

Vanderbilt Law Review En Banc

Volume 66
Issue 1 *En Banc* - 2013

Article 1

2024

Making Crowdfunding Credible

Douglas S. Ellenoff

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vlreb>

Recommended Citation

Ellenoff, Douglas S. (2024) "Making Crowdfunding Credible," *Vanderbilt Law Review En Banc*: Vol. 66: Iss. 1, Article 1.

Available at: <https://scholarship.law.vanderbilt.edu/vlreb/vol66/iss1/1>

This Roundtable is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review En Banc by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

ROUNDTABLE

Making Crowdfunding CREDIBLE

*Douglas S. Ellenoff**

INTRODUCTION	19
I. CROWDFUNDING	20
A. <i>General Provisions</i>	20
B. <i>Investment Advice</i>	22
C. <i>The Crowd as a Check</i>	24
D. <i>Solicitation and Advertising</i>	24
E. <i>Disclosure</i>	26
CONCLUSION.....	27

INTRODUCTION

The enactment of the Jumpstart Our Business Startups Act (the “JOBS Act”) on April 5, 2012 was both a pivotal moment for capital formation and an acknowledgment that the Internet and social media necessitated the change.¹ Except for securities lawyers and regulators, this shouldn’t be much of a surprise, since both the Internet and social media have impacted almost all other industries around the world, and it has been eighty years since the original Securities Act of 1933 was passed. The JOBS Act seeks to more intelligently align capital formation with the way modern society operates and interacts on a daily basis.

The Securities Act of 1933 (the “Securities Act”), as amended, requires that any offer or sale of securities be registered with the Securities and Exchange Commission (the “SEC”) unless there is an exemption available.² Typically, the exemptions that are available

* Member, Ellenoff Grossman & Schole LLP.

1. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 315 (2012) (codified in scattered sections of 15 U.S.C.).

2. 15 U.S.C. §77e (2006).

under the Securities Act are limited and permitted only in the context of “friends and family” financings or either sophisticated or accredited investors being offered to participate in the financing. The rationale for these exemptions is that the potential investors either know the entrepreneurs by virtue of their relationships or have the financial sophistication to understand or the means to assume the risk of loss of their investments.³ The policy considerations for permitting each of these exemptions recognize that these financings do not trigger many of the societal or regulatory concerns present in an offering to the general public or to nonaccredited investors. Where the entrepreneur has no preexisting relationship with the investor, the risk of fraud may be higher. More sophisticated or wealthier investors are presumed to be able to analyze the investment opportunity for themselves or bear the financial risk. It is important to remember that the Securities Act originated out of the tremendous losses suffered by the U.S. populous during the Great Depression. Titles II and III of the JOBS Act are meaningful departures from the eighty-year-old tenets established by the Securities Act, which defined in many ways the difference between what a private placement and public offering were deemed to be, and thus, when registration was required.

This Essay will primarily focus on Title III, which creates exemptions for “crowdfunding,”⁴ although Title II is also relevant to an overall understanding of the impact of the JOBS Act. Title II relates to the so-called lifting of the ban on general solicitation that prohibited the public marketing of unregistered private offerings. Under Title II, so long as the securities are only sold to accredited investors, such public solicitation will be permitted, as with registered securities.⁵ Although Title III is the law today, crowdfunding remains subject to the SEC establishing and approving final rules. As of April 13, 2013, the SEC has received over 180 comment letters from the public.

I. CROWDFUNDING

A. General Provisions

Crowdfunding is a new exemption under the Securities Act that will permit entrepreneurs to raise up to \$1 million from investors, including nonaccredited investors, through the sale of unregistered

3. See 17 C.F.R. § 230.501 (delineating the accredited investor exception).
4. Jumpstart Our Business Startups Act § 301–05.
5. 15 U.S.C. § 77d; see also 17 C.F.R. § 230.501.

securities.⁶ Such offerings must be conducted through Internet-based funding portals, which are regulated by both the SEC and FINRA, or through FINRA-licensed broker-dealers.⁷ Title II also specifically provides that licensed broker-dealers may conduct crowdfunding offerings and will have greater flexibility in the services that they may provide to both issuers and entrepreneurs. Offerings may only be conducted by entrepreneurs through domestic corporate entities, and there is a \$1 million aggregate annual cap that is determined on a twelve-month rolling basis.⁸

In addition to the cap on the amount that the issuer may raise, Title III contains limitations on the amount any investor may invest in any one crowdfunding opportunity or in crowdfunding activity generally, also determined on the basis of a rolling twelve-month period.⁹ Investors with an annual income or net worth of up to \$100,000 will be permitted to invest up to \$2,000 or five percent of their annual income or net worth in any twelve-month period, whichever is greater.¹⁰ Investors with an annual income or net worth of \$100,000 or greater will be permitted to invest ten percent of their annual income or net worth.¹¹ The statutory provision is somewhat unclear since there is both an annual income and a net worth test; however the SEC is aware of this drafting issue and intends to clarify the issue in their final rules.¹² Investors are limited to investing \$100,000 in overall crowdfunding opportunities in a twelve-month period. Also, investors who purchase securities in a crowdfunding transaction are restricted from transferring those securities for a period of one year, although this restriction is subject to certain exceptions, including transfers: (i) to the issuer, (ii) to an accredited investor, (iii) pursuant to an offering registered with the SEC, or (iv) to the investor's family members.¹³

It is interesting to note that there is no definition of "investor" in Title III. As counsel to the Crowdfunding Intermediary Regulatory Advocates ("CFIRA"), an industry association, we have argued to the

6. Jumpstart Our Business Startups Act § 302, 15 U.S.C.A. § 77d(6)(A) (West Supp. 2012).

7. *Id.* § 77d(6)(C).

8. *Id.* § 77d(6)(A).

9. *Id.* § 77d(6)(B).

10. *Id.*

11. *Id.*

12. Memorandum from Sebastian Gomez Abero, Special Counsel, Sec. & Exch. Comm'n, Meeting With Representatives of Frankfurt Kurnit Klein & Selz (Feb. 27, 2013), *available at* www.sec.gov/comments/jobs-title-iii/jobtitleiii-222.pdf.

13. Jumpstart Our Business Startups Act § 302, 15 U.S.C.A. § 77d-1(e).

SEC that both accredited investors and institutional investors ought to be excluded from both sets of caps, since the protections aren't necessary or applicable to protect these types of investors. If this were to be the accepted interpretation, entrepreneurs may be better able to raise additional funds, and accredited and institutional investors could invest more.

B. Investment Advice

Unlike a licensed broker-dealer, a funding portal is restricted from offering investment advice or recommendations to investors.¹⁴ Depending upon how the SEC drafts the proposed rules for Title III, the consequences of what is deemed to be "investment advice" could have a significant impact on investors and the emergence of the crowdfunding industry. In the past, the SEC has defined investment advice as "provid[ing] advice, or issu[ing] reports or analyses, regarding securities or as to the advisability of investing in, purchasing, or selling securities."¹⁵

Although there are many concerns for the crowdfunding industry with respect to how investment advice may be interpreted and applied to funding portal activity, one of the most significant concerns is how and what opportunities may be "posted" to a funding portal website.¹⁶ If the SEC determines that a funding portal "curating" opportunities on its website is investment advice, then funding portals must post *all* opportunities that are consistent with their terms of use in order to comply with the prohibition on providing any investment advice. Funding portals do have the ability to preclude certain pre-identified types of offerings, so that not all opportunities must be posted. For example, they can be limited by geography, industry, revenues, social responsibility policies, and other similar factors. The limitations must be explicitly stated in the funding portal's terms of use and must apply an objective standard.¹⁷

14. Jumpstart Our Business Startups Act § 304(b), 15 U.S.C.A. § 78c(a)(80).

15. SEC Staff Legal Bulletin No. 11 (Sep. 19, 2000), *available at* <http://www.sec.gov/interp/legal/slbim11.htm>; *see also* 15 U.S.C. § 80b-2(a)(11) (2006) (defining "investment advisor" similarly).

16. We use the term "posting" of opportunities by an entrepreneur on a funding portal as opposed to "listing", which is a term of art in the securities industry and is only lawful in the context of a regulated stock exchange or alternative trading platform.

17. *See* Letter from The Crowdfund Investing Regulatory Advocates to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (June 5, 2012), *available at* <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-29.pdf>. The author was also a participant in group meetings with the SEC where these issues were discussed.

Investment advice is a broader concept than just curation. For example, the SEC has indicated that adding information on the homepage of the funding portal that highlights the deals of the day, week, or month may also be interpreted to be a violation. Profiling an investor and then suggesting certain new deals available to him the next time he returns to the site based upon his prior activity would also cause regulatory concern. An investor may opt in to receiving such pushed information after completion of necessary consents.¹⁸

Funding portals registered as a broker-dealer may “curate.” However, with curation may come the associated risk to the operator that such activity requires heightened due diligence responsibilities, and consequently, potential liability. Title III specifically provides that an issuer has liability in the offering or sale of a security in a crowdfund transaction that “makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.”¹⁹ This provision is contained in the section of Title III specific to the obligations and responsibilities of issuers and defines “issuer” to include “any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer” offering or selling a security in a crowdfund transaction *and* “and any person who offers or sells the security in such offering.”²⁰ Arguably, the provisions of Title III would limit the statutory responsibility and liability of a funding portal (but not of a broker-dealer) if the portal does not curate and isn’t involved in the “offer and sale” of securities—much like eBay and Craigslist are merely posting sites. If Congress had intended for the funding portals to have such liability, they more likely would have said it expressly and not made a vague reference to it in the section of Title III regarding issuers rather than the section related to funding portal activities and responsibilities. This is further bolstered by the congressional intent to maintain a regulatory light touch with respect to funding portals.²¹

18. *Id.*

19. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(c)(2)(A).

20. *Id.* § (c)(3).

21. See, e.g., 158 Cong. Rec. S5,474–78 (daily ed. July 26, 2012) (statement of Sen. Jeff Merkley) (urging that funding portals be subject to a “streamlined regulatory approach”); A. Brian Dengler, *Lawmaker Urges “Light Touch” to Crowdfunding Regulation*, CrowdFund Intermediary Regulatory Advocates (July 13, 2012 6:26 PM), <http://www.cfira.org/?p=705> (“[Rep. Patrick McHenry] said the basic construct of the crowdfund provisions of the JOBS Act was a ‘light touch to regulation.’”).

Since funding portals will in all likelihood have reduced responsibilities compared to typical broker-dealers, investors really must proceed to these sites with a *caveat emptor* mindset since there will not be any meaningful curation of opportunities by the operator even if the interpretation is relaxed. Title III does require that criminal background checks be undertaken with respect to the entrepreneurs and certain affiliated parties to the opportunities, which ought to be a meaningful antifraud detection mechanism.²²

C. The Crowd as a Check

Many operators of funding portals have observed in articles and conferences that I have attended that another overlooked and underappreciated aspect of Title III is the equally active role social media will play in securities-based crowdfunding, like it does already in donations- and rewards-based crowdfunding. The crowd will be active and involved and will provide meaningful commentary and leadership in the investment-decision process. It will cause discussion of many traditional due diligence topics, but in an open and transparent environment, on subjects such as: who the people involved in the campaign are, who their colleagues are, what they have done previously in their business lives, valuation and structure, and competitors and other risks of the opportunity. According to discussions that we have engaged in with the owners and operators of certain international funding platforms that are already conducting crowdfunding activities in the United Kingdom and Australia, the role of the crowd has been important, active, and lively.

D. Solicitation and Advertising

Often lost in the discussion about crowdfunding is that entrepreneurs and funding portals are limited in their communications with the public. Unlike Title II, where the communications between an issuer and the public will be permissive, subject only to common law antifraud standards, Title III is more restrictive. Under Title III, an issuer may not advertise its offering except to direct prospective investors to the funding portal or broker.²³ Although a funding portal may generally market itself as an interesting place for the public to register in order to find and search various investment opportunities, it may not market specific

22. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(5).

23. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(b)(2).

opportunities or offerings.²⁴ By restricting the funding portal to marketing itself only as a marketplace of opportunities and prohibiting portals from actively marketing specific opportunities, casual visitors to the website will not take the time and trouble, in my judgment, to either register on the site or to undertake the education required to actually invest. Practically, the consequence of this rule suggests to me that only truly interested investors will come to the site, either because they have specific interest in one particular crowdfunding campaign that they learned about directly from the entrepreneur, or because they are seeking out the platform to identify a range of possible opportunities. For these reasons, contrary to often-stated concerns by investor-protection advocates, it is extremely unlikely that “widows and orphans” will unwittingly get caught up in crowdfunding.

An additional feature of Title III that should help address the concerns of regulators and investor-protection advocates is that funding portals may not solicit purchases, sales, or offers to buy securities offered by the portal.²⁵ Funding portals are also prohibited from paying their agents or employees any compensation based on the sale of securities offered on their website.²⁶ This is an expansion of the SEC’s general prohibition on paying finders in ordinary private placements and exempt transactions. Additionally, an investor seeking to invest in a crowdfunded offering faces several hurdles to investing, which should help dissuade those investors tempted solely by a salesperson’s pitch. An interested investor must first register with an intermediary (such as the funding portal). The intermediary then has several substantive obligations to protect investors under Title III. Intermediaries must ensure that investors review certain educational material and acknowledge that the investor both understands the risks inherent in a crowdfunding investment and can sustain the risks of loss. Investors must demonstrate to the intermediary an understanding of the risks associated with investing in new ventures and small business.²⁷

In practice, this means that only truly interested parties, acting of their own volition and not at the urging of paid salespeople, who are prepared to take the time to register with the funding portal, share personal information, and undergo investor education, will ever

24. Jumpstart Our Business Startups Act § 304(b), 15 U.S.C.A. § 78c(a)(80).

25. *Id.* § 78c(a)(80)(B).

26. *Id.* § 78c(a)(80)(C).

27. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(4).

have access to, and the opportunity to, actually make a crowdfunding investment.

E. Disclosure

Equal access to and disclosure of material information is a core principal of federal and state securities regulations. It is essential for investors to have the necessary information to appreciate the potential risks and rewards of an investment. Consistent with most securities programs, although more streamlined than other private placement requirements to nonaccredited investors, Title III requires issuers to provide investors with a description of the following, along with certain financial disclosures and information:

Company: the issuer and its members, including the name, legal status, physical address, the names of the directors and officers holding more than twenty percent of the shares of the issuer;

Offering: the anticipated business plan of the issuer, the target offering amount, the deadline to reach the target offering amount and the price to the public of the securities;

Structure: the ownership and capital structure of the issuer, including terms of the securities of the issuer being offered;

Valuation: how the securities being offered are being valued and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions;

Risks: the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties;

Financial Statements: the extent to which an issuer must disclose its financial statements varies depending on the aggregate amount offered, including any prior offerings in the preceding twelve-month period.

For crowdfunding offerings with an aggregate offering amount up to \$100,000, the issuer must disclose its most recently filed income tax returns and its financial statements certified by the issuer's principal executive officer.

For offerings that exceed \$100,000 during the twelve-month period but are less than \$500,000, the issuer must provide financial statements reviewed by an independent public accountant.

For an aggregate offering amount exceeding \$500,000, the issuer must provide audited financial statements.²⁸

28. *Id.* § 77d-1(b)(1).

CONCLUSION

As I have travelled and discussed crowdfunding, I have highlighted to audiences that crowdfunding is CREDIBLE:

C is for Caps on investor investments;

R is for the funding portals that are required to be Regulated by the SEC and FINRA;

E is for the requirement for meaningful investor Education;

D is for the full and fair Disclosure of the opportunity;

I is for Informed risk;

B is for the Background checks that are required of the entrepreneurs;

L is for the Limit on the amount an entrepreneur may raise; and

E is for the Entrepreneur and assisting capital formation in the United States.

The importance of crowdfunding may be only truly appreciated once you understand the following statistics: (i) seventy percent of all venture capital in the United States is deployed to opportunities in New York, California, and Massachusetts²⁹ and (ii) over ninety-five percent of all venture funding is for opportunities managed by men.³⁰ Crowdfunding, when it becomes available to startups and the public, will more efficiently enable entrepreneurs across the country to raise much needed capital from friends, family, customers, and others for their community-based businesses and high-growth technology opportunities.

29. SMALL BUSINESS ADMINISTRATION, START UP AMERICA: EMPOWERING AMERICA'S ENTREPRENEURS (2013), *available at* <http://www.sba.gov/startupamerica>.

30. Leslie Bradshaw, *How Women Are Getting Left Out of the Venture Capital Game*, *Forbes* (Mar. 25, 2013, 10:05 PM), <http://www.forbes.com/sites/lesliebradshaw/2012/01/10/how-women-are-getting-left-out-of-the-venture-capital-game/>.