laws.[9] Although the SEC failed to meet the 270 day deadline set by Congress for the agency to create regulations to carry out the crowdfunding provisions,[10] many crowdfunding advocates' hope returned when the SEC commissioners unanimously agreed to proposed rules regarding investment crowdfunding regulations in October 2013.[11] However, the initial optimism from many supporters largely dissipated after reading the 585 page text of the proposed rules.[12]

This Note discusses the terms required by the statutory language of the JOBS Act and evaluates whether the proposed rules effectuate those terms in a manner that will be practicable for small businesses. There is a clear disconnect between the two primary goals of the investment crowdfunding legislation: (1) allowing companies to reach investors quickly and cheaply, and (2) investor protection. Unfortunately for small businesses strapped for capital, the SEC's proposed rules likely fail to reconcile these disparate aims.

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[8] Deborah L. Cohen, *Fund for All: 'Crowdfund' Supporters Look to Congress to Lighten Regulatory Load*, A.B.A. J. (Mar. 1, 2012), available at http://www.abajournal.com/magazine/article/fund_for_all_crowdfunding_supporters_look_to_congress_to_lighten_regulatory/; Kent Hoover, *SEC's Crowdfunding Strategy Seemed to be "What's the Hurry?"*, WASH. BUREAU (Dec. 26, 2013), available at http://www.bizjournals.com/bizjournals/washingtonbureau/2013/12/20/sec-finally-gets-around-to-proposing.html

[9] Pub. L. No. 112-106, 2012 HR 3606 (April 5, 2012), 126 Stat 306.

[10] *Id.* '

[11] Anton Root, *SEC Proposes Rules on Crowdfunding in Unanimous Vote*, CROWDSOURCING (Oct. 23, 2014), available at http://www.crowdsourcing.org/editorial/sec-proposes-rules-on-equity-crowdfunding-in-unanimous-vote/29008; Dave Michaels, *SEC to Issue Crowdfunding Proposal Easing Investor Verification*, BLOOMBERG (Oct. 18, 2013), available at http://www.bloomberg.com/news/2013-10-17/sec-to-release-crowdfunding-rule-easing-investor-verification.html.

[12] Sarah N. Lynch, *SEC Releases 'Crowdfund' Rule*, REUTERS (Oct. 23, 2013), available at http://www.reuters.com/article/2013/10/23/us-sec-crowdfunding-idUSBRE99M03O20131023

Part I examines the historical background of both the securities laws and crowdfunding measures. Part II looks first at the requirements mandated under the JOBS Act and then seeks to provide a brief summation and explanation of the most important provisions of the SEC's 585 page rule proposal release. Part III evaluates the likely ramifications of the requirements under the currently proposed rules and discusses some of the critical problems contained in the proposed scheme. Part IV offers an alternative approach to implementing equity crowdfunding in a way that preserves benefits to issuers without unduly jeopardizing investor security.

I. HOW DOES EQUITY CROWDFUNDING FIT WITHIN THE FEDERAL SECURITIES LAWS?

Unless an exemption is available, all securities offerings must be registered with the SEC pursuant to the federal securities laws.[13] Registration, however, is not practicable for early-stage small businesses seeking relatively small amounts of capital because it is prohibitively expensive and time-consuming.[14] Under existing securities laws, equity crowdfunding falls within the definition of a security and no current exemption reasonably applies to remove such an offering from the onerous registration requirements.

A. The purposes and underlying principles of the federal securities laws

The principal federal securities laws in the United States, the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), were enacted in response to the 1929 stock market crash that many believe led to the Great Depression.[15] In

[13] "Section 5(c) of the Securities Act provides that no one may offer securities until a registration statement has been filed with the SEC. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2010). Section 5(a)(1) of the Act prohibits sales of those securities until the registration statement has become effective. Id. § 77e(a)(1)." C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 42 n.197 (2012).

[14] Bradford, *supra* note 13, at 42 (citing Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & Bus. 1, 7-8 (2007); Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They 'Suitable' for the Retail Investor?*, 72 S. Cal. L. Rev. 67, 75 (1998).

[15] *First Inaugural Address of Franklin D. Roosevelt* (Mar. 4, 1933), *reprinted in* 2 DOCUMENTS OF AMERICAN HISTORY 239, 240 (H. Commager 9th ed. 1973); *Letter from Franklin D. Roosevelt to Sam Rayburn* (Mar. 26, 1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND

response to the widespread belief that unregulated speculation caused the eventual crash, the federal securities laws created a disclosure-based system in which the primary goal is to protect investors by ensuring that they have access to as complete and accurate information as possible.[16] Securities sold in the United States must be registered pursuant to the Securities Act unless the seller perfects an exemption.[17] As mentioned above, the purpose of the general registration requirement is to compel companies issuing securities to fully disclose relevant and current information to investors so that investors can make informed decisions.[18] The downside to this disclosure-based system, however, is that it places heavy burdens on corporations seeking to raise capital.[19]

Despite the general prohibition against selling unregistered securities, not all offerings of securities must be registered with the SEC.[20] "By exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering the cost of offering securities to the public."[21] These exempt securities and transactions[22] have been carefully

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SECURITIES EXCHANGE ACT OF 1934, item 18 (J. Ellenberger & E. Mahar eds. 1973) [hereinafter LEGISLATIVE HISTORY] ("The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted boom which had so much to do with the terrible conditions of the years following 1929.")

[16] Schreiber v. Burlington N., Inc., 472 U.S. 1, 8 (1985); Elisabeth Keller & Gregory Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 338 (1988).

[17] 15 U.S.C.A. § 77d (West 2012).

[18] http://www.sec.gov/about/laws.shtml

[19] *See* John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583 (2013).

[20] *Id.*

[21] *Id.*

[22] Exempt securities, which are mostly found in§3 of the Securities Act, describe securities to which the exemption attaches to the security itself such that the security itself is exempt from registration. Marc I. Steinberg, SECURITIES REGULATION (6th ed. 2013). Exempt transactions, which are mostly found in§4 of the Securities Act, describe specific transactions, such as a private offering that meets certain requirements under §4(a)(2), that are exempt. *Id.* For exempt transactions, the issuer or seller must perfect an exemption each time a separate transaction occurs. *Id.*

constructed and adjusted in order to ensure an appropriate balance between allowing companies to access capital and protecting investors.[23]

B. What is crowdfunding and how does it fit within the framework of the federal securities laws?

Crowdfunding, previously only permissible on a non-securities basis,[24] is the practice of raising capital through small investments from a large pool of investors, typically through offers conducted via the internet.[25] Equity crowdfunding regulation seeks to close a perceived funding gap by allowing companies, particularly start-ups and small businesses, to capitalize on advancing technology by using the Internet to raise money from the community in a manner never before allowed under the securities laws.[26] The goal is to allow companies that have conventionally been unable to borrow from banks or utilize traditional equity markets to receive contributions from large numbers of ordinary investors in return for an equity interest in the venture.[27] Because investors receive an equity interest in return for their investment, crowdfunding offerings of equity would need to conform to the burdensome requirements of state and federal securities laws without the addition of a new exemption.[28]

As it has continued to gain momentum, equity crowdfunding has created excitement among entrepreneurs and professionals involved in the securities markets and regulation because

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[23] To illustrate this point, consider a private offering issued pursuant to the Regulation D exemption. Under this exemption, the issuer is released from registration and reporting requirements under the securities laws, but the issuer must satisfy certain disclosure and other requirements in order to perfect the exemption. 17 C.F.R. § 230.506. Additionally, Reg. D prohibits the offer or sale of the securities to more than non-accredited investors, and completely prohibits the offer or sale to any non-accredited investor if the issuer engages in general advertising or solicitation. 17 C.F.R. § 230.506. Thus, issuers raising funds through an exempt offering are not given carte blanche; rather, they are afforded leeway so long as they comply with the prescripts of the exemption.

[24] Non-equity models of crowdfunding—i.e. the rewards based model that repays investors with a tangible reward rather than an equity interest in the company—do not trigger the securities laws provisions because they do not involve the sale of a security. See, e.g., Bradford, *supra* note 13, at 29-31.

[25] Lindsey Anderson Smith, *Crowdfunding and Using Net Worth to Determine Investment Limits*, 90 DENV. U.L. REV. ONLINE 127, 129 (2013).

[26] *See* Rory Eakin, *Crowdfunding Fills Gap for Investors and Companies*, THE STREET (Oct. 19, 2012), http://www.thestreet.com/story/11742415/1/crowdfunding-fills-gap-for-investors-and-companies.html.

[27] Anderson Smith, *supra* note 25, at 129.

[28] Bradford, *supra* note 13, at 29 (concluding that equity crowdfunding involves a sale of securities and, therefore, triggers the securities law registration and reporting requirements).

many believe it offers the potential to drastically reduce the strain of disclosing information under the paper-based securities laws while maintaining similar levels of investor protection.[29] Using the internet to facilitate investment in start-up companies creates an opportunity to ensure that all potential investors have access to the same information, which can be updated quickly and cheaply and also provides an electronic record of all communications and transactions that occur through this medium.[30] Many of the loadbearing provisions of the federal securities regulatory framework have been in place for more than eighty years and could not possibly have foreseen the advent of a means of disseminating information as is currently possible via the Internet.[31] Unfortunately, as one critic observed, the Jobs Act inappropriately took a deductive approach to regulating equity crowdfunding by trying to "squeeze a modern-day investing technique into a dated regulatory scheme."[32] Rather than attempting to force equity crowdfunding into the traditional regulatory framework, Congress should have acknowledged that current technology completely changes the methodologies required to structure transactions and convey information between parties.[33]

Similarly, equity crowdfunding presents a rather unique occasion for Congress and the SEC to rethink their commitment to a disclosure-based system as the primary mode of protecting investors. The disclosure-based system has long been exalted for minimalizing government intervention while providing potential investors with the information necessary to assess the

[29] Wroldsen, *supra* note 19, at 601.

[30] *Id.* In addition to the cost savings to issuers and the increased speed of communications available through Internet-based crowdfunding, investors would arguably benefit from certain increased protections under such an electronic system. Because there is an electronic record of all disclosures made and any communication between investors and the issuer, for example, violations of the anti-fraud provisions of the securities laws would seemingly be easier to prove.

[31] William R. McLucas et. al., *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. LAW. 1221, 1222 (1996). *See also* Wroldsen, *supra* note 29, at 601.

[32] Wroldsen, *supra* note 29, at 601 ("While a deductive approach is 'top down,' giving priority to existing legal regimes and principles and seeking to accommodate new phenomena within established legal frameworks, an inductive approach is 'bottom up,' giving priority to new phenomena and seeking to revise existing legal frameworks to meet innovative demands.").

[33] *Id.*

pertinent risks and make an informed decision regarding whether to invest.[34] In assessing the risks associated with equity crowdfund investing and determining the proper regulatory response to those risks, however, a new approach may be more effective.[35] The history of the Rule 504 exemption provides a historical analogy through which regulators can contemplate how best to control investing under equity crowdfunding.[36] The SEC has acknowledged the similarities between companies whose stock was used to defraud investors under Rule 504 and crowdfunding companies, and has also recognized the need to protect investors from fraud.[37] Nonetheless, the effectiveness of disclosure requirements as a means of protecting investors is disputed, especially in the crowdfunding context where many investors have little experience or expertise in understanding such financial disclosures.[38]

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[34] Howell E. Jackson, *Regulation in A Multisectored Financial Services Industry:*, 77 Wash. U. L.Q. 319, 344 (1999).

[35] Wroldsen, *supra* note 19, at 601.

[36] Rule 504 permitted small companies to offer unregistered securities directly to the general public without substantive disclosures and, as a result, unscrupulous promoters capitalized to "facilitate a number of fraudulent secondary transactions," the most common of which was the pump-and-dump scheme in which fraudsters would artificially inflate the price of a security and then unload the securities on a secondary market before investors discovered the artificial inflation of the stock price. Wroldsen, *supra* note 29, at 603-04 (quoting Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7541 (May 21, 1998), available at http://www.sec.gov/rules/proposed/33-7541.htm.). As originally adopted, the exemption was limited to offerings or sales up to $500,000. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,257-58 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239) (adopting Regulation D). "Under the current version of the rule, any nonpublic company may take advantage of the $1 million ceiling, but the offering cannot be made through a general solicitation of purchasers, and resales of securities are restricted unless the offering is registered under state law." Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws-Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1769 (2012) (citing 17 C.F.R. §230.504(b)(2)).

[37] *See* Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform, 112th Cong. 11 (2011) (statement of Meredith B. Cross, Director, Division of Corporation Finance, Securities and Exchange Commission) ("The Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures . . . . In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market . . . . In assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.").

[38] *See e.g.* Bradford, *supra* note 24, at 109-12; Robin Hui Huang, *The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis*, 41 H.K. L. J. 261, 272-75 (2011); Wroldsen, *supra* note 29, at 609.

> [D]isclosure documents like prospectuses are close to impenetrable for many investors. When faced with complex structured products, investors are more likely to use emotional responses . . . [; thus,] risk disclosure does not necessarily lead to risk awareness on the part of average investors[, which] casts doubt on the effectiveness of disclosure-based regulation . . . [particularly because] even in the [United States], retail investors have limited knowledge of finance and are not capable of fully understanding disclosures.[39]

Thus, although disclosure has traditionally been the predominant safeguard against defrauding investors, mandated disclosure of complex financial information may be ineffectual in the context of crowdfunding.[40] Rather than the replacing the disclosure-based reporting system with a federal merit review system, the best alternative is to implement a system that protects investors without placing prohibitive costs on issuers and intermediaries. Namely, reducing the investment cap so that each investor is limited to $250 per year reduces the loss exposure for investors without burdening issuers with unaffordable compliance costs.[41]

II. UNDERSTANDING CURRENT PROPOSED CROWDFUNDING PROVISIONS

Before evaluating the merit of the current state of the equity crowdfunding laws, it is crucial to understand those laws. Therefore, this section attempts to succinctly lay out the central provisions contained in the JOBS Act and the proposed SEC rules.

A. Equity crowdfunding under the JOBS Act

Under the JOBS Act, a company may raise up to $1 million through equity crowdfunding in any rolling twelve-month period.[42] The language of the $1 million aggregate limit exhibits a

[39] Wroldsen, *supra* note 29, at 609 (quoting Huang, *supra* note 35, at 272-75).

[40] To be fair, the SEC has taken actions to combat the misunderstanding of business disclosures by requiring companies to present disclosures in plain language and focusing increasing importance on Management's Discussion and Analysis as a means to explain the disclosures to investors in a meaningful way. Even so, crowdfunding, by presenting investment opportunities to the crowd, offers investment opportunities to many unsophisticated potential investors who are particularly unlikely to understand financial disclosures—if they review them at all. Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 753-77 (2006).

[41] *See* Part IV.A

[42] JOBS Act, Pub. L. No. 112-106, 126 Stat. 302 (2012); Securities Act of 1933 §4(a)(6)(A); 15 U.S.C. § 77d(a)(6) ("the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the

clear Congressional intent that if a company was able to raise $1 million in a twelve-month period, the company should not also be allowed to conduct an equity crowdfunding offering to raise additional funds during that period.[43] The JOBS Act also institutes investor caps that limit the amount of money an issuer is permitted to raise from a single investor through equity crowdfunding within a twelve-month period.[44] For investors having annual income *or* net worth below $100,000, the aggregate amount of securities sold by an issuer to any investor cannot exceed the *greater of* $2,000 *or* 5% of the investor's annual income or net worth within a twelve-month period.[45] In regard to investors who clear the $100,000 annual income or net worth threshold, the twelve-month investment is limited to 10% of the investor's annual income or net worth, but not to exceed $100,000 over the twelve-month period.[46] The statutory language makes clear that the amount subject to the investment cap for each investor includes the aggregate of securities sold under the equity crowdfunding exemption as well as any other provision of the federal securities laws.[47] Therefore, if an issuer receives an investment pursuant to another exempt offering from a particular investor that exceeds the investment cap under the crowdfunding exemption, the issuer is prohibited from selling securities to that investor pursuant to an equity crowdfunding offering within a twelve-month period.[48] Additionally, securities sold pursuant to the crowdfunding exemption are restricted securities and, except for certain excused

exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than $1,000,000.").

[43] SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before the Subcommittee on Investigations, Oversight and Regulations of the House Committee on Small Business, 113th Cong. 14-18 (2014) (statement of Mercer E. Bullard, Director, Business Law Institute University of Mississippi School of Law) (noting that the Act's use of the phrase "including any amount sold in reliance on the [crowdfunding] exemption" clearly demonstrates that the $1 million limitation applies to all securities offerings during the twelve month period).

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.* ("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 . . . .") (emphasis added).

[48] *Id.*

transfers laid out in the statute, cannot be transferred by the purchaser for one year after the date of the purchase.[49]

The JOBS Act also requires that each transaction must be conducted through an online intermediary that is registered with the SEC[50] as a broker-dealer or funding portal.[51] These intermediaries are required to comply with considerable regulatory provisions.[52] The Act directs the SEC to implement rules requiring brokers and funding portals to provide disclosures to investors relating to risks and investor education materials.[53] Although the SEC is provided with substantial discretion in determining the specific requirements, the rules must require a broker or funding portal to take action to ensure that investors review the disclosures, affirm that they understand the risk of loss, and verify their understanding of the particular risks of investing in start-ups, emerging businesses, or small issuers.[54] Brokers and funding portals are also required to investigate the issuer's officers, directors, and major shareholders by "obtaining a background and securities enforcement regulatory history check" to reduce the risk of fraud to investors.[55] Adding to the oversight function thrust upon intermediaries under the JOBS Act, broker-dealers and funding portals are subject to SEC rules designed to guarantee that purchasers have not exceeded the investment limitations for all equity crowdfunding offerings by any issuer during a twelve-month period and also must ensure that the offering proceeds are turned over to the issuer

[49] Section 4A(e) (prohibiting the transfer of securities within one year of purchase, except when transferred: (1) to the issuer of the securities; (2) to an accredited investor; (3) as part of an offering registered with the Commission; or (4) to a family member of the purchaser or the equivalent, or in connection with certain events, including death or divorce of the purchaser, or other similar circumstances, in the discretion of the Commission.).

[50] These intermediaries are also required to "register with any applicable self-regulatory organization." 15 U.S.C.A. § 77d–1.

[51] *Id.* The term funding portal describes a new registration category, created to specifically for crowdfund offerings, that hosts an online platform on which securities transactions are conducted.

[52] *See* JOBS Act §304, 126 Stat. at 321-22.; 15 U.S.C. § 78c.

[53] *Id.*

[54] *Id.*

[55] *Id.* The broker or funding portal is also required to make certain information—information provided by the issuer—available to investors and the SEC at least twenty-one days in advance of the offering. *Id.*

only when the target offering amount is reached.[56] While the clear purpose of charging intermediaries with overseeing much of the equity crowdfunding process is to increase investor protection by adding prophylactic safeguards against fraud, the requirements place a heavy burden on intermediaries, especially intermediaries that facilitate transactions for many issuers.

B. SEC proposed rules

The SEC voted unanimously to propose "Regulation Crowdfunding," which is the set of rules designed to implement equity crowdfunding, for public comment on October 23, 2013.[57]

1. ISSUER REQUIREMENTS

The equity crowdfunding exemption is available only to companies incorporated or organized under the laws of a state or territory of the United States.[58] Additionally, investment companies,[59] companies required to file annual reports under the Exchange Act, and blank check companies[60] cannot employ the crowdfunding exemption.[61] Any issuer seeking to raise capital via equity crowdfunding must file specified information with the SEC.[62] Issuers must disclose the name, legal status, physical address, and website address of the company, along with basic information regarding directors, officers, and persons that are beneficial owners of 20% or more

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[56] *Id.*

[57] Press Release, Sec. & Exch. Comm'n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Uwv3ZvldWBI .

[58] SEC Proposing Release at 35.

[59] This refers to companies that fall into the definition of an "investment company" under the Investment Company Act of 1940.

[60] "A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person." Answers: Blank Check Company, Sec. Exch. Comm'n (Aug. 10, 2012), http://www.sec.gov/answers/blankcheck.htm

[61] SEC Proposing Release at 35.

[62] Issuers are required to file Form C on EDGAR, the SEC's data handling system. SEC Proposes Regulations Implementing "Regulation Crowdfunding" Under Section 4(a)(6) of the Securities Act, CROWDCHECK (Oct. 2013), http://www.angelcapitalassociation.org/data/Events/Webinars/CrowdCheck-CrowdfundingOverview.pdf. In addition to filing these required disclosure forms with the SEC, issuers are also obligated to investors and intermediaries. *Id.*

of the issuer's outstanding securities.[63] These disclosures must also include the issuer's number of employees as well as a description of the business and the projected plan for the business, though the SEC has clarified that it does not require nor expect companies to provide "business plans."[64] Under the proposed rules, the company must also reveal the material terms of any indebtedness and any exempt offering conducted within the past three years as well as certain related-party transactions.[65]

Along with pertinent information about the company, an issuer must provide information concerning the offering itself. Any company relying on the crowdfunding exemption must disclose the target offering and deadline with a discussion clarifying whether it will accept investments beyond the target amount.[66] If the company plans to accept capital beyond its target, it must describe how oversubscriptions will be distributed.[67] An issuer must also explain the material risk factors of investing in the offering, specifically discussing any rights held by principal shareholders, the valuation method used to value the securities and any changes that method may undergo in the future, and the hazards minority shareholders face, giving particular consideration to dilution of interest as the result of future issuances of additional securities or issuer repurchases.[68] Issuers must also inform investors that they are buying restricted securities and that, with limited exceptions, securities purchased in the offering may not be resold for one year following the initial purchase.[69]

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[63] SEC Proposing Release at 41.

[64] SEC Proposing Release at 58.

[65] SEC Proposing Release at 59.

[66] SEC Proposing Release at 53-54.

[67] SEC Proposing Release at 53-54.

[68] SEC Proposing Release at 121. The discussion of risks facing minority shareholders should include the dangers associated with certain corporate action, such as, issuing additional shares and repurchasing existing shares.

[69] SEC Proposing Release at 153, 271.Within the restricted period, however, investors are free to sell the securities to the following persons, among others: (i) to the issuer of the securities; (ii) to an accredited investor as defined in Regulation D; (iii); to a family member of the purchaser; or (iv) to any investor as part of an SEC registered offering. SEC Proposing Release at 271.

Despite requiring considerable issuer disclosures and permitting relatively flexible communication among investors and issuers within the intermediary's platform, the exemption places strict limits on advertising.[70] An issuer's notice promoting the terms of an offering is limited to the following:

> (1) a statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the potential investor to the intermediary's platform; (2) the terms of the offering;[71] and (3) factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer.[72]

Notices allowed under the exemption are similar to "tombstone ads," but they must also direct investors to the intermediary's website.[73] Although no other public communication regarding the offering is permissible, an issuer may communicate with current and potential investors about the offering through communication channels provided through the intermediary's platform, but the issuer must identify itself as the issuer in any such communications.

The two issuer disclosure requirements that seem to have garnered the most attention, however, are the financial statement reporting obligation and the ongoing disclosure requirements.[74] For purposes of reporting financial statements, the crowdfund exemption categorize offerings into three categories: (1) offerings of $100,000 or less require the issuer to

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[70] SEC Proposing Release at 107-11. An issuer may "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker." SEC Proposing Release at107.

[71] "Under the proposed rules, "'terms of the offering' would include: (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period." SEC Proposing Release at 111.

[72] SEC Proposing Release at 109-10.

[73] SEC Proposing Release at110.

[74] *See e.g.* Robb Mandelbaum, *What the Proposed Crowdfunding Rules Could Cost Businesses*, N.Y. TIMES, Nov. 14, 2013, http://boss.blogs.nytimes.com/2013/11/14/what-the-proposed-crowdfunding-rules-could-cost-businesses/?_php=true&_type=blogs&_r=0; Sherwood Neiss, *It might cost you $39K to crowdfund $100K under the SEC's new rules*, VENTURE BEAT, Jan. 2, 2014, http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/; David Nicklaus, *Crowdfunding rules contain too much red tape for some*, ST. LOUIS POST DISPATCH, Nov. 1, 2013, http://www.stltoday.com/business/columns/david-nicklaus/crowdfunding-rules-contain-too-much-red-tape-for-some/article_96cb42d7-f07b-515b-8183-57962eb00ef2.html.

provide financial statements that have been certified as true and complete by the issuer's principal executive officer in addition to the company's tax returns; (2) offerings of more than $100,000, but not more than $500,000, mandate that the issuer provide financial statements reviewed by an independent public accountant; and (3) offerings of more than $500,000 require the issuer to provide financial statements that have been audited by an independent public accountant.[75] In determining the extent of review necessary, the value of the offering is calculated by aggregating the amount of securities offered with the issuer's other equity crowdfunding offerings for the previous twelve months.[76] In addition to filing these disclosures with the SEC and posting the information on its website in conjunction with the offering, the issuer must also file and disclose similar information each year on a continuing basis until the company becomes a reporting registrant under the Exchange Act, the securities are no longer publicly held, or the company dissolves or liquidates.[77]

2. Intermediary Requirements

As mandated by the JOBS Act, offerings made pursuant to the proposed equity crowdfunding exemption must be made through a single intermediary—either a broker or a funding portal.[78] In addition to registering with the SEC and a self-regulatory organization, intermediaries must comply with significant procedures designed to monitor issuers and protect investors.[79] The intermediary must have a reasonable basis to believe that the issuer is in compliance with all applicable requirements of the regulatory provisions governing the exemption.[80] Similarly, the intermediary is responsible for verifying that investors are within the

[75] SEC Proposal Release at 22, 24-26.
[76] SEC Proposal Release at 19-20.
[77] SEC Proposal Release at 92-96.
[78] SEC Proposal Release at 123.
[79] *See generally* SEC Proposal Release at 132-219.
[80] Intermediaries are permitted to rely on the issuer's reasonable representations in establishing a reasonable basis of the issuer's compliance with the Proposed Rule.

annual investment limitations provided by the crowdfunding exemption.[81] As with the issuer compliance rule, the intermediary satisfies its duty by obtaining a reasonable basis for believing the investor has complied with the rule and is allowed to rely on the investor's reasonable representations.[82] Another investor protection provision commands intermediaries to conduct background and history checks on each issuer, along with the issuer's directors, officers, and major shareholders.[83] Intermediaries are required to deny access to their platforms if they have a reasonable basis to believe the issuer, a director, officer, or major shareholder violates the Bad Actor provisions.[84]

The Proposed Rules also elaborate on the educational materials that intermediaries must present to investors pursuant to the exemption.[85] The materials required by the proposed rules must include:

> • the process for the offer, purchase and issuance of securities through the intermediary;
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> • the risks associated with investing in securities offered and sold in reliance on Section 4(a)(6);
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> • the types of securities that may be offered on the intermediary's platform and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution;
>
> • the restrictions on the resale of securities offered and sold in reliance on Section 4(a)(6);
>
> • the types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information, and the possibility that the issuer's obligation to file annual reports may terminate in the future;
>
> • the limitations on the amounts investors may invest, as set forth in Section 4(a)(6)(B);
>
> • the circumstances in which the issuer may cancel an investment commitment;
>
> • the limitations on an investor's right to cancel an investment commitment;

[81] SEC Proposal Release at 168.
[82] *Id.*
[83] SEC Proposal Release at 136.
[84] SEC Proposal Release at 141.
[85] SEC Proposal Release at 152-60.

• the need for the investor to consider whether investing in a security offered and sold in reliance on Section 4(a)(6) is appropriate for him or her; and

• that following completion of an offering, there may or may not be any ongoing relationship between the issuer and intermediary.[86]

The educational materials must be presented to investors when they open accounts with the intermediary and must be in plain language.[87]

Additionally, the proposed rules require "an intermediary to provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform, subject to certain conditions."[88] Intermediaries must facilitate transparent communication channels that provide public access to the discussions taking place in the channels, but the ability to post information within these channels must be restricted to persons who have opened an account with the intermediary on its platform.[89] Moreover, the intermediary is to require all persons posting a comment on these channels to "clearly and prominently disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer's offering."[90]

Intermediaries are subject to varying limitations, depending on whether they register as brokers or as funding portals.[91] Unlike registered broker-dealers, the proposed rules prohibit funding portals from: (1) offering investment advice or recommendations; (2) soliciting purchases, sales or offers to buy the securities displayed on its platform; (3)

[86] SEC Proposing Release at 153-54.
[87] SEC Proposal Release at 152.
[88] SEC Proposing Release at 175.
[89] SEC Proposing Release at 176-78.
[90] SEC Proposing Release at 178.
[91] SEC Proposing Release at 123.

compensating employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform; or (4) holding, managing, possessing, or otherwise handling investor funds or securities.[92]

3. Issuer and Intermediary Liability

Section 4A(c) of the JOBS Act provides that an "issuer" is liable to crowdfunding investors if it makes an untrue statement of material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading—unless the purchaser knew of the untruth or omission, or the issuer did not know, and in the exercise of reasonable care could not have known, about the untruth or omission.[93] The SEC's proposed rules suggest that intermediaries may face liability under Section 4A(c) in connection with investor lawsuits, including suits concerning offering documents that are posted on the intermediary's platform because the statutory language applies this liability to "any person who offers or sells the security in such offering."[94] Based on this statement, the SEC indicated that "it appears likely that intermediaries . . . would be considered issuers for purposes of [the] liability provision."[95]

Further, the JOBS Act and proposed rules do not relieve issuers or intermediaries from liability arising under other anti-fraud statutes or rules of the current securities laws.[96] This means that, in addition to the potential liability provided under the JOBS Act, issuers continue to face liability for manipulative or deceptive practices or misleading statements under the often utilized Rule 10b-5.[97] Similarly, issuers, intermediaries, and everyone who "willfully

[92] JOBS Act, Pub. L. No. 112-106, 126 Stat. 302 (2012).
[93] SEC Proposing Release at 280.
[94] SEC Proposing Release at 280.
[95] SEC Proposing Release at 280.
[96] SEC Proposing Release at 281.
[97] SEC Proposing Release at 240 n.623.

participates" in an offering face liability for false or misleading statements made to encourage a securities transaction under Section 9(a)(4) of the Exchange Act.[98] As a result, both issuers and intermediaries must determine what due diligence procedures are necessary to prove that the issuer or intermediary did not know it and reasonably could not have known it.[99]

III. FLAWS IN THE PROPOSED REGULATORY SCHEME

The legislative and regulatory framework created by the JOBS Act and the proposed rules is unlikely to provide an effective tool through which corporations can raise capital because it provides onerous regulatory requirements with relatively low maximum capital limits. For experienced companies with sufficient resources, pursuing a capital raise under another statutory exemption (i.e. private placement offerings under Regulation D) provides more bang for the corporation's buck. For entities without sufficient means to employ one of the current exempt offering options, the proposed crowdfunding rules include barriers that are likely insurmountable.

As discussed above, the proposed rules allow individuals to invest up to certain thresholds established under the JOBS Act,[100] limit the amount of capital an issuer can raise in a given period, require issuers to disclose certain information regarding the offering, and create a regulatory scheme for intermediaries facilitating crowdfund offerings.[101] Under the proposed rules, issuers are able to raise up to $1 million in any 12-month period from unaccredited investors through an intermediary.[102] Although the language of the JOBS Act indicates that the

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[98] SEC Proposes Regulations Implementing "Regulation Crowdfunding" Under Section 4(a)(6) of the Securities Act, CROWDCHECK (Oct. 2013), http://www.angelcapitalassociation.org/data/Events/Webinars/CrowdCheck-CrowdfundingOverview.pdf.

[99] Client Memorandum, SEC Proposes Rules for Crowdfunding Intermediaries, DAVIS POLK (Nov. 2013), file:///C:/Users/Owner/Downloads/11.18.13.SEC_.Proposes.Rules_.Crowdfunding.Intermediaries%20(1).pdf.

[100] Because the proposed rules simply implement the investor caps mandated by the JOBS Act, and discussed in Part II.A, this section will not recount those requirements.

[101] Part II.B.

[102] SEC Proposed Rule at 10 *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

$1 million limit should be aggregated with any other funds raised by the issuer within a 12-month period,[103] the SEC's proposed rules do not aggregate the amount raised in an equity crowdfund offering with funds raised in other types of offerings.[104] The SEC justifies its divergence from the statutory mandate based on a perceived ambiguity in the Act:

> Title III provides that the $1 million limitation applies to the "aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under [Section 4(a)(6)]." Section 4A(g), however, provides that "[n]othing in the exemption shall be construed as preventing an issuer from raising capital through means other than [S]ection 4[(a)](6)." These two provisions create statutory ambiguity because the first provision could be read to provide for the aggregation of amounts raised in all exempt transactions, even those that do not involve crowdfunding, while the second provision could be read to provide that nothing in the Section 4(a)(6) exemption should limit an issuer's capital raising through other methods.[105]

Under a proper reading of the Act's plain language, however, there is no ambiguity. The first provision under review is only amenable to one meaning: the $1 million cap applies to all securities sold by the issuer.[106] The second provision, which the SEC found to create ambiguity, posits that nothing in the equity crowdfunding exemption shall be understood as **preventing** an issuer from raising money through other means.[107] Applying the $1 million limit to all capital raised by the issuer in a twelve-month period does not prevent an issuer from raising money through alternative means; it merely *delays* the issuer's ability to raise funds through other

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[103] JOBS Act, 126 Stat. 302 (2012); Securities Act of 1933 §4(a)(6)(A); 15 U.S.C. § 77d(a)(6) ("the aggregate amount sold to all investors by the 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, is not more than $1,000,000.").

[104] SEC Proposing Release at 16-20.

[105] SEC Proposing Release at 16-17.

[106] For a thorough analysis of the appropriate statutory construction of this provision, *see* SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before the Subcommittee on Investigations, Oversight and Regulations of the House Committee on Small Business, 113th Cong. 14-23 (2014) (statement of Mercer E. Bullard, Director, Business Law Institute University of Mississippi School of Law).

[107] §4A(g).

means.[108] Moreover, the SEC's tortured reading of the statutory language is inconsistent with the underlying purpose of the exemption:[109] "to alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts."[110] The SEC's improper application of JOBS Act is important not simply because it fails to carry out Congressional intent, but also because such a reading makes it more likely that small-businesses—the companies the JOBS Act sought to help—may be squeezed out of the crowdfunding market by larger companies.[111]

Of the requirements on issuers, the most contentious are the financial disclosures and the ongoing reporting requirements. Specifically, many critics have voiced their objections to the requirement that for equity crowdfunding offerings of $500,000 or greater, the issuer must provide CPA audited financials.[112] To provide perspective for just how arduous this requirement is, consider that the requirements for a Regulation D offering, which does not limit the amount of capital that may be raised, allow an issuer to forego audited financial statements if such statements cannot be obtained without unreasonable effort or expense.[113] Although the equity crowdfunding exemption is intended to protect small and emerging companies, there is no flexibility for these companies to avoid the expensive audit requirement, even though such

[108] Bullard, *supra* note 43, at 22 ("The SEC's interpretation makes a mockery out of Congress's plain English use of the phrase in the provision: 'including any amount sold in reliance on the exemption provided under this paragraph.'").

[109] *Id.* at 23 ("the Commission's interpretation flatly contradicts its repeated characterization of the entities for which crowdfunding was intended as a 'small businesses' raising 'small dollar amounts' in order to remedy existing 'funding gaps.'").

[110] Proposing Release at 11; 78 Fed. Reg. 214, at 66496 (Tuesday, November 5, 2013).

[111] Bullard, *supra* note 4343, at 22.

[112] *See e.g.* SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before the Subcommittee on Investigations, Oversight and Regulations of the House Committee on Small Business, 113th Cong. (2014) (statement of David J. Paul, Co-Founder of Crowdfunding Intermediary Regulatory Advocates) available at http://smallbusiness.house.gov/uploadedfiles/1-16-2014_paul_testimony_-_djp_-_final.pdf; Mandelbaum, *supra* note 74; Sarah N. Lynch, *SEC releases 'crowdfunding' rule*, REUTERS, Oct. 23, 2014, http://www.reuters.com/article/2013/10/23/us-sec-crowdfunding-idUSBRE99M03O20131023; Andrew Ackerman & Angus Loten, *SEC Moves Ahead With 'Crowdfunding' Proposal*, WALL ST. J., Oct. 23, 2014, http://online.wsj.com/news/articles/SB10001424052702303615304579153463087785476.

[113] 17 C.F.R. §230.502(b)(2).

allowances are made for larger offerings under Regulation D.[114] Therefore, the reporting requirements for offerings of $500,000 or more will likely have the effect of driving issuers to utilize Regulation D offerings or perhaps cause them to limit the offering to under $500,000 to avoid the onerous auditing requirements.[115] In addition to making a portion of the exemption ineffective, such a result would also undermine the Congressional purpose of making investment opportunities more accessible to unaccredited investors because Regulation D severely limits the ability for investment by unaccredited investors.[116]

In addition to the burdensome financial disclosures an issuer must make at the time of the initial offering,[117] the issuer must also provide a narrative discussion of its financial situation that is very similar to a Management Discussion and Analysis section of an Exchange Act report or Form S1 of a registration statement.[118] Along with the issuer's hefty initial disclosure requirements, it must annually update investors, the SEC, and its intermediary with financials to the same extent required at the time of the initial raise (i.e. financial disclosure requirements depending on the amount of money raised in the initial offering).[119]

As discussed above, many of the conditions placed upon intermediaries come directly from the JOBS Act.[120] For instance, the JOBS Act requires that intermediaries provide educational materials to investors and receive positive affirmation that the investor has reviewed

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[114] *Id.*; Mandelbaum, *supra* note 74.

[115] *Id.*

[116] *Id.*

[117] Under the JOBS Act and proposed rules, an issuer raising $100,000 or less must provide two years of financial statements, certified by the principal executive, as well as its most recent tax return. Companies raising between $100,000 and $500,000 must disclose only the financial statements, but the statements must be reviewed by an independent certified public accountant. Companies raising more than $500,000 must have their financials audited. SEC Proposal Release at 22, 24-26.

[118] *Id.* at 66-67.

[119] *Id. at 92-97.*

[120] *See* Part II.A.

and understood the materials.[121] The proposed rules clarify that offerings must be conducted exclusively online through a platform operated by a registered broker or a funding portal[122] and that the intermediary is responsible for providing educational materials to investors and taking measures to ensure that the materials are accessible to investors.[123] The proposed rules fail, however, to provide any clear indication of how intermediaries are to satisfy the Act's requirement that intermediaries "ensure that each investor reviews investor-education materials."[124] In fact, the proposed rules suggest that an intermediary may satisfy this obligation by presenting information in a clickwrap agreement that merely requires investors to check a box acknowledging that they have read the materials.[125] Although such agreements have been endorsed in other contexts,[126] they fail to capitalize on the unique opportunity presented by disseminating information via the Internet and also fail to properly protect investors by verifying that they have actually reviewed the information. The internet provides the tools for intermediaries to create a more effective system to ensure that investors adequately review disclosures. Among the myriad of procedures proposed by commentators, perhaps the simplest and most effective would be to "require that each investor scroll through a series of web pages that show only one or two short sentences in a large font setting forth the most important investor-education facts, with a button confirming that they have read them and a link to more

[121] JOBS Act §304, 126 Stat. at 321-22.; 15 U.S.C. § 78c.

[122] SEC Proposal Release at 31.

[123] Although the SEC makes intermediaries responsible for ensuring that investors receive meaningful educational materials in an accessible manner, the Commission provides intermediaries broad flexibility in determining the proper way to satisfy the investor-education requirement. Possible exampl

[124] Bullard, *supra* note 43, at 28 (quoting JOBS Act, 126 Stat. 302 (2012).

[125] *Id.* Clickwrap agreements, which typically requires a user to select a box recognizing that he or she has read the required materials before the user can proceed, have become standard practice throughout the software industry. See Nathan J. Davis, *Presumed Assent: The Judicial Acceptance of Clickwrap*, 22 BERKELEY TECH. L.J. 577, 579 (2007).

[126] Davis, *supra* note 125.

information related to that webpage."[127] Such a system would be inexpensive to implement and would provide a significant opportunity for each investor to consider the material information relating to the issuer and the offering in a clear, accessible manner. There are many ways in which intermediaries can deliver educational information to investors in a meaningful and economical manner, and the SEC should not allow intermediaries to shirk their educational responsibilities by permitting clickwrap agreements that let investors bypass disclosures designed to protect them.

As explained previously, the SEC's interpretation of issuer liability section 4A(c) suggest that funding portals may fall within the definition of an "issuer" under that section.[128] If this interpretation of the statutory language is correct—and it appears to, in fact, be accurate—funding portals, their directors, officers, and other employees involved with an offering bear enormous levels of risk because they could face personal liability for each transaction conducted through the platform.[129] Imposing such a high degree of risk on intermediaries may cause conservative market participants to stay out of these offerings completely while only more aggressive participants are willing to bear the risk, which is a dangerous proposition for a budding market's long-term success.[130]

IV. PROPOSED LEGISLATION

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[127] Bullard, *supra* note 43, at 29.
[128] *See supra* Part II.B.3
[129] Paul, *supra* note 112, at 5. As Paul explains:

> The proposed consequence for a violation under this provision is to allow an investor to recover the amount of his or he investment, even if he or she no longer holds the security.
>
> To put a fine point on this, this would mean that if the platform does one hundred $1 million deals, then each of a portal's affiliated persons would have $100 million in personal exposure. A portal effectively becomes a guarantor for every single statement in every offering document of every offering on its platform.

Id.

[130] Paul, *supra* note 112, at 6.

Because the burden placed on issuers under the current proposed rules is too onerous compared with the capital raising potential under the exemption, a new strategy is required if Congress and the SEC realistically expect businesses to utilize an equity crowdfunding exemption to the federal securities laws. The main problem is that, under the current structure, it simply isn't worthwhile for businesses to utilize the exemption because compliance costs are high and the amount that can be raised is low. Naturally, then, the changes to the structure can occur by either focusing on reducing compliance costs or by increasing the amount that may be raised under the equity crowdfunding exemption. Although either approach would create more incentive for businesses to utilize the exemption, increasing the maximum offering amount would have a lesser impact on the group the exemption was designed to assist—small and emerging businesses. Raising the offering amount and maintaining—or perhaps increasing—disclosure requirements and the costs associated with compliance would create another exemption tailored for large companies that are knowledgeable with SEC compliance and can afford the high costs. By maintaining a conservative offering limit and reducing costs of compliance, however, small and emerging companies would have a greater opportunity to access new sources of capital. Although these changes would greatly increase the practicability of the exemption, it does not solve or address a remaining problem: issuers and intermediaries face immense liability risk under the current framework.[131]

A. Reduce the investment cap

In order to reduce the compliance costs of the equity crowdfunding exemption, Congress must find a method of protecting investors other than through heavy issuer disclosure obligations. By imposing lower investment limitations on investors that are closer to the original

[131] The risk of liability facing issuers and intermediaries under the JOBS Act and the proposed rules presents a significant problem, but that problem is beyond the scope of this article.

proposed figure of $250 per investor in a 12-month period,[132] the risk to each investor is substantially mitigated. Although this would greatly reduce the individual investment amount in any 12-month period, the lower risk to investors would allow Congress and the SEC to reduce or eliminate many of the current disclosure and reporting requirements.[133]

The securities laws' disclosure-based system has used access to information as the primary mechanism through which to protect consumers.[134] Investing in new companies and small businesses, however, is inherently risky and there is generally little dependable information regarding the business on which investors can rely in making their decision to invest.[135] When one combines the lack of reliable business information available, the inherent riskiness of investing in these types of companies, and the general inexperience and ignorance of many of the investors targeted by equity crowdfunding, the futility of the proposed reliance on disclosures to protect investors becomes apparent. Traditional disclosure requirements add significant costs to conducting the offering for issuers and, under these circumstances, offer marginal benefits to investors.[136]

Instead, imposing smaller investment caps on investors within a 12-month period in any particular issuer reduces the risk to investors by simply decreasing their loss exposure. Because of the reduced potential risk to investors, there is no need to impose onerous requirements on

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[132] Jenny Kassan, *The JOBS Act leaves crowdfunding investors unprotected — the SEC is working with a flawed law*, VENTURE BEAT, Oct. 31, 2013, available at http://venturebeat.com/2013/10/31/the-jobs-act-leaves-crowdfunding-investors-unprotected-the-sec-is-working-with-a-flawed-law/.

[133] http://venturebeat.com/2013/10/31/the-jobs-act-leaves-crowdfunding-investors-unprotected-the-sec-is-working-with-a-flawed-law/; http://www.youtube.com/watch?v=Vi-KBrezafQ

[134] *See* Part I.B

[135] SEC Proposal Release at 334 (citing Alicia Robb, E.J. Reedy, Janice Ballou, David DesRoches, Frank Potter and Zhanyun Zhao, An Overview of the Kauffman Firm Survey: Results from the 2004-2008 Data, Kauffman Foundation, available at http://www.kauffman.org/uploadedFiles/kfs_2010_report.pdf); SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before the Subcommittee on Investigations, Oversight and Regulations of the House Committee on Small Business, 113th Cong. (2014) (statement of Daniel S. Gorfine, Director of Financial Markets Policy at the Milken Institute) available at http://smallbusiness.house.gov/uploadedfiles/1-16-2014_gorfinetestimony_final.pdf.

[136] *See* Part I.B.

companies raising money under the crowdfunding exemption, such as requiring audited financial statements. Not only does this approach provide a more cost-effective approach for small issuers' to raise capital, but it also provides a more effective means of investor protection because, rather than relying on highly speculative and volatile disclosures from these start-ups and small businesses, it reduces investors' exposure to loss.

B. Aggregate the $1 million limit on offerings with all other offerings by the issuer within 12-month period

As discussed above, the plain language of the JOBS Act indicates that the $1 million limitation applies to the aggregate of all offerings conducted by the issuer in a 12-month period, but the SEC has taken the position that the $1 million limit stands alone and should not be combined with any other offerings by the issuer.[137] Refusing to aggregate a crowdfunding offering with the issuer's other offerings runs contrary to the exemption's stated "goal of alleviating the funding gap faced by startups and small businesses" because it creates an advantage for larger entities looking to use an equity crowdfunding offering to supplement additional offerings.[138] Rather than aiding small businesses in attaining the necessary capital that has traditionally been so hard to come by, "every large issuer will consider whether it would be an effective social strategy to conduct a crowdfunding offering in order to 'reach out' to their small shareholders while the issuer is also conducting a concurrent private offering from which small investors would be excluded."[139]

By aggregating the amounts raised in these offerings, small businesses, rather than larger more established businesses, would be encouraged to utilize crowdfunding offerings in raising

[137] *See* Part III.
[138] SEC Proposing Release at 17.
[139] Bullard, *supra* note 43, at 19-20.

money early in the business life cycle.[140] The equity crowdfunding exemption was designed to facilitate capital raising for small businesses, but, by allowing issuers to utilize a crowdfunding offering in addition to a large offering through another exemption, the proposed rules effectively provide an advantage to larger businesses and there is a legitimate chance that small businesses may be edged out of the crowdfunding market.[141] Ignoring the aggregation rules contained in the JOBS Act, the proposed rules fail to remedy the funding gap between small and mid-sized to large businesses, which was the express purpose of the crowdfunding legislation.[142]

Similarly, the SEC has taken a dubious approach to integration between offerings under the crowdfunding exemption and other concurrent offerings.[143] As explained by the SEC, "[t]he integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering."[144] Curiously, the SEC's proposed rules would apply no integration restrictions at all to the equity crowdfunding exemption.[145] The area in which the folly of this approach is most apparent is that of public advertisement. Public advertising is generally prohibited in connection with sales to non-accredited investors, but, without integration rules, an issuer could publicly advertise pursuant to a Regulation D offering[146] and, in effect, indirectly advertise the concurrent

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[140] http://www.youtube.com/watch?v=Vi-KBrezafQ.
[141] *Id.*
[142] *Id.*
[143] Bullard, *supra* note 43, at 7.
[144] SEC Proposing Release at 27.
[145] *See* Section 4A(g) of the Securities Act (providing that "[n]othing in the exemption shall be construed as preventing an issuer from raising capital through means other than [S]ection 4[(a)](6)"); SEC Proposing Release, at 18; Bullard, *supra* note 43, at 11.
[146] General advertising and solicitation is admissible in Regulation D offerings so long as the securities are only offered and sold to accredited investors. Securities and Exchange Commission Release No. 33-9415 (July 10, 2013).

crowdfunding offering.[147] Therefore, an issuer could employ general advertising and solicitation techniques pursuant to a Regulation D offering targeted only at accredited investors, while indirectly releasing the information to the general public to bolster its crowdfunding offering in contravention of the advertising limitations on crowdfunding offerings.[148] The rationale for allowing general advertising and solicitation to accredited investors in Regulation D offerings is that the investors are sophisticated and capable of protecting their interests.[149] Such reasoning does not apply to the equity crowdfunding exemption, however, because issuers can offer and sell securities to anyone—not just accredited investors. To prevent issuers from contravening the strict advertising limitations applicable to crowdfunding offerings, Congress and the SEC should implement integration rules that would prohibit the issuance of a crowdfunding offering within 60 days after public communication in an offering by the same issuer.[150]

C. Eliminate the provision of the proposed rules allowing investors to self-certify financial qualifications

Under the proposed rules, issuers and intermediaries may rely on an investor's representations regarding that investor's eligibility to invest with respect to the investment limitation caps.[151] The SEC should eliminate the provision in the proposed rules that allows investors to self-certify their financial qualifications.[152] If investors are allowed to self-certify their financial qualifications, it is likely that they will not understand the technical requirements

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[147] Bullard, *supra* note 43, at 7.

[148] Bullard, *supra* note 43, at 8.

[149] Robert J. Haft, Arthur F. Haft, & Michele Haft Hudson, *Rule 506(c) eliminates prohibition against general solicitation in certain Rule 506 offerings*, 2 Venture Cap. & Bus. Fin. § 11:4.50 (2014).

[150] Bullard, *supra* note 43, at 13.

[151] Bullard, *supra* note 43, at 27.

[152] Sec Proposed Rule at 169 *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf ("For these reasons, the proposed rules provide that an intermediary may rely on an investor's representations concerning compliance with investment limitation requirements based on the investor's annual income and net worth and the amount of the investor's other investments in securities sold in reliance on Section 4(a)(6) through other intermediaries.").

and may, for example, include the value of their home in calculating their net worth.[153] Such mistakes in complying with the financial qualifications increase the risk of investors facing financial duress through crowdfunding, which not only harms the investor, but also jeopardizes the long-term success of the crowdfunding market.[154] The costs of implementing a safeguard to ensure that investors actually meet the investment cap eligibility requirements are not prohibitive. Requiring that investors provide their most recent pay stub or tax return, for example, would add little cost to both the investor and the issuer or intermediary, but would deter investors from embellishing their qualifications in order to invest more. Of course, an investor's financial position becomes irrelevant under this article's suggested plan of greatly reducing the investment cap to a flat rate, such as $250 per offering by any investor in a 12-month period. Under such an approach, all members of the crowd are treated identically and there are no complex investment tier systems based on an investor's financial position, so the self-certification problem would become moot.

V. CONCLUSION

Although the JOBS Act and the SEC's proposed rules on equity crowdfunding mark a step in the right direction in making capital markets more accessible to small businesses, there is a low probability that the rules as proposed will provide any practical advantage to small businesses and start-ups. The proposed rules fail to adequately balance the need for cost-effective access to capital and investor protection in a framework that encourages businesses to utilize equity crowdfunding. By implementing the changes to the proposed regulatory framework set forth in this paper, the cost an issuer would face during an equity crowdfunding

[153] Bullard, *supra* note 43, at 27.
[154] Bullard, *supra* note 43, at 28.

offering would be significantly reduced and, because of the reduced investment caps, the risk to investors would remain acceptable.