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## How the SEC’s Crowdfunding Rules for Funding Portals Save the Two-Headed Snake: Drawing the Proper Balance Between Integrity and Cost

*“Has not the famous political Fable of the Snake, with two Heads and one Body, some useful Instruction contained in it? She was going to a Brook to drink, and in her Way was to pass thro’ a Hedge, a Twig of which opposed her direct Course; one Head chose to go on the right Side of the Twig, the other on the left, so that Time was spent in the Contest, and before the Decision was completed, the poor Snake died with thirst.”<sup>1</sup>*

### I. INTRODUCTION

On October 30, 2015, the Securities and Exchange Commission (SEC) adopted final rules to implement equity crowdfunding under Title III of the Jumpstart Our Business Startups Act (JOBS Act).<sup>2</sup> The SEC approved the final rules, named Regulation Crowdfunding, by a three to one vote, establishing the regime under which small businesses and startups can raise capital from individual investors online.<sup>3</sup> For the first time, unaccredited investors can invest a relatively small dollar amount of capital in securities, which private businesses offer over the Internet.<sup>4</sup>

Crowdfunding is gaining wide-scale attention because of its seamless capacity to raise capital online.<sup>5</sup> The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (CROWDFUND Act), which is Title III of the JOBS Act, provides a crowdfunding exemption that allows the public to invest in small businesses.<sup>6</sup> The CROWDFUND Act requires entrepreneurs and investors to exchange capital through an intermediary, which is an online website.<sup>7</sup> The CROWDFUND Act requires intermediaries—or

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1. BENJAMIN FRANKLIN, NOT YOUR USUAL FOUNDING FATHER: SELECTED READINGS FROM BENJAMIN FRANKLIN 268 (Edmund S. Morgan ed., Yale Univ. Press 2006) (1789) (quoting Benjamin Franklin’s famous two-headed-snake anecdote).

2. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Adopts Rules To Permit Crowdfunding, (Oct. 30, 2015), <http://www.sec.gov/news/pressrelease/2015-249.html> [<http://perma.cc/CWK7-4QRR>] (announcing final crowdfunding rules); Ellen Canan Grady & Richard J. Busis, *SEC Adopts “Regulation Crowdfunding,”* LEXOLOGY (Nov. 9, 2015), <http://www.lexology.com/library/detail.aspx?g=6e698531-148e-4036-a291-55cfa7224b80> [<http://perma.cc/2NJ6-NGJ5>] (explaining Regulation Crowdfunding).

3. See Grady & Busis, *supra* note 2 (explaining Regulation Crowdfunding).

4. See *id.* (explaining Regulation Crowdfunding).

5. See *infra* Part II.A.3 (demonstrating crowdfunding gaining national momentum).

6. See *infra* Part II.A.1 (explaining JOBS Act).

7. See *infra* Part II.B.1 (explaining crowdfunding intermediaries).

“gatekeepers”—to register with the SEC as either a broker or a funding portal.<sup>8</sup> Thus, intermediaries are the lynchpin of the CROWDFUND Act because they provide essential and early-stage investor protection.<sup>9</sup>

For many small entrepreneurs, starting a new business is a risky endeavor.<sup>10</sup> Often, a startup business struggles to procure investors and financing, especially when the business has no operating profit.<sup>11</sup> Largely due to the significant risk associated with starting a new business, the usual sources of funding—loans from family and friends, bank loans, venture capital, and retained earnings—are not commonly available to small startups.<sup>12</sup> This funding gap means many potentially successful business ventures fail because they are unable to procure adequate funding.<sup>13</sup>

Like with crowdsourcing, pooling from the public to finance startups and small businesses offers an opportunity to close this funding gap.<sup>14</sup> By definition, crowdsourcing is an exchange and procurement of ideas or content through the request of contributions from large groups online.<sup>15</sup> Equity

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8. See *infra* Part II.B.1 (explaining crowdfunding intermediaries). A funding portal is a novel type of intermediary that is subject to more limitations than a broker-dealer. See *infra* Part II.B.1.

9. See *infra* Part II.B.1 (explaining crowdfunding intermediaries).

10. See Jeff Pruitt, *5 Ways for Startups To Reduce the Risk in Starting a New Venture*, PHOENIX BUS. J. (Sept. 24, 2014, 2:00 PM), <http://www.bizjournals.com/phoenix/blog/techflash/2014/09/5-ways-for-startups-to-reduce-the-risk-in-starting.html?page=all> [<http://perma.cc/4J6Y-DHXT>] (noting entrepreneur must consider risk in nearly all business decisions); see also President Barack Obama, *Remarks on Signing the Jumpstart Our Business Startups Act*, GOV'T PUBL'G OFF. 1 (Apr. 5, 2012), <http://www.gpo.gov/fdsys/pkg/DCPD-201200249/pdf/DCPD-201200249.pdf> [<http://perma.cc/NS27-AMS6>] (noting entrepreneurial endeavors involve substantial risks).

11. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (2012) (stating small entrepreneurs traditionally encounter great difficulty obtaining capital). Entrepreneurs with insufficient personal financing must rely on other means to fund their business, such as friends, family, or acquaintances. See *id.*; see also Claire Martin, *Craft Beer, the (Very) Limited Edition*, N.Y. TIMES (Jan. 18, 2014), [http://www.nytimes.com/2014/01/19/business/craft-beer-the-very-limited-edition.html?\\_r=0](http://www.nytimes.com/2014/01/19/business/craft-beer-the-very-limited-edition.html?_r=0) [<http://perma.cc/9969-B6HA>] (describing small brewery's plight to obtain financing).

12. Bradford, *supra* note 11, at 5 (stating “bank lending, venture capital, [and] retained earnings” difficult for small businesses to obtain). Venture capital, which is used for the early stages of startup companies, funds only about three percent of startup ventures. See Dileep Rao, *Why 99.95% of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital*, FORBES (July 22, 2013, 10:00 AM), <http://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time-seeking-venture-capital/> [<http://perma.cc/J7JW-F2ZK>] (noting ninety-seven percent of venture capital funding went to post-startup companies); see also TY KISEL, *GETTING A BUSINESS LOAN: FINANCING YOUR MAIN STREET BUSINESS* 61 (Apress 2013) (stating two percent of startups have what venture capital funders seek).

13. See Bradford, *supra* note 11, at 5 (highlighting difficulty for startups to procure funding). Even though wealthy individuals, known as angel investors, sometimes fund startups and small businesses, such funding is limited. See *id.*; see also Shekhar Darke, Note, *To Be or Not To Be a Funding Portal: Why Crowdfunding Platforms Will Become Broker-Dealers*, 10 HASTINGS BUS. L.J. 183, 187 (2014) (stating “angel investors [usually] invest in companies before . . . companies are ready for venture capital funding”).

14. See Benjamin P. Siegel, Note, *Title III of the Jobs Act: Using Unsophisticated Wealth To Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 778 (2013) (explaining benefits of pooling from public).

15. See *Definition of Crowdsourcing*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/crowdsourcing> (last visited Sept. 22, 2014) [<http://perma.cc/F3NH-AKDC>] (defining crowdsourcing).

crowdfunding is a new concept originating from nonequity forms of crowdfunding, often referred to as reward crowdfunding.<sup>16</sup> Unlike reward crowdfunding, equity crowdfunding donors do not receive a product in exchange for their financial contributions.<sup>17</sup> The issuing startup, instead, provides donors with unregistered securities.<sup>18</sup> A security is an interest in a company that provides that security holder with the right to share profits.<sup>19</sup> In 2012, Congress signed the equity model of crowdfunding for unaccredited investors and small businesses into law as the CROWDFUND Act.<sup>20</sup>

The CROWDFUND Act required the SEC to adopt rules to facilitate equity crowdfunding.<sup>21</sup> Although the final rules do not go into effect until 180 days after publication in the Federal Register, preliminary observations can be made.<sup>22</sup> Both the CROWDFUND Act and the SEC's final rules impose restrictions for intermediaries, particularly for the newly introduced funding portals.<sup>23</sup> These restrictions raise the question of whether or not the SEC's rules create an appropriate balance between adequately protecting unaccredited investors and allowing funding portals to act as gatekeepers.<sup>24</sup> The specific

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*Wikipedia* and *Yelp* are some of the most prominent examples of crowdsourcing. See DON TAPSCOTT & ANTHONY D. WILLIAMS, *WIKINOMICS: HOW MASS COLLABORATION CHANGES EVERYTHING* 71 (Penguin Group 2006); Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the Crowdfund Act*, 66 VAND. L. REV. EN BANC 43, 47 (2013) [hereinafter *Keep It Light*].

16. See Bradford, *supra* note 11, at 14-15 (explaining crowdfunding categories: donation model, reward model, prepurchase model, lending model, and equity model). Different types of crowdfunding can be distinguished by what the donee promises in return for the donor's contribution. See *id.* at 14; see also Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1458 (explaining reward model). Websites such as *Kickstarter* and *IndieGoGo* follow the reward crowdfunding model. See Schwartz, *supra*. In reward crowdfunding, artists and entrepreneurs raise money online from investors who are fans, strangers, or members of the general public in support of their ventures. See *id.*

17. Bradford, *supra* note 11, at 16-17 (describing exchange process in reward crowdfunding).

18. See *id.* (distinguishing equity crowdfunding from reward crowdfunding); Schwartz, *supra* note 16, at 1458 (describing reward crowdfunding). Unlike reward crowdfunding, equity crowdfunding authorizes investors to profit monetarily from their contributions. See Schwartz, *supra* note 16, at 1459.

19. *Definition of Security*, BLACK'S LAW DICTIONARY (9th ed. 2009).

20. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. 306, 315-23 (2012) (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933 and Securities Exchange Act of 1934).

21. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. 306, 320-22 (2012) (codified as amended in scattered sections of 15 U.S.C.) (requiring SEC to issue final regulations no later than 270 days after JOBS Act enactment).

22. See Gregory D. Deschler, Comment, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries*, 58 ST. LOUIS U. L.J. 1145, 1147, 1157 (2014) (noting policy challenges will still persist).

23. See 15 U.S.C. § 77d-1(a) (2012) (describing requirements on funding portals); *infra* Part II.B.2 (explaining SEC's final rules on funding portals).

24. See Schwartz, *supra* note 16, at 1462-63 (exposing obligations on intermediaries). These questions raise concerns as to how funding portals will operate in practice. See Letter from William Galvin, Sec'y of the Commonwealth of Mass., to Elizabeth Murphy, Sec'y of U.S. Sec. & Exch. Comm'n (Aug. 8, 2012), [http://www.sec.state.ma.us/sct/sctpdf/Jobs\\_Act0001.pdf](http://www.sec.state.ma.us/sct/sctpdf/Jobs_Act0001.pdf) [<http://perma.cc/D2DF-RH65>] [hereinafter Galvin Letter] (stating 15 U.S.C. § 77d-1(a)(1) should require public disclosure of intermediaries' registration materials); Letter from Maurice Lopes, CEO of EarlyShares.com, Inc., to Elizabeth Murphy, Sec'y of U.S. Sec.

concern to investors in donating capital to these funding portals is that investments may be subject to fraud.<sup>25</sup> Due to funding portals' novelty, this Note pays special attention to funding portals in the context of the SEC's final rules.<sup>26</sup>

This Note argues that the SEC's rules for funding portals are well founded because the rules cost-effectively solidify funding portals' gatekeeping function as legitimate, in establishing the new, low-cost entity known as the Form Funding Portal (Form FP).<sup>27</sup> Form FP will allow funding portals to initiate and operate business at lower costs than operating business using the more traditional Form Broker-Dealer (Form BD) because the Form FP will allow funding portals to charge issuers lower prices than those normally charged to brokers asking for service fees.<sup>28</sup> Further, this Note argues that the SEC's rules for intermediaries—particularly funding portals—adequately protect investors by ensuring the crowdfunded startups seeking investments are bona fide issuers and legitimate operators.<sup>29</sup> The SEC granted funding portals broad discretion for cancelling issuers that present a risk of fraud, which emphasizes the SEC's desire to establish funding portals as an integrity-enhancing conduit.<sup>30</sup> The SEC's rules for funding portals also strengthen investor protection by requiring funding portals to provide communication channels, to transmit funds to issuers and investors through third parties, and to mandate investor education.<sup>31</sup>

Part II of this Note inspects the background and history of equity crowdfunding, with a focus on the incorporation of intermediaries in securities law.<sup>32</sup> Further, Part II discusses the legislative history of the JOBS Act and the rationale for amending the Securities Act of 1933 ('33 Act).<sup>33</sup> The pinnacle of Part II examines the most crucial aspects of the SEC's rules for funding portals.<sup>34</sup> Part II.A focuses primarily on the legislative history and purpose of the JOBS Act and CROWDFUND Act.<sup>35</sup> Part II.B.1 then focuses on the

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& Exch. Comm'n (Aug. 16, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-127.pdf> [<http://perm.a.cc/HC8A-BYWW>] (questioning whether 15 U.S.C. § 77d-1(a)(11) prohibits intermediary's ability to have financial interest in issuer).

25. See Galvin Letter, *supra* note 24.

26. See *infra* Part II.B.2 (explaining SEC's final rules on funding portals).

27. See *infra* Part III (analyzing SEC's relationship with intermediaries).

28. See *infra* Part II.A.2 (arguing SEC's rules establish streamlined requirements for intermediaries).

29. See *infra* Part III (analyzing SEC's relationship with intermediaries).

30. See *infra* note 120 and accompanying text (arguing manner of intermediaries' obligation to reduce fraud enhances investor protection).

31. See *infra* Part III.A.1 (explaining SEC's rules equip intermediaries' with fraud-reducing abilities).

32. See *infra* Part II (describing background of crowdfunding).

33. See *infra* Part II.

34. See *infra* Part II (describing SEC's final rules).

35. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. 306, 315-23 (2012) (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933 and Securities Exchange Act of 1934).

CROWDFUND Act requirement for funding portals.<sup>36</sup> Part II.B.2 focuses on the SEC's final rules.<sup>37</sup>

Part III argues that the SEC's rules properly and efficiently regulate funding portals.<sup>38</sup> The SEC demonstrates mindfulness and commitment to balancing both funding portals' economic interests with Form FP and investor protection by way of mandatory investor education.<sup>39</sup> Further, Part III suggests the SEC's rules for funding portals facilitate openness and transparency through communication channels, which will likely reduce fraud.<sup>40</sup> Finally, Part IV summarizes the SEC's rulemaking dilemma for balancing the interests of business with investor protection.<sup>41</sup>

## II. HISTORY

### A. A Background of JOBS Act's Crowdfunding Provision

#### 1. The CROWDFUND Act Exemption

The legislative purpose of the JOBS Act is to increase American jobs and foster economic growth in broadening small companies' access to the public capital markets.<sup>42</sup> Permitting equity crowdfunding is one of several JOBS Act

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36. See 15 U.S.C. § 77d(a)(6)(C) (2012) (requiring Title III transactions go through broker or funding portal); 15 U.S.C. § 77d-1(a) (2012) (mandating requirements on intermediaries).

37. See *infra* Part II.B.2 (detailing SEC's final rules). Commentators argue that most crowdfunding transactions will likely occur through funding portals. See Stuart R. Cohn, Essays, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012) (explaining Title III offers unlikely to use registered brokers). Commentators further claim that a broker's potential liability will not be worth the profits obtained through Title III offerings. *Id.*; Shahrokh Sheik, *Fast Forward on Crowd Funding Although: Donation-Based Crowdfunding Has Experienced Some Success, Questions Remain About the Practicality of Equity-Based Crowdfunding*, 36 L.A. LAW. 34, 37 (2013) (opining most Title III offerings will go through funding portals).

38. See *infra* Part III (analyzing SEC's final rules for intermediaries).

39. See *infra* Part III.

40. See *infra* Part III.

41. See *infra* Part IV (recognizing SEC's need to balance competing interests in regulatory oversight).

42. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933 and Securities Exchange Act of 1934). The JOBS Act has seven titles that largely deregulate securities legislation with the goal of improving access to capital. See *id.* Title I encourages public offerings by reducing the disclosure requirements for emerging growth companies during both the Initial Public Offering (IPO) process and after the company goes public. See *id.* §§ 77b, 78c, 78n-1, 78n, 77g, 78m, 78o-6, 77e, 77f, 78k-1, 126 Stat. at 307-12. Title II allows for general solicitation and advertising for initial public offerings under Rule 506 of Regulation D and Rule 144A of the '33 Act. See *id.* § 77d, 126 Stat. at 313-15. Title III, the focus of this Note, provides a crowdfunding exemption for unaccredited investors. See *id.* §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. at 315-23. Title IV creates a new exemption from the registration requirements under the '33 Act for companies selling less than \$50 million in securities over a twelve-month period. See *id.* §§ 77c, 77r, 77d, 126 Stat. at 323-25. Title V and VI increases the number of shareholders a company needs before the SEC requires registration under Section 12(g) of the 1934 Securities Exchange Act from 500 persons to 2000 persons or 500 persons who are not accredited investors. See *id.* §§ 78l, 78o, 78d, 126 Stat. at 325-27. Title VII delegates rulemaking authority to the SEC to "provide online information and conduct outreach to inform small and

initiatives designed to advance this objective.<sup>43</sup> Crowdfunding law diverges from the long-settled laws for public offerings of securities.<sup>44</sup> A featured principle of crowdfunding is that public, online *crowds* of possible investors may examine small businesses' proposed offerings and provide contributions.<sup>45</sup> Generally, whenever a company (whether a large corporation or a small startup) offers the public exchange of securities, the company's securities must register with the SEC unless it satisfies an exemption.<sup>46</sup>

Small startup companies seeking only a relatively small amount of capital normally find it burdensome to register with the SEC because it consumes too many resources.<sup>47</sup> Accordingly, the CROWDFUND Act aims to rectify this burden by balancing efficient and affordable oversight while reducing the risk of fraud for unaccredited investors.<sup>48</sup> Although smaller offerings are less burdensome to register than larger offerings, smaller offerings are still likely to face excessive costs.<sup>49</sup> To alleviate this capital-raising shortcoming for small

medium sized businesses, women owned businesses, veteran owned businesses, and minority owned businesses of the changes made by this Act." *Id.* § 78d, 126 Stat. at 327.

43. See 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) (explaining purpose of CROWDFUND Act).

44. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. 306, 315-23 (2012) (codified as amended in scattered sections of 15 U.S.C.) (amending '33 Act and Securities Exchange Act of 1934); Galvin Letter, *supra* note 24 (explaining equity crowdfunding).

45. See C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 196 (2012), <http://ssrn.com/abstract=2066088> [<http://perma.cc/4QDA-TJQ2>] [hereinafter *Promise Unfulfilled*] (explaining crowd may choose contribution amount); Siegel, *supra* note 14, at 788 (explaining investors choose company they help fund). Title III crowdfunding, targeted toward unaccredited investors, limits individual investors with an annual income under \$100,000 from contributing more than \$2000 or five percent of annual income. 15 U.S.C. § 77d (a)(6)(B)(i) (2012) (providing cap for investors with income under \$100,000). In addition, critics of equity crowdfunding believe allowing unsophisticated investors to participate in the exempted exchange of crowdfunding securities is akin to inviting fraud. See Chris Gay, *Equity Crowdfunding: Good for Capitalism or for Fraudsters?*, U.S. NEWS & WORLD REP. (Nov. 21, 2012, 9:25 AM), <http://money.usnews.com/money/personal-finance/mutual-funds/articles/2012/11/21/will-crowdfunding-unleash-innovation-encourage-securities-fraud-or-both> [<http://perma.cc/4JLV-CX2N>] (evidencing concerns of fraud for equity crowdfunding). Similar opinions claim that it is obviously possible to deceive large groups of funding portal investors. Galvin Letter, *supra* note 24.

46. See Bradford, *supra* note 11, at 44 (explaining crowdfunding exemptions). The '33 Act provides that an offer to sell securities must either be registered with the SEC or meet an exemption. See 15 U.S.C. § 77e (2012) (prohibiting interstate exchange of unregistered securities).

47. Cf. Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 384 (2009) (expounding costly SEC registration voids return on investment for average recording project); Robb Mandelbaum, *Should You Crowdfund Your Next Business?*, INC. MAG. (May 2014), <http://www.inc.com/magazine/201405/robb-mandelbaum/jobs-act-crowdfunding-problems.html> [<http://perma.cc/H4PH-6WRR>] (describing SEC registration process as expensive).

48. See 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown) (demonstrating aim to balance SEC oversight with reducing information asymmetries); 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) (explaining purpose of Title III); *Promise Unfulfilled*, *supra* note 45, at 197-98 (explaining crowdfunding aimed to "balance the capital formation benefits . . . against the cost of allowing those offering, including possible investor losses").

49. See *Keep It Light*, *supra* note 15, at 46 (noting expensive disclosure for small offerings not economical); Bradford, *supra* note 11, at 42-43 (explaining burdens of SEC registration); Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1, 32 (1981) (noting smaller

businesses and startups, the CROWDFUND Act amends Section 4 of the '33 Act by exempting transactions from registration where the total amount an issuer sells to all investors is not more than \$1,000,000.<sup>50</sup> This exemption is targeted at increasing small businesses' access to capital, without imposing burdensome regulations on small businesses and intermediaries.<sup>51</sup>

## 2. *Bipartisan Support, Economic Revitalization, and Democratizing Securities*

The JOBS Act received strong bipartisan support, with the House of Representatives passing the bill 390 to 23 and the Senate passing it 73 to 26.<sup>52</sup> Although Congress designed the CROWDFUND Act to boost economic activity, some lawmakers and commentators argued it leaves unaccredited investors vulnerable due to their unfamiliarity with investing.<sup>53</sup> Other critics

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offerings usually less expensive than larger offerings).

50. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 77d, 126 Stat. 306, 315 (2012) (codified in 15 U.S.C. § 77d(a)(6) (2012)) (exempting registration requirement for exchanging small amounts of capital).

51. See Siegel, *supra* note 14, at 790 (explaining purpose of Title III); *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml> (last visited Oct. 26, 2014) [<http://perma.cc/9W43-ZTCY>] (stating JOBS Act will help businesses raise funds in capital markets by minimizing regulatory requirements).

52. See 158 CONG. REC. D225-01 (2012) (indicating House passed JOBS Act on March 8, 2012); 158 CONG. REC. D289-02 (2012) (indicating Senate passed JOBS Act on March 22, 2012); Thomas A. Martin, *The JOBS Act of 2012: Balancing Fundamental Securities Law Principles with the Demands of the Crowd* 2-3 (Williamette Univ. Coll. of Law, Working Paper, 2012), <https://web.law.columbia.edu/sites/default/files/microsites/capital-markets/files/JOBS%20Act%20Fundamental.pdf> [<https://perma.cc/NF7D-E2MT>] (describing House version of bill received strong bipartisan support); see also Editorial Bd., *Small Biz Jobs Act Is a Bipartisan Bridge Too Far*, BLOOMBERG VIEW (Mar. 18, 2012, 7:01 PM), <http://www.bloombergvew.com/articles/2012-03-18/small-biz-jobs-act-is-a-bipartisan-bridge-too-far-view> [<http://perma.cc/P7RP-2T2N>] (describing JOBS Act bipartisanship).

53. See 158 CONG. REC. E407-02 (daily ed. Mar. 21, 2012) (statement of Sen. Janice Schakowsky); Siegel, *supra* note 14, at 794 (arguing nonaccredited investors financially illiterate). After the Enron scandal, Congress sought to improve corporate transparency and provide potential investors—particularly small investors—with access to information they need to make educated financial decisions. 158 CONG. REC. E407-02 (daily ed. Mar. 21, 2012) (statement of Sen. Janice Schakowsky). Critics contend the JOBS Act eliminates many protections, which leaves unsophisticated investors vulnerable. *Id.* Commentators repeatedly expressed concern over the JOBS Act's potential for weakening investor protections. *Promise Unfulfilled*, *supra* note 45, at 198 (opining shortcomings of Title III); Luis A. Aguilar, S.E.C. Comm'r, Public Statement, Investor Protection Is Needed for True Capital Formation: Views on the JOBS Act (Mar. 16, 2012), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171490120#.VFevulahGAY> [<http://perma.cc/S395-KAWJ>] (expressing concern for investors' vulnerability to fraud); Editorial, *They Have Very Short Memories*, N.Y. TIMES (Mar. 10, 2012), <http://www.nytimes.com/2012/03/11/opinion/sunday/washington-has-a-very-short-memory.html> [<http://perma.cc/UZR3-QMR8>] (describing JOBS Act as "terrible package of bills that would undo essential investor protections"). Professor Bradford argues that the individual investor caps of \$2000 are too high, which exposes funding portal investors to more risk than they can afford. See *Promise Unfulfilled*, *supra* note 45, at 198; *supra* note 45 and accompanying text (explaining \$2000 cap). Other commentators argue that Congress passed the JOBS Act in a hasty manner. See Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 261 (2013) ("Congress hastily passed a law that removed protections for the most vulnerable investors."); Jim Lardner, *Backroom Maneuvering on the JOBS Act*, AMS. FOR FIN. REFORM BLOG (Dec. 11, 2012, 9:07 AM), <http://blog.ourfinancialsecurity.org/2012/12/11/backroom-maneuvering-on-the-jobs-act-2/> [<http://perma.cc/DRR4-HAFK>] (arguing Congress rushed JOBS Act).

claim that the CROWDFUND Act invites unaccredited investors to make risky investments in highly speculative businesses with large chances of illiquidity.<sup>54</sup> Lawmakers intended, however, to rebut these claims through protecting unsophisticated investors with modest income from fraud and overinvesting by restricting the amount one may invest per year and by requiring preinvestment education for all crowdfunding donors.<sup>55</sup> Furthermore, unsophisticated investors, despite critical speculation, had already been investing in unregulated crowdfunding offerings, albeit not in exchange for equity.<sup>56</sup>

The JOBS Act purported to revitalize a languid economy by allowing small businesses to gain capital from broader, public contributions.<sup>57</sup> The JOBS Act's major goals were to increase job creation and entrepreneurial activity and to promote economic growth, through public access to capital markets for startups.<sup>58</sup> More specifically, Congress designed the CROWDFUND Act to

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54. See Bradford, *supra* note 11, at 105 (arguing small business investments illiquid and risky); 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, 1767 (2012) (opining increase in unsophisticated investors' exposure to risky investments diminishes investor protection). Factors that contribute to the riskiness of investing in small businesses are investors' disproportionate exposure to fraud and the inherent uncertainty of the startup itself. See Bradford, *supra* note 11, at 105-06 (analogizing to previous increases of fraud as result of regulatory relaxations). Startups are uncertain because nearly all of the essential decisions impacting a company's success remain to be made, and many important uncertainties concerning a company's efforts remain unresolved. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076-77 (2003).

55. See *Keep It Light*, *supra* note 15, at 45 (noting Congress's attentiveness to possibility of fraud); *supra* note 45 and accompanying text (explaining statutory limitation on investors' contributions). *But see* Hazen, *supra* note 54, at 1765 (arguing limiting offerings to small amounts does not deter scammers); Bradford, *supra* note 11, at 107 (claiming crowdfunding entrepreneur-issuers have all information, which increases risk of self-dealing); Darke, *supra* note 13, at 189 (stating investments in startups expose investors to fraud and create self-dealing opportunities for entrepreneurs). "It is naïve to assume that limiting offerings to small amounts per investor will deter scammers from taking advantage of investors via crowdfunding." Hazen, *supra* note 54, at 1765. Congress also mandated that intermediaries ensure that investors review investment-education information and demonstrate an understanding of the level of risk applicable to investing in startups. See 15 U.S.C. § 77d-1(a)(4)(A)-(C) (2012) (requiring intermediaries ensure investors demonstrate competence in startup investment).

56. See Bradford, *supra* note 11, at 105 (arguing low cost to investors of deregulating crowdfunding likely); *supra* note 16 and accompanying text (explaining different models of crowdfunding). Professor Bradford argues that crowdfunding investments on models other than equity crowdfunding, for example reward crowdfunding on *Kickstarter*, carry the same risk of loss as equity crowdfunding, except they do not offer the potential benefit of receiving financial returns. See Bradford, *supra* note 11, at 105 (stating significant money already invested in nonsecurities crowdfunding). Professor Bradford further notes that adding the ability to obtain equity would increase the possibility of net gains rather than increase risk. See *id.*

57. See *Keep It Light*, *supra* note 15, at 45 (recognizing equity crowdfunding connects entrepreneurs with public investors while mitigating initial public offering process); Martin, *supra* note 52, at 2 (noting JOBS Act "designed to boost new company formation and create jobs"); John Berlau, *Declaration of Crowdfunding Independence*, CROWDFUNDINSIDER 2 (Nov. 18, 2014), <http://www.scribd.com/doc/246995194/CEI-John-Berlau-Declaration-of-Crowdfunding-Independence> [<http://perma.cc/C538-F6FS>] (arguing crowdfunding supports economy and job growth).

58. See Catherine Clifford, *Crowdfunding Seen Providing \$65 Billion Boost to the Global Economy in 2014 (Infographic)*, ENTREPRENEUR (Jan. 16, 2014), <http://www.entrepreneur.com/article/230912> [<http://perma.cc/T85Q-HDPF>] (noting crowdfunding added 270,000 jobs in 2014); Tanya Prive, *Equity*



help reduce both the funding gap and regulatory restraints that startups and small businesses encounter when seeking to obtain capital in relatively low dollar amounts.<sup>59</sup> Congress was eager to boost economic growth in light of lagging entrepreneurial activity and concerns over potential increases in unemployment.<sup>60</sup> Some commentators, however, doubt the JOBS Act's potential to create jobs, especially with recent economic improvements.<sup>61</sup>

Nevertheless, the CROWDFUND Act modernized Depression-era securities laws by democratizing the issuance of securities.<sup>62</sup> The legislation aimed to create a financing model that allowed the greater public to fund small businesses and startups.<sup>63</sup> With this new legislation, unsophisticated, individual investors can participate in choosing a business's offering without going through Wall Street.<sup>64</sup> Unlike in prior exemptions, the equity

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*Crowdfunding: The Driving Force Behind Job Creation*, HUFFINGTON POST (July 1, 2013, 6:33 PM), [http://www.huffingtonpost.com/tanya-prive/equity-crowdfunding-the-d\\_b\\_3530776.html](http://www.huffingtonpost.com/tanya-prive/equity-crowdfunding-the-d_b_3530776.html) [<http://perma.cc/29RC-3LWL>] (acknowledging JOBS Act's potential to galvanize job creation). *But see* Martin, *supra* note 52, at 2 (contending JOBS Act does not directly increase job creation).

59. *See, e.g.*, 158 CONG. REC. S1781 (daily ed. Mar. 19, 2012) (statement of Sen. Carl Levin) (stating rules generally prohibit raising very small amounts from ordinary investors without significant costs); 157 CONG. REC. S8458-02 (daily ed. Dec. 8, 2011) (statement of Sen. Jeff Merkley) (stating CROWDFUND Act provides regulated ways for startups to raise capital from ordinary investors); 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) (“[Crowdfunding] removes the SEC restrictions allow[ing] entrepreneurs and small businesses to raise capital from everyday investors.”).

60. *See* Bradford, *supra* note 11, at 100 (describing recent decline in entrepreneurial activity). The total entrepreneurial activity (TEA) fell from 10.6% in 2005 to 6.9% in 2009. *See* Abdul Ali et al., *2009 National Entrepreneurial Assessment for the United States of America*, GLOBAL ENTREPRENEURSHIP MONITOR 7 (2010), <http://www.gemconsortium.org/docs/download/666> [<http://perma.cc/BY6P-ZB98>] (presenting TEA statistics). TEA, however, increased to 12.7% in 2013. *See* Donna J. Kelley et al., *2013 United States Report*, GLOBAL ENTREPRENEURSHIP MONITOR 22 (2014), <http://www.gemconsortium.org/docs/download/3375> [<http://perma.cc/R88N-TME2>] (presenting TEA statistics). In addition, unemployment declined in 2012 from 7.9% to 6.7% in 2013. *Id.* at 2 (presenting unemployment figure); *see also* Martin, *supra* note 52, at 2 (stating Congress responded to weak economic recovery with JOBS Act).

61. *See* Steven Davidoff Solomon, *S.E.C.'s Delay on Crowdfunding May Just Save It*, N.Y. TIMES (Nov. 18, 2014, 2:56 PM), <http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/> [<http://perma.cc/U92P-U6LL>] (arguing little evidence exists proving JOBS Act creates jobs). Professor Solomon claims Congress enacted the JOBS Act merely to show that it was taking action to spur job creation. *See id.* In December 2014, the United States unemployment rate dropped to 5.6%. *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, USDL-15-0001, THE EMPLOYMENT SITUATION—DECEMBER 2014 (2014).

62. *See* John S. Wroldsen, *The Crowdfund Act's Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 358-59 (2013) (explaining crowdfunding involves use of Internet to raise capital from many people for common goal); John Berlau, *Regulatory Barriers Are Holding Back Investing and Lending Opportunities for Crowdfunding*, FORBES (Oct. 24, 2014, 2:43 PM), <http://www.forbes.com/sites/real-spin/2014/10/24/regulatory-barriers-are-holding-back-investing-and-lending-opportunities-in-crowdfunding/> [<http://perma.cc/S992-3W43>] [hereinafter *Regulatory Barriers*] (explaining Great Depression-era securities laws prohibited equity crowdfunding).

63. *See* President Barack Obama, *supra* note 10 (noting JOBS Act allows American public access to equity crowdfunding); Kay Koplovitz, *Equity Crowdfunding at Year One, What's the Impact?*, FORBES (Sept. 26, 2014, 11:23 AM), <http://www.forbes.com/sites/kaykoplovitz/2014/09/26/equity-crowdfunding-at-year-one-whats-the-impact/> [<http://perma.cc/TE53-GKRU>] (stating equity crowdfunding represents “democratization of capital sources”).

64. Amy Cortese, *Pennies from Many*, N.Y. TIMES (Sept. 25, 2011), <http://www.nytimes.com/2011/09/26/>

crowdfunding exemption allows small businesses to sell unregistered securities to unaccredited investors.<sup>65</sup> This new freedom expands the scope of securities regulations for funding portal investors, intermediaries, and issuers.<sup>66</sup>

### 3. SEC's Delay and States' Response

The JOBS Act provided the SEC with a deadline of December in 2012 to finalize the new rules.<sup>67</sup> Shortly after the JOBS Act's passage, the SEC sought public comments and published proposals.<sup>68</sup> The SEC received hundreds of comments, many of them critical of the SEC's delay.<sup>69</sup> The SEC adopted final

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opinion/a-proposal-to-allow-small-private-companies-to-get-investors-online.html?\_r=0 [http://perma.cc/S9KF-W858]. Equity crowdfunding allows investors to "directly fund other individuals or businesses . . . without going through a bank or Wall Street middleman." *Id.*

65. See *Keep It Light*, *supra* note 15, at 44 (stating Title III democratizes securities market). Title III opens the exchange of securities to those other than wealthy, accredited investors. *Id.* at 44-45.

66. See Schwartz, *supra* note 16, at 1473-75 (explaining how crowdfunding of securities facilitates democratization of market for startups).

67. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 77d, 77d-1, 78l, 78c, 77r, 78o, 126 Stat. 306, 320-22 (2012) (codified as amended in scattered sections of 15 U.S.C.) (requiring SEC to issue final regulations no later than 270 days after JOBS Act enactment).

68. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Seeks Public Comment Prior to JOBS Act Rulemaking (Apr. 11, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171488238#V LvsGovn8Uw> [http://perma.cc/F5ZG-C7H7] (announcing SEC accepting comments prior to publication of proposed JOBS Act). On April 11, 2012, six days after Congress signed the JOBS Act into law, the SEC allowed the public to comment on Title III before it proposed the rules. See *id.*: *Comments on SEC Regulatory Initiatives Under the JOBS Act: Title III—Crowdfunding*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/comments/jobs-title-iii/jobs-title-iii.shtml> (last visited Jan. 18, 2015) [http://perma.cc/M833-K3GD] (providing database for public comments made prior to proposing Title III rules). The SEC unanimously voted to propose rules for Title III of the JOBS Act. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#VLvhG4vn8Uw> [http://perma.cc/UL6L-6N2W] [hereinafter Proposal on Crowdfunding Press Release] (explaining background of SEC's rulemaking for Title III).

69. See *Comments on Proposed Rule: Crowdfunding*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/comments/s7-09-13/s70913.shtml> (last visited Jan. 18, 2015) [http://perma.cc/7667-H8MD] [hereinafter *Comments on Proposed Rule*] (providing comment database for ninety-day comment period). The SEC provided a ninety-day public-comment period following the proposals' publication in the Federal Register. See Proposal on Crowdfunding Press Release, *supra* note 68; *Comments on Proposed Rule*, *supra*. The public-comment period ended on February 3, 2014, and then the SEC reviewed the comments and considered them when adopting the final rules. See Proposal on Crowdfunding Press Release, *supra* note 68. When the final rules were in limbo, many commentators requested that the SEC adopt final rules as soon as possible so that entrepreneurs can begin raising capital. See, e.g., Mohamed Ahmad, Comment to Proposed Crowdfunding Rule (Aug. 21, 2014), <http://www.sec.gov/comments/s7-09-13/s70913-343.htm> [http://perma.cc/VLR5-37FG] (asking SEC to not delay final Title III rules); Deborah L. Jacobs, *SEC Proposes Crowdfunding Rules*, FORBES (Oct. 23, 2013, 2:41 PM), <http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/> [http://perma.cc/8LHG-JZRH] (criticizing SEC's delay in adopting final rules); Larry MacDonald, *SEC Holding Crowdfunding Hostage*, HUFFINGTON POST (Dec. 10, 2014, 3:58 PM), [http://www.huffingtonpost.com/larry-macdonald/sec-holding-crowdfunding-\\_b\\_6296472.html?utm\\_hp\\_ref=business&ir=Business](http://www.huffingtonpost.com/larry-macdonald/sec-holding-crowdfunding-_b_6296472.html?utm_hp_ref=business&ir=Business) [http://perma.cc/8UJ6-W4LA] (asserting businesses suffered because of SEC's prolonged adoption of final rules); Peter Schoffelen, Comment to Proposed Crowdfunding Rule (Aug. 22, 2014), <http://www.sec.gov/comments/s7-09-13/s70913-345.htm> [http://perma.cc/8CZH-8NG2] (noting SEC over 500 days past its deadline); Jan Wellmann, Comment to Proposed Crowdfunding Rule (Sept. 22, 2014), <http://www.sec.gov/comments/s7-09-13/s70913-438.htm> [http://perma.cc/8GRE-N89K] (critiquing SEC's delay in issuing final Title III rules).

rules on Friday, October 30, 2015.<sup>70</sup>

Due largely in part to the crowdfunding industry's eagerness for the SEC to adopt final rules, approximately twenty-nine states enacted their own intrastate crowdfunding legislation.<sup>71</sup> About eight other states are in the process of enacting an intrastate exemption.<sup>72</sup> Only about four states expressly rejected crowdfunding exemptions.<sup>73</sup> The states that adopted intrastate crowdfunding legislation take different approaches from the federal counterpart by instituting rules considerably more liberal than Regulation Crowdfunding.<sup>74</sup> Federal securities regulations allow states to enact intrastate crowdfunding legislation because federal regulations exempt an offering made solely in a single state by a company in that state.<sup>75</sup> The SEC recently proposed modernizing this

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70. See Regulation Crowdfunding, 80 Fed. Reg. 71,387, 71,428 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, et al.).

71. See *Intrastate Crowdfunding Directory*, N. AM. SEC. ADM'RS ASS'N, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/intrastate-crowdfunding-directory/> (last visited Nov. 9, 2014) [<http://perma.cc/RRV7-8BWF>] (listing states enacting intrastate crowdfunding exemption); Anthony J. Zeoli, *State of the States*, CROWDFUNDING LEGAL HUB (Jan. 16, 2015), <http://crowdfundinglegalhub.com/2015/01/16/state-of-the-states-list-of-current-active-and-proposed-intrastate-exemptions/> [<http://perma.cc/F9AG-ZDUY>] (listing states enacting intrastate crowdfunding exemption); see, e.g., ALA. CODE § 8-6-11 (a)(14) (2014); COLO. REV. STAT. ANN. § 11-51-304 (6) (West 2014); GA. COMP. R. & REGS. 590-4-2.08 (2014).

72. See Zeoli, *supra* note 71 (listing states proposing enactment of intrastate crowdfunding exemption). The states in the process of enacting an intrastate crowdfunding exemption include Alaska, Arkansas, California, Connecticut, Illinois, Kentucky, Minnesota, Missouri, New Jersey, New Mexico, Pennsylvania, South Carolina, Utah, and Virginia. See *id.*; see, e.g., H.B. 308, 28th Leg., 2nd Sess. (Alaska 2014); S.B. 665, 28th Gen. Assemb., Reg. Sess. (Ark. 2015); A.B. 2096, 2013-2014, Reg. Sess. (Cal. 2013).

73. See Zeoli, *supra* note 71 (listing states rejecting intrastate crowdfunding exemption).

74. Compare 7 TEX. ADMIN. CODE § 139.25 (2014) (omitting requirement of annual filings with Texas State Securities Board), with 15 U.S.C. § 77d-1(b)(4) (2014) (requiring issuers to annually report results of operations and audited financial statements to SEC). See also Solomon, *supra* note 61 (stating several states relax their intrastate exemption).

75. See 15 U.S.C. § 77c(a)(11) (2012) (exempting sale of securities to residents of single state by issuer in same state); 17 C.F.R. § 230.147 (2015) (clarifying Section 3(a)(11) of '33 Act). Section 3(a)(11) of the '33 Act exempts securities offered and sold only to residents within a single state when the issuer of that security is also a resident of the same state. See 17 C.F.R. § 230.147 (2015). There are three major business components an issuer must show in order to qualify for this intrastate exemption. See LISA C. THOMPSON & BRENT A. OLSON, BUSINESS LAW DESKBOOK § 27B:15, ARIZ. PRAC., Westlaw (database updated Dec. 2014). First, an issuer must conduct "substantial operational" activity within its state of incorporation. See Section 3(a)(11) Exemption for Local Offerings, Securities Act Release No. 33-4434, 26 Fed. Reg. 9158, 3 (Dec. 6, 1961) (explaining *doing business in state* rule). Second, all of an issuer's offers and sales must be solely to residents of the state where the issuer conducts substantial operational activity. See *id.* at 2. Finally, the securities an issuer sold must "come to rest only in the hands of residents within the state." *Id.* For example, if a party purchases securities in a state and then resells the securities to an out-of-state purchaser, this third component is likely satisfied. See *id.*; see also THOMPSON & OLSON, *supra*, § 27B:15 (explaining third component). In addition, the SEC adopted Rule 147, providing the *doing business* test, to ensure clarity in interpreting Section 3(a)(11). THOMPSON & OLSON, *supra*, § 27B:15. To satisfy the *doing business* test, an issuer must receive eighty percent of its gross revenues from in-state business, own eighty percent of its assets within the state, and intend to use at least eighty percent of proceeds from the federally-exempted intrastate securities sold for the purchase of property in the state or for conducting business within the state. See 17 C.F.R. § 230.147(c)(2)(i)-(iii) (2015) (providing *doing business* test); THOMPSON & OLSON, *supra*, § 27B:15 (explaining Rule 147).

intrastate safe harbor, Rule 147, to allow issuers to use the Internet to offer and sell its securities.<sup>76</sup>

Some argued that if the SEC adopted its final rules in a timely manner, then states would be preempted from legislating their own crowdfunding exemption.<sup>77</sup> Furthermore, critics contend that intrastate crowdfunding will be largely irrelevant now that the SEC has finalized its rules.<sup>78</sup> At least one commentator argued that Congress erroneously imposed a strict deadline on the SEC to finalize crowdfunding rules and should have allowed the SEC to observe the states' experiments with their own crowdfunding legislation.<sup>79</sup> When the legality of intrastate crowdfunding was uncertain, the SEC released a Compliance and Disclosure Interpretation to clarify securities offerings made pursuant to Section 3(a)(11) of the '33 Act and Rule 147.<sup>80</sup>

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76. See Exemptions To Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69,788 (proposed Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230). The SEC proposed that all sales must occur within the same state where the issuer's principal place of business is located. See *id.* The SEC further proposed that the offering must be registered in the state where all of the purchasers are residents or that the sale be conducted pursuant to an exemption from state law registration in such a state that limits the amount of securities an issuer may sell and sales not in excess of \$5 million in a twelve-month period. See *id.* The proposals would further allow issuers to make offers accessible to out-of-state residents as long as sales are made only to in-state residents. See *id.*

77. See Solomon, *supra* note 61 (claiming SEC's delay prompted states to enact crowdfunding exemption); *cf.* Crowdfunding, 78 Fed. Reg. at 66,536 (explaining federal crowdfunding exemption's relationship to state law). Once the SEC's final rules are effective, issuers relying on Section 4(a)(6) will not be required to register transactions with each state where it offers and sells securities. See Crowdfunding, 78 Fed. Reg. at 66,536 (stating preemption of state registration laws will reduce issuer uncertainty regarding necessity of state registration); see also 15 U.S.C. § 77r(a)(1)(A), (b)(4)(C) (2012) (preempting states from imposing additional rules on federal crowdfunding offerings).

78. See Tom Sharbaugh, *Some States Are Sidestepping the JOBS Act's Burdensome Crowdfunding Rules*, CROWDFUND INSIDER (May 16, 2014, 8:30 AM), <http://www.crowdfundinsider.com/2014/05/38730-states-sidestepping-jobs-acts-burdensome-crowdfunding-rules/> [<http://perma.cc/CN39-MCX4>] (describing federal crowdfunding's relationship with state law). With the final rules, companies using the intrastate exemption will have access to the broader federal crowdfunding exemption. See *id.* According to one commentator, companies relying on their state's more affordable and less burdensome intrastate crowdfunding exemption will not likely continue to do so. See *id.* (questioning companies' use of intrastate exemption after adoption of federal crowdfunding rules). Each state that has its own intrastate exemption for crowdfunding must show that the exemption generally falls under the Section 3(a)(11) or that federal securities laws preempt state laws. See 15 U.S.C. § 77r(a)(1)(A), (b)(4)(C) (2012) (preempting states from imposing additional rules on federal crowdfunding offerings); Schwartz, *supra* note 16, at 1465 (explaining states preempted from imposing additional regulations on interstate crowdfunding offerings); Bradford, *supra* note 11, at 145 (explaining states free to regulate intrastate securities sold by small issuers on crowdfunding sites).

79. See Solomon, *supra* note 61 (arguing Congress should have allowed SEC to observe states' experimentation with intrastate crowdfunding exemption).

80. See *Compliance and Disclosure Interpretations: Securities Act Rules*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#141-04> (last updated Aug. 6, 2014) [<http://perma.cc/AYA2-4CL2>] (explaining Rule 147 in context of state crowdfunding exemption). An issuer's use of an Internet portal for an offering to residents of a single state pursuant to state law is not incompatible with a claim of exemption under Rule 147. See *id.* The portal must utilize *adequate measures*, such as disclaimers and restrictions, to ensure it makes security offerings solely to residents in respective states. See *id.*; see also Anthony J. Zeoli, *SEC Releases New Guidance on Intrastate Offerings*, CROWDFUNDING LEGAL HUB (May 13, 2014, 11:22 PM), <http://crowdfundinglegalhub.com/2014/05/13/sec->

## B. Intermediaries

### 1. Intermediaries in the CROWDFUND Act

Corporate finance and securities transactions commonly use intermediaries—particularly when securities are publically exchanged—to perform a gatekeeping function.<sup>81</sup> Conflicts of interest and fraudulent conduct are primary concerns in the securities-intermediary context.<sup>82</sup> Under the CROWDFUND Act exemption, investors must make offers and sales of crowdfunded equity through registered brokers or funding portals.<sup>83</sup> The CROWDFUND Act introduced funding portals as a new type of transactional intermediary.<sup>84</sup>

### 2. SEC's Final Rules

The CROWDFUND Act creates an exemption that allows an intermediary to register with the SEC as a funding portal, which reduces obstacles broker-dealer registrants face.<sup>85</sup> Commentators suggest crowdfunding intermediaries will be the most sophisticated party in CROWDFUND Act transactions because they participate in the greatest amount of transactions.<sup>86</sup> Under the

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releases-new-guidance-on-intrastate-offerings/ [http://perma.cc/M2CH-UZDS] (explaining SEC's Compliance and Disclosure Interpretations).

81. See Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 191 (2013) (describing intermediaries in corporate finance and securities context). A financial intermediary is essentially a "middleman" used to increase the overall efficiency of transactions. See *id.* at 179-80. Further, financial intermediaries facilitate the imbalance of information that could detrimentally affect respective markets. See *id.* at 180; Jonathan M. Barnett, *Intermediaries Revisited: Is Efficient Certification Consistent with Profit Maximization?*, 37 J. CORP. L. 475, 476 n.1 (2012) (using intermediary and gatekeeper interchangeably).

82. See Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 51 (2004) (describing conflicts of interest as identifiable problem within securities intermediary market); Stephen J. Choi & Jill E. Fisch, *How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 273 (2003) (suggesting great source of intermediary problems result from conflicts of interest); Heminway, *supra* note 81, at 196-98 (explaining conflicting interests in context of Title III); *infra* note 84 and accompanying text (explaining intermediaries mandated to reduce fraud in Title III exchanges).

83. See 15 U.S.C. § 77d(a)(6)(C) (2012) (requiring exempted transactions under Title III be conducted through broker or funding portal).

84. See 15 U.S.C. § 78c(a)(80) (2012) (defining funding portals); Cohn, *supra* note 37, at 1439 (explaining funding portals). Funding portals are websites that catalog equity-crowdfunded ventures for interested investors. Cohn, *supra* note 37, at 1439. A regulated intermediary is mandated to reduce fraud or other destructive activity. See *id.* Moreover, funding portals must register with both the SEC and any applicable self-regulatory organization. See 15 U.S.C. § 77d-1(a)(2) (2012) (explaining requirements on intermediaries).

85. See 15 U.S.C. § 77d(a)(6) (2012) (exempting securities exchanged through funding portal).

86. See *The JOBS Act—Importance of Effective Implementation: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. (2012) (statement of C. Steven Bradford, Professor, University of Nebraska College of Law) (stating intermediaries will be "repeat players").

SEC's final rules, the term *funding portal* meets the Securities Exchange Act of 1934's ('34 Act) definition of a broker because a funding portal is engaged in effectuating securities.<sup>87</sup> The '33 Act, which unlike the '34 Act, prohibits a funding portal's directors, officers, or partners from having a financial interest in an issuer displayed on their website.<sup>88</sup> Moreover, the '33 Act requires funding portals to take "measures to reduce the risk of fraud," which can be accomplished by obtaining a background and an enforcement-history check on an issuer's major stakeholders.<sup>89</sup> Section 4A(a)(6) requires funding portals to provide the SEC and potential investors with issuers' Section 4A(b) disclosures.<sup>90</sup> In addition, Section 4(a)(6)(B) imposes investor limitations on

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87. See Regulation Crowdfunding, 80 Fed. Reg. 71,387, 71,428 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, et al.) (explaining brokers and funding portals). Exchange Act Section 3(a)(4) defines "broker" as any person that enables transactions in securities for the account of others. See 15 U.S.C. § 78c(a)(4) (2012). Funding portals are defined as any "person" involved in transactions—pursuant to Section 77d(6)—for the offer or sale of securities on the behalf of another's account. See *id.* § (a)(80). A funding portal may not offer investment advice, solicit the sales of securities offered on its website, compensate employees based on the sale of securities on its website, or handle investor funds or securities. See *id.*; see also Ross Jordan, Note, *Thinking Before Rulemaking: Why the SEC Should Think Twice Before Imposing a Uniform Fiduciary Standard on Broker-Dealers and Investment Advisers*, 50 U. LOUISVILLE L. REV. 491, 514 nn.168-69 (2012) (claiming some burdensome aspects of Investment Advisors Act). Furthermore, the SEC said it substitutes the word "person" in Section 77d(6) with "broker" to make it clear that funding portals are brokers. See Regulation Crowdfunding, 80 Fed. Reg. at 71,428 (explaining requirements on intermediaries). Although funding portals are essentially brokers, they are exempted from the requirement of registering as a broker-dealer. See *id.*; see also *infra* note 100 (explaining requirements for funding portal registration).

88. See 15 U.S.C. § 77d-1(a)(11) (2012) (prohibiting funding portals from having financial interest in issuers featured on their website). The SEC implemented this requirement by extending the statute's language to the intermediary itself. See Regulation Crowdfunding, 80 Fed. Reg. at 71,431 (describing prohibition of intermediaries' financial interest in issuers). The primary concern with a funding portal having a financial interest is that such an arrangement risks creating an incentive for funding portals to advance the particular issuer's fundraising efforts over those of other issuers, perhaps adversely affecting investors. See *id.* This rule is intended to protect investors from the potential conflicts of interest created when the entity facilitating a crowd-funded transaction has a financial interest in the result. See *id.*

89. See 15 U.S.C. § 77d-1(a)(5) (2012). The primary stakeholders are expressly the officers, directors, and any person holding more than twenty percent of the outstanding equity of every issuer whose securities are offered by such person. See *id.* The SEC implemented this provision by requiring an intermediary to have a "reasonable basis" for concluding an issuer complied with the requirements of Section 4A(b) and established a method for keeping accurate records of their investors. See Regulation Crowdfunding, 80 Fed. Reg. at 71,433. The rules would permit intermediaries to "reasonably rely" on an issuer's Section 4A(b) disclosures. See *id.* In addition, a funding portal must deny access to its platform or cancel the offering if it believes an issuer engaged in potentially fraudulent activity. See *id.* at 71,436. Furthermore, funding portals cannot be the recordkeepers because funding portals may not "hold, manage, possess, or otherwise handle investor funds or securities." See 15 U.S.C. § 78c(a)(80)(D) (2012) (prohibiting funding portals from handling investor funds); Regulation Crowdfunding, 80 Fed. Reg. at 71,449 (describing recordkeeping function of funding portals).

90. See 15 U.S.C. § 77d-1(b) (2012) (listing required information issuers must provide to SEC, intermediaries, and investors). A funding portal must make issuers' information publicly and easily available on the funding portal's website for a minimum of twenty-one days before any securities are sold in the offering, during which time the funding portal may accept investment commitments. See Regulation Crowdfunding, 80 Fed. Reg. at 71,441-71,442 (explaining disclosure requirements for issuers). The SEC also required that this information be publicly available on the funding portal's website until the offer and sale of securities are completed or cancelled. See *id.* at 71,441.

the aggregate amount of securities sold to investors.<sup>91</sup>

Although not specifically required in the CROWDFUND Act, Congress considered whether funding portals should provide a mechanism for facilitating communication between issuers and investors on a funding portal's website.<sup>92</sup> To reduce the risk of fraudulent comments, funding portals are required to maintain records of conversation.<sup>93</sup> Commentators expect these communication channels will provide transparency and reduce fraud because issuers will be subjected to scrutiny from the crowd.<sup>94</sup> This means the public, specifically prospective investors, will have broad access to view investors' comments about issuers on a funding portal's online platform.<sup>95</sup> The '33 Act

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91. See 15 U.S.C. § 77d(a)(6)(B) (2012) (imposing investor limitations); 15 U.S.C. § 77d-1(a)(8) (2012) (imposing obligation on intermediaries to ensure compliance with investor limitations). The SEC required a funding portal have—prior to allowing an investor purchase—a “reasonable basis” for concluding that an investor satisfies the statutory limitations. See Regulation Crowdfunding, 80 Fed. Reg. at 71,442. As commentators indicated, this poses the question of how a funding portal may determine whether an investor already exceeds limits when aggregating an investor's contributions to other intermediaries. See Letter from Michael Mace, CEO of Cera Tech., to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2, ¶ 5 (Apr. 13, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-10.pdf> [<http://perma.cc/MN9K-WJMY>] (arguing intermediaries should not be expected to track investments made on other intermediaries). As a result, the rules allow a funding portal to rely on an investor's representations of annual income, net worth, and amount of the investor's other investments in securities sold through other intermediaries. See Regulation Crowdfunding, 80 Fed. Reg. at 71,444.

92. See 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown). Senator Brown inspired the SEC's communication channels when he said “intermediaries should allow fellow investors to endorse or provide feedback about issuers and offerings, provided that these investors are not employees of the intermediary.” *Id.*

93. See Regulation Crowdfunding, 80 Fed. Reg. at 71,446 (explaining communication channels on intermediary's website). The rules forbid funding portals from participating in investor-issuer communications, aside from establishing guidelines for communication and removing fraudulent communications. See *id.* at 71,447. Additionally, the rules require that the funding portals make the communication channels publicly viewable. See *id.* To reduce the risk of fraudulent comments, funding portals are required to maintain records of conversations. See *id.* at 71,447 n.828; see also *Spurring Job Growth, Through Capital Formation: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 112th Cong. 3 (2012) (statement of Timothy Rowe, CEO, Cambridge Innovation Center) [hereinafter *Rowe Testimony*] (“Yet any eBay user will tell you that the incorporation of a system that tracks the reputation of buyers and sellers significantly mitigates fraud.”).

94. See *The JOBS Act—Importance of Effective Implementation: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 7 (2012) (statement of Alon Hillel-Tuch, CFO, RocketHub) [hereinafter *Hillel-Tuch Testimony*] (discussing communication channels); *Rowe Testimony*, *supra* note 93 (explaining communication channels will provide transparency); see also AM Marzoña, *How Useful Are Online Product Reviews? Don't Ask the Experts, Study Shows*, GMA NEWS (Dec. 22, 2011, 6:11 PM), <http://www.gmanetwork.com/news/story/242466/scitech/science/how-useful-are-online-product-reviews-don-t-ask-the-experts-study-shows> [<http://perma.cc/LW3S-4RM6>] (stating online reviews have persuasive impact because customers' opinions, unlike sponsored business', independent); *Responding to Reviews*, YELP, [https://biz.yelp.com/support/responding\\_to\\_reviews](https://biz.yelp.com/support/responding_to_reviews) (last visited Feb. 18, 2015) [<http://perma.cc/RHE2-UJGC>] (stating response to customer reviews can build cooperation with customers). Crowdfunding is highly transparent, and there is opportunity for substantial feedback from other community participants. See *Hillel-Tuch Testimony*, *supra*. The crowd will help police players and keeps them honest. See *id.* Portals provide a clear and central location for communication by potential investors to analyze and share their views on offerings. *Id.*

95. See Regulation Crowdfunding, 80 Fed. Reg. at 71,445 (stating only committed investors may post

also requires funding portals to ensure that all offering proceeds are only provided to the issuer once the issuer met or exceeded its target amount.<sup>96</sup> Accordingly, the SEC requires funding portals to direct investors to transfer proceeds to a *qualified third party*.<sup>97</sup> These third parties then hold the proceeds for the benefit of the investors or issuers and return the funds to the entitled party.<sup>98</sup> Unlike the SEC's proposals, the qualified third parties now have an expanded definition, per Regulation Crowdfunding, of "bank" under the '34 Act.<sup>99</sup> The CROWDFUND Act also defers to the SEC's discretion surrounding the establishment of process for a funding portal to register with the SEC—a more streamlined process compared to the existing system for broker-dealers.<sup>100</sup> Funding portals are now permitted to earn a commission from issuers posting on their platform.<sup>101</sup> A single funding portal registration can operate several different websites.<sup>102</sup>

The SEC does not want to restrict an issuer or its officers, directors, control persons, or affiliates from purchasing securities in an offering.<sup>103</sup>

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comments).

96. See 15 U.S.C. § 77d-1(a)(7) (2012) (requiring crowdfunded proceeds go to issuer when target met).

97. See Regulation Crowdfunding, 80 Fed. Reg. at 71,448 (describing maintenance and transmission of funds).

98. See *id.* Funding portals are statutorily prohibited from holding funds, so they may only "direct" investors to transmit funds to a qualified third party. *Id.* at 71,449; see also 15 U.S.C. § 78c (a)(80)(D) (2012) (prohibiting funding portals from handling investor funds).

99. See 15 U.S.C. 78c(a)(6) (2012) (defining "bank"); Regulation Crowdfunding, 80 Fed. Reg. at 71,450 (describing expansion of bank). The SEC's rationale for applying the '34 Act's definition of bank to the term qualified third party was so investors, issuers, and intermediaries could benefit from the existing regulatory protections that apply to banks. See Regulation Crowdfunding, 80 Fed. Reg. at 71,449. *But see* Anthony J. Zeoli, *Who Is Holding Your Money and Can You Trust Them?*, CROWDFUNDING LEGAL HUB (May 23, 2014, 7:53 PM), <http://crowdfundinglegalhub.com/2014/05/23/who-is-holding-your-money-and-can-you-trust-them/> [<http://perma.cc/D5NZ-C5S6>] (claiming banks have least connection to transaction, least public exposure, and little regulation). A "qualified third party" is also a credit union or certain types of registered broker-dealers. Regulation Crowdfunding, 80 Fed. Reg. at 71,450.

100. Compare 15 U.S.C. § 78o(b) (2012) (describing registration process for broker-dealers), with 15 U.S.C. § 77d-1 (a)(7) (2012) (omitting extensive instructions concerning registration for funding portals). The SEC may impose additional requirements that they determine are in furtherance of the "protection of investors and in the public interest." See 15 U.S.C. § 77d-1(a)(12) (2012). Accordingly, the SEC established a streamlined registration process for funding portals that is less extensive than that of Form BD for broker-dealers. See Regulation Crowdfunding, 80 Fed. Reg. at 71,454. Registering as a funding portal entails filing Form FP, which requires information of a funding portal's control relationships and its disciplinary history. See *id.* at 71,455.

101. See Robb Mandelbaum, *S.E.C. Clarifies That Crowdfunding Portals Will Be Able To Take Commissions*, N.Y. TIMES (Nov. 4, 2013, 3:19 PM), <http://boss.blogs.nytimes.com/2013/11/04/s-e-c-clarifies-that-crowdfunding-portals-will-able-to-take-commissions/> [<http://perma.cc/86FD-A74X>] ("To be clear . . . the rules do permit funding portals to receive commissions."); Sara Hanks, *Regulation CF: Funding Portals Can Charge Commissions!*, CROWDCHECK BLOG (Oct. 30, 2013), <http://www.crowdcheck.com/blog/regulation-cf-funding-portals-can-charge-commissions> [<http://perma.cc/3FSA-AUNC>] (stating funding portals can receive commissions from issuers).

102. See Regulation Crowdfunding, 80 Fed. Reg. at 71,457 (describing requirements for funding portals).

103. See Crowdfunding, 78 Fed. Reg. at 66,474 (explaining intermediaries must use heightened scrutiny when these persons invest).



Commentators that disagree with this concept, however, are concerned that non-bona fide issuers may nominate other issuers to invest in order to create the guise of success and thereby attract more investors.<sup>104</sup> Furthering these concerns, investors have an unconditional right to rescind an investment commitment, for any reason, until forty-eight hours before the deadline identified in an issuer's offering materials.<sup>105</sup> Commentators argue this potentially long window for rescinding investment commitments will facilitate non-bona fide investment schemes.<sup>106</sup> The SEC stated that funding portals should pay exceedingly high attention to other issuers' investments to ensure the investments were not and are not made to create an impression that an offering will likely be successful.<sup>107</sup> This bad-faith scenario could obligate funding portals to cancel an offering if they believe an issuer or offering presents the potential for fraud.<sup>108</sup>

### 3. FINRA's Proposed Rules

Section 4A(a)(2) of the '33 Act requires funding portals to register with any applicable self-regulatory organization (SRO).<sup>109</sup> The SEC implemented this provision by requiring CROWDFUND Act funding portals to become members

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104. See Letter from Jack Herstein, President of N. Am. Sec. Adm'rs Ass'n, Inc., to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (July 3, 2012), <https://www.sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf> [<http://perma.cc/BA6K-YN34>] (recommending prohibition on purchases by issuers, its officers, or affiliates from counting toward target offering). Commentators claim this prohibition will prevent issuers who receive insufficient capital from unaffiliated investors from "gam[ing] the system to accept investor funds in an offering that would otherwise fail." *Id.* ROCKETHUB identified this problem as *pump and dump*, where a deceitful issuer directs fake investors to *pump up* the offering by contributing significant capital up front to create the appearance of likely success, thereby attracting unaffiliated, bona fide investors. See ROCKETHUB, IMPLEMENTATION OF CROWDFUNDING: BUILDING ON TITLE III OF THE JOBS ACT: RESPONSE TO PROPOSED RULES, Release No. 33-9470, at 26 (2014), <http://www.sec.gov/comments/s7-09-13/s70913-206.pdf> [<http://perma.cc/CX6H-5XZQ>] [hereinafter ROCKETHUB RECOMMENDATIONS] (expressing concern regarding risk of *pump-and-dump* schemes). Once the unaffiliated, bona fide investors start joining the sham-investing success, the initial fake investors can slowly rescind their investments. See *id.*

105. See Regulation Crowdfunding, 80 Fed. Reg. at 71,453 (describing investors' with unconditional rescission right).

106. See Deschler, *supra* note 22, at 1157 (opining SEC's rescission rule provides large risk of fraud); ROCKETHUB RECOMMENDATIONS, *supra* note 104, at 12 (expressing concern for long rescission periods in context of *pump-and-dump* schemes). Commentators argue it is particularly important that funding portals empower investors with educational materials that highlight signs of fraud. See Cody R. Friesz, Note, *Crowdfunding & Investor Education: Empowering Investors To Mitigate Risk & Prevent Fraud*, 48 SUFFOLK U. L. REV. 131, 149 (2015) (arguing investors should be wary of investments too good to be true).

107. See Crowdfunding, 78 Fed. Reg. at 66,474 (explaining intermediaries must use heightened scrutiny when officers and directors invest). For example, an issuer repeatedly making investment commitments and cancellations may raise a red flag. See *id.*

108. See *id.* at 66,474 n.472 (stating intermediaries must cancel offering if it believes issuer presents potential for fraud); *supra* note 89 (explaining proposals for intermediaries' obligation to reduce fraud).

109. See 15 U.S.C. § 77d-1 (2012) (requiring CROWDFUND Act intermediaries to register with SRO). An SRO is a nongovernmental organization that is "statutorily empowered to regulate its members by adopting and enforcing rules of conduct." *Self-Regulatory Organization*, BLACK'S LAW DICTIONARY (10th ed. 2014).

of an SRO.<sup>110</sup> FINRA's proposed rules for funding portals, which are less extensive than the SEC's, are consistent with the CROWDFUND Act's general goal of shaping streamlined and cost-efficient regulations.<sup>111</sup>

### III. ANALYSIS

#### A. Adequacy of the SEC's Rules for Funding Portals

##### 1. Funding Portals' Ability To Reduce Fraud

###### a. Communication Channels

Congress intended that the CROWDFUND Act minimize fraud for unaccredited investors and the SEC's rule to mandate communication channels helps to attain that goal.<sup>112</sup> The rule provides prospective investors with additional protections and transparency because it allows prospective investors to view already-committed investors' feedback.<sup>113</sup> Communication channels greatly incentivize issuers to participate in fair and honest conduct because the public channels expose contrary conduct.<sup>114</sup> The communication channels also reduce information asymmetries because investors can post questions to the issuer's account at any time.<sup>115</sup> Consequently, unanswered or unsavory responses reflect negatively on the issuer because the unsavory response or lack of response will likely discourage prospective investors from funding the venture.<sup>116</sup> Moreover, funding portals develop a simple and user-friendly interface that encourages users to easily provide feedback, much like with *Amazon* or *eBay*.<sup>117</sup> The record of conversations and feedback on a funding portal's website also mitigates the risk of fraud because this information will be

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110. See Regulation Crowdfunding, 80 Fed. Reg. at 71,429 (requiring intermediaries to register with SRO). Financial Industry Regulatory Authority (FINRA) is currently the only SRO. See *id.* FINRA, although not a branch of the government, is authorized by Congress to protect investors through rules that facilitate fairness and honesty in the securities industry. See *About FINRA*, FIN. INDUS. REG. AUTH., <http://www.finra.org/About> (last visited Mar. 12, 2015) [<http://perma.cc/MG8H-YW8M>] (explaining FINRA's role in securities regulation).

111. See Notice of Filing of a Proposed Rule Change To Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4518, 80 Fed. Reg. 66,348, 66,349 (Oct. 22, 2015) (explaining purpose of FINRA's proposals); *Regulatory Notice 13-34*, FIN. INDUS. REG. AUTH. (Oct. 2013), <http://www.finra.org/web/groups/investor/@ip/@reg/@notice/documents/notices/p370743.pdf> [<http://perma.cc/N6SM-HGTJ>] (demonstrating commitment to streamlined and cost-efficient regulations).

112. See *supra* notes 53, 93 (explaining funding portal investors' vulnerability to fraud and SEC's proposal for communication channels, respectively).

113. See *supra* note 93 (explaining communication channels).

114. See *supra* note 94 (suggesting communication channels provide transparency).

115. See *supra* note 94 (suggesting transparency reduces information asymmetries).

116. See *supra* note 94 (stating customer reviews persuasive for prospective customers). Like with businesses on *Yelp*, issuers have incentive to build trust and positive relationships with their investors because unsatisfying responses or no responses could lead to a lack of trust in the issuer. See *supra* note 94.

117. See *supra* note 93 (comparing intermediaries to *eBay*).

subject to the SEC's review.<sup>118</sup>

*b. Funding Portals' Obligations To Reduce Fraud*

Prior to hosting an issuer's offering, funding portals will need to have a "reasonable basis" for concluding that an issuer complied with Section 4A(b).<sup>119</sup> This obligation provides an additional layer of protection against fraud because issuers already have an independent obligation to comply with Section 4A(b).<sup>120</sup> The rule requires funding portals to make issuers' Section 4A(b) disclosures publically available, which enables the public to scrutinize dubious issuers and further reduces the risk of fraud.<sup>121</sup> Although prospective investors' ability to scrutinize issuers is questionable because prospective investors are unsophisticated and have a limited ability to validate issuers' Section 4A(b) disclosures, a funding portals' obligation to act as a gatekeeper will likely prevent fraudulent issuers from operating.<sup>122</sup> Intermediaries, which are the most sophisticated party in crowdfunding, may use resources, such as advice from in-house or outside counsel, third-party services, and algorithmic methods of ascertaining inconsistent information to scrutinize issuers' Section 4A(b) disclosures.<sup>123</sup> It is vital for funding portals to attempt to prevent fraudulent offerings because crowdfunding investors will largely be unsophisticated.<sup>124</sup>

Funding portals must also assiduously scrutinize uncompleted, unrealized offerings on their platform for potential fraud.<sup>125</sup> Unlike the requirement for having a "reasonable basis" before posting an offering, funding portals must deny an unrealized offering merely if it believes the issuer presents a potential for fraud.<sup>126</sup> Funding portals have a strong incentive not to abuse this discretion because their reputational integrity is at stake, which is expected to play a significant role in the CROWDFUND Act as a result of its design for

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118. See *supra* note 93 (stating intermediaries required to maintain records of conversations).

119. See *supra* notes 89-90 (explaining intermediaries must have "reasonable basis" for concluding issuer complied with Section 4A(b)).

120. Cf. 15 U.S.C. § 77d-1(b) (2012) (listing disclosure requirements for issuers); Regulation Crowdfunding, 80 Fed. Reg. at 71,433 (discussing rule to require public accessibility of issuers' Section 4A(b) disclosures).

121. See *supra* note 90 (stating SEC's intention of making issuers more transparent).

122. See *supra* note 45 and accompanying text (explaining crowdfunding investors will be unsophisticated).

123. Cf. Crowdfunding, 78 Fed. Reg. at 66,542 (stating intermediaries hire outside consultants and attorneys); *The JOBS Act: Importance of Effective Implementation*, *supra* note 86 (arguing intermediaries will likely afford securities lawyers).

124. Cf. *supra* note 48 (explaining crowdfunding investors will be unsophisticated).

125. See *supra* notes 89-90 (explaining intermediaries merely must believe offering presents potential for fraud).

126. Compare Regulation Crowdfunding, 80 Fed. Reg. at 71,433 (requiring intermediaries have reasonable basis for issuers' compliance with Section 4A(b)), with Crowdfunding, 78 Fed. Reg. at 66,463 (proposing to not require intermediaries have reasonable basis if issuer presents potential for fraud).

openness and transparency.<sup>127</sup> If an issuer sneaks through a funding portal's initial review in complying with Section 4A(b) and is granted access to the funding portal's platform, then funding portal investors must learn the fundamental signs of fraudulent issuers through prerequisite investor education.<sup>128</sup> It is questionable whether funding portal investors will be able to identify a fraudulent issuer, especially when more sophisticated funding portals are not able to do so.<sup>129</sup> This question emphasizes the need for investors to be adequately educated about the risks associated with fraud and the need for funding portals to have careful procedures in place to monitor issuers' conduct.<sup>130</sup>

Concerns over a funding portal's broad discretion arise over non-bona fide investments made to appear successful during the window for rescinding investment commitments.<sup>131</sup> In these *pump-and-dump* schemes, an issuer could conceal fraud as soon as it accesses the online platform because the issuer has the ability to direct sham investors to create an illusion of success.<sup>132</sup> An issuer's ability to provide a long investment-rescission period enables fake investors to slowly rescind their investments once the fraudulent issuer procures sufficient contributions.<sup>133</sup> These schemes may be easy for funding portals to miss because funding portals likely have many live offerings and investment commitments to monitor at one time.<sup>134</sup> The *pump-and-dump* scheme is concerning because even an issuer complying with Section 4A(b) is still capable of successfully committing fraud.<sup>135</sup> Therefore, funding portals must use an extremely high level of care and judiciously monitor situations where an issuer receives investments from other issuers.<sup>136</sup> Bona fide investors must also heavily rely on communication channels to engage issuers on the whereabouts of their contributions.<sup>137</sup> Furthermore, funding portals need to

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127. See Regulation Crowdfunding, 80 Fed. Reg. at 71,517 (stating funding portals can protect integrity of offering process and market reputation of platforms); see also Crowdfunding, 78 Fed. Reg. at 66,463 (explaining intermediary's reputation at stake if fraud occurs on its watch).

128. See *supra* note 106 (articulating need for investors to identify signs of fraudulent issuers). It is erroneous to presume that investors' dependence on diligence and education will avoid investing in fraudulent offerings. See *supra* note 106. That possibility greatly emphasizes the need for funding portals to optimize effective use of their gatekeeping function. See *supra* note 106.

129. See *supra* notes 45, 53 and accompanying text (explaining crowdfunding investors will be unsophisticated).

130. See *supra* notes 45, 53 and accompanying text (discussing concerns related to unsophisticated investors).

131. See *supra* notes 104, 106 (explaining *pump-and-dump* schemes).

132. See *supra* notes 104, 106 (detailing risks arising out of *pump-and-dump* schemes).

133. See *supra* notes 104, 106 (explaining concerns regarding *pump-and-dump* schemes).

134. See Deschler, *supra* note 22, at 1172 (discussing need for intermediaries to monitor *pump-and-dump* schemes).

135. See *id.* (discussing concerns regarding *pump-and-dump* schemes).

136. See Crowdfunding, 78 Fed. Reg. at 66,474 (explaining intermediaries must use heightened scrutiny when issuers invest).

137. See *supra* note 93 (stating communication channels provide transparency).

monitor discussions to ensure that issuers are not participating in *pump-and-dump* schemes.<sup>138</sup> Although there are still potential weaknesses in the ability to consistently detect fraud in light of the SEC's new rules, the rules do facilitate openness and transparency, which is a step in the right direction and will ultimately reduce opportunities for crowdfunding securities fraud.<sup>139</sup>

*c. Transmission of Funds*

Fortunately, the SEC's rules requiring funding portals to direct investor and issuer funds to a qualified third-party bank is also consistent with reducing fraud.<sup>140</sup> This requirement reduces both a funding portal's and an issuer's capability to participate in self-serving opportunities because the proceeds are held in a third-party bank account until the issuer meets its target-offering amount.<sup>141</sup> Although third-party banks face little public accountability in that they do not receive immediate public scrutiny the same way issuers do, the SEC's rules afford issuers, investors, and funding portals the protections of already existing regulations.<sup>142</sup> The rules hold a third-party escrowee accountable as a bank, thus deterring the third party from participating in fraud and misappropriation.<sup>143</sup>

*d. Limitation on Investment Advice & Investor Education Requirements*

An important limitation on funding portals is that they are prohibited from offering investment advice to unsophisticated investors.<sup>144</sup> Some critics have argued that this limitation is fatal because an unaccredited investor's vulnerability to fraud is increased without proper resources informing his or her decision to contribute to an issuer, however, this criticism is unfounded.<sup>145</sup> Although it is possible a broker-dealer's ability to provide investment advice may reduce an investor's vulnerability to fraud, the mandatory investor education that investors must endure before contributing to an issuer will reduce the risk of fraud.<sup>146</sup> Moreover, the inability to provide investment advice does not significantly reduce investors' vulnerability, as critics may claim, because if, by analogy, an investment advisor working from a broker-

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138. See *supra* notes 93-94 (discussing communication channels).

139. See *supra* text accompanying note 127 (explaining openness and transparency in SEC's proposed rules).

140. See *supra* notes 96-99 (describing funding portals' responsibility for transmitting funds).

141. Compare *supra* notes 96-99 (explaining funding portals transmit funds through third-party bank), with Darke, *supra* note 13, at 189-90 (claiming online investments expose investors to fraud and facilitate self-dealing opportunities for issuer entrepreneurs).

142. See *supra* notes 96-99 (explaining prohibition against funding portals handling investor funds).

143. See *supra* notes 96-99 (describing funding portals' responsibility for transmitting funds).

144. See 15 U.S.C. § 78c(a)(80) (2012) (prohibiting funding portals from offering investment advice).

145. See *supra* notes 45, 53 (explaining vulnerabilities unsophisticated investors face when investing).

146. See Regulation Crowdfunding, 80 Fed. Reg. at 71,495 (stating mandatory investor education helps inform investors of risks associated with Title III investments).

dealer's website, similar to the funding portals at issue, believes one of the listed issuers engaged in fraudulent conduct, then the broker-dealer must immediately cancel the issuer.<sup>147</sup> The fraudulent offering would be canceled before the broker-dealer's investment advisor ever counsels an investor of possible fraud.<sup>148</sup> A similar result arises in the context of funding portals because if one of its listed issuers is engaging in fraudulent conduct, the funding portal must also cancel the order and again, investment advice provided to deter fraud is moot.<sup>149</sup> Thus, a funding portal's inability to offer investment advice does not necessarily increase an investor's vulnerability to fraud.<sup>150</sup>

## 2. *Efficient and Manageable Requirements for Funding Portals*

Cost efficient and manageable requirements are essential aspects of the CROWDFUND Act.<sup>151</sup> The SEC's rule for the streamlined Form FP, which imposes lighter regulations than Form BD, is consistent with the goal of cost-effectively allowing funding portals to register and operate.<sup>152</sup> The SEC conservatively expects that funding portals will save \$353,000 in startup costs and \$180,000 in annual costs compared to working with traditional broker-dealers.<sup>153</sup> Form FP will provide prospective intermediaries with a more affordable alternative to Form BD because prospective intermediaries registering as a funding portal will be required to file less extensive information and pay lower initial fees.<sup>154</sup> Importantly, the lower cost to register as a funding portal for prospective intermediaries means intermediaries will likely attract more issuers because funding portals are then unlikely to pass down large fees to issuers, making intermediaries more appealing to prospective issuers.<sup>155</sup> Although funding portals' operations cannot offer investment advice (unlike intermediaries registering under Form BD), funding portals' lower

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147. *See id.* at 71,517 (requiring intermediaries to cancel offering if issuer presents possibility of operating fraudulently); *see also* Crowdfunding, 78 Fed. Reg. at 66,474 n.472.

148. *See* Regulation Crowdfunding, 80 Fed. Reg. at 71,543 (stating intermediaries must cancel offering if issuer presents risk of fraud). The rules require a funding portal to "promptly" remove an offering from its platform if the funding portal obtains information that an issuer possibly engaged in fraudulent conduct. *Id.*

149. *See id.* (requiring intermediaries to cancel offering if issuer presents possibility of fraudulent).

150. *See supra* notes 144-149 and accompanying text (arguing funding portals' inability to offer investment advice does not increase fraud).

151. *See supra* notes 47-48 (stating Title III's purpose to offer manageable and cost effective investment opportunities). Specifically, startup costs for first-year funding portal registrants are expected to pay much less than prospective registrants filing under Form BD. *See* Regulation Crowdfunding, 80 Fed. Reg. at 71,509-10 (comparing funding portal costs with broker-deal costs).

152. *See supra* note 100 (explaining Form FP).

153. *See* Regulation Crowdfunding, 80 Fed. Reg. at 71,510 (estimating costs for crowdfunding intermediaries).

154. *See id.* at 71,388 (stating Title III's aim to offer manageable and cost-effective investment opportunities).

155. *Cf. id.* (estimating costs for crowdfunding intermediaries).

registration and compliance costs, and the possibility that more issuers will be attracted to funding portals, will offset these limitations.<sup>156</sup> Moreover, prospective intermediaries registering as funding portals may prefer limited operations because the CROWDFUND Act is expected to attract small businesses.<sup>157</sup>

The SEC's rules properly provide CROWDFUND Act funding portals with discretion to collect a commission from offerings posted on their platforms.<sup>158</sup> Thus, CROWDFUND Act funding portals will have access to additional revenue-generating compensation from offerings.<sup>159</sup> For example, assume that the entrepreneurs of an opportunity are satisfied because they received their target capital.<sup>160</sup> The opportunity is successful and draws a hefty profit.<sup>161</sup> The investors are also satisfied because they earn a return on their investment.<sup>162</sup> The SEC's rules permit funding portals to take a percentage of an issuer's success.<sup>163</sup> Although issuers could be burdened with the additional expense of commissioning the funding portal, this is unlikely because the rule requires funding portals to disclose the percentage of commissions earned.<sup>164</sup> Thus, successful issuers could offset the commissions they owe to funding portals by increasing their offering-target amount in consideration of this expense.<sup>165</sup>

Similar to other nonequity crowdfunding platforms, like *Kickstarter*, CROWDFUND Act funding portals can attract more issuers through refusing commissions from issuers unsuccessful in raising target capital.<sup>166</sup> This will prevent forcing a failed issuer to pay a commission to the funding portal, which eases the costs of a failed endeavor.<sup>167</sup> Finally, compensating funding portals for an issuer's successful offering is in accordance with efficient regulations because it provides funding portals with a revenue-generating incentive to facilitate successful offerings.<sup>168</sup>

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156. *Cf. supra* note 87 (articulating limitations on funding portals).

157. *See supra* note 57 and accompanying text (stating Title III aimed to stimulate small business). Prospective funding portals may be attracted to the fact that they are barred from offering investment advice due to the complexity of investment-advisor regulations. *See* Crowdfunding, 78 Fed. Reg. at 66,472 n.443 (explaining conditions on brokers offering investment advice); *supra* note 87 (explaining burdensome aspects of investment advisor regulation).

158. *See supra* note 101 (stating funding portals can earn commissions from issuers).

159. *See* Mandelbaum, *supra* note 101 (explaining intermediaries can opt to take commissions).

160. *See supra* note 45 (explaining process of crowdfunding).

161. *Cf. supra* note 45 (detailing crowdfunding principles).

162. *See supra* note 45 (explaining process of crowdfunding).

163. *See supra* note 101 (stating funding portals can earn commissions from issuers).

164. *See* Regulation Crowdfunding, 80 Fed. Reg. at 71,441 (requiring intermediaries to disclose manner of compensation based on offerings).

165. *Cf. Bradford, supra* note 11, at 105 (detailing crowdfunding principles).

166. *Cf. supra* note 16 (stating equity crowdfunding similar to reward-based crowdfunding).

167. *Cf. supra* note 56 (explaining crowdfunding has benefit of receiving financial returns).

168. *Cf. supra* note 45 (explaining process of crowdfunding).

## IV. CONCLUSION

In a sense, Benjamin Franklin's famous snake-with-two-heads anecdote is analogous to the struggle the SEC faces with its regulatory oversight in balancing differing interests. On one side, it is necessary to ensure the SEC protects unaccredited investors from the risk of fraud; this protection, however, requires restrictive regulations that impede the flow of capital and business. On the other side, economic growth inherently demands freedom and flexibility to enable businesses to move unencumbered from regulatory restraints. The SEC is tasked with remedying these diverging interests.

Whether these differing interests can, in practice, be effectively balanced is still yet to be seen in the context of the CROWDFUND Act. It is not entirely clear whether the CROWDFUND Act will end up like Franklin's two-headed snake, failing to achieve either objective, as the result of the dilemma in balancing these two ideals. The SEC's rules, however, are mindful of this balance and are the proper path for working toward stabilizing both interests. Therefore, the SEC's rules for funding portals are well founded because they embark on establishing funding portals as cost-effective gatekeepers, while also protecting investors' interests.

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