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## Title III of the JOBS Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital of Fraudsters' Bank Accounts?

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## NOTE

### TITLE III OF THE JOBS ACT: USING UNSOPHISTICATED WEALTH TO CROWDFUND SMALL BUSINESS CAPITAL OR FRAUDSTERS' BANK ACCOUNTS?

#### I. INTRODUCTION

Starting a business is a significant undertaking. Entrepreneurs often work grueling, around-the-clock hours in high-pressure environments for the opportunity to be one of the rare successful businesses that survive the first few tumultuous years.<sup>1</sup> Recently, the impetus behind entrepreneurship has been a shot at quick and tremendous success, as exemplified by companies like Facebook,<sup>2</sup> Instagram,<sup>3</sup> Twitter,<sup>4</sup> Rovio,<sup>5</sup> and Zynga.<sup>6</sup>

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1. *Frequently Asked Questions*, U.S. SMALL BUS. ADMIN., 3 fig.5 (Sept. 2013), [http://www.sba.gov/sites/default/files/FAQ\\_Sept\\_2012.pdf](http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf). “Seven out of 10 new employer firms survive at least 2 years, half at least 5 years, a third at least 10 years, and a quarter stay in business 15 years or more.” *Id.*

2. Geoffrey A. Fowler, *Facebook: One Billion and Counting*, WALL ST. J., Oct. 5, 2012, at B1 (commenting on the growth of Facebook since being founded in 2004 to having over one billion users and a valuation of over \$100,000,000,000 in May of 2012).

3. Dominic Rushe, *Instagram Founders Turn Two Years of Work into \$1bn—Only in Silicon Valley*, GUARDIAN (Apr. 10, 2012, 1:31 PM), <http://www.guardian.co.uk/technology/2012/apr/10/instagram-founders-two-years-silicon-valley> (describing how Instagram went from being founded to a one billion dollar acquisition in two years).

4. Om Malik, *A Brief History of Twitter*, GIGAOM (Feb. 1, 2009, 11:35 AM), <http://www.gigaom.com/2009/02/01/a-brief-history-of-twitter> (discussing how work on Twitter's predecessor “Twtr” began in 2006, and as of 2009, Twitter was rumored to be valued at \$250 million).

5. See *Rovio Entertainment*, CRUNCHBASE, <http://www.crunchbase.com/company/rovio-entertainment> (last updated June 27, 2013) (recounting the over \$42 million in financing that Rovio Entertainment has received and describing the globally successful Angry Birds “app” and franchise).

6. See Dean Takahashi, *How Zynga Grew from Gaming Outcast to \$9 Billion Social Game Powerhouse*, VENTUREBEAT (Dec. 12, 2011, 7:00AM), <http://www.venturebeat.com/2011/12/12/zynga-history> (describing how the company went from being founded in July of 2007 to a one billion dollar IPO, at an \$8,900,000,000 valuation, in December of 2011).

One of the biggest obstacles in starting any business is gaining access to capital.<sup>7</sup> In today's unstable economy, entrepreneurs have had diminishing success in securing capital through the traditional methods of bank loans, venture capital firm financing, and initial public offerings.<sup>8</sup> However, since the creation and rapid development of the Internet, securing capital for a venture has become much easier.<sup>9</sup> Increased access to the Internet and the craze of social media have connected people from around the world and greatly facilitated the creation of and participation in burgeoning businesses.<sup>10</sup>

The ever-growing interconnectedness of people in recent years has significantly facilitated the ability to "crowdsource."<sup>11</sup> Crowdsourcing is "collecting contributions from many individuals to achieve a goal."<sup>12</sup> The process of crowdsourcing has been increasingly used in the context of raising financial capital for businesses and has been appropriately dubbed "crowdfunding."<sup>13</sup> Crowdfunding utilizes a large number, or "crowd," of investors each contributing a small amount of capital to secure the total required funding amount needed for product realization.<sup>14</sup> However, until recently, only unregistered, non-equity

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7. See President Barack Obama, Remarks on Signing the Jumpstart Our Business Startups Act, (Apr. 5, 2012) [hereinafter Obama, Remarks], available at <http://www.gpo.gov/fdsys/pkg/DCPD-201200249/pdf/DCPD-201200249.pdf> ("[N]o matter how good [entrepreneurs'] ideas are, if [they] can't get a loan from a bank or backing from investors, it's almost impossible to get their businesses off the ground.").

8. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 [hereinafter Bradford, *Crowdfunding*].

9. See, e.g., D. Scott Freed, *Crowdfunding as a Platform for Raising Small Business Capital*, MD. B.J., July–Aug. 2012, at 12, 14 (stating that crowdfunding has "received significant attention and support" as a method of raising capital); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 880–82 (2011) (describing the impact that the Internet has on crowdfunding and raising capital).

10. See Bradford, *Crowdfunding*, *supra* note 8, at 5; Randy L. Dryer, *Advising Your Clients (and You!) in the New World of Social Media: What Every Lawyer Should Know About Twitter, Facebook, YouTube, & Wikis*, UTAH B.J., May–June 2010, at 16, 16. Dryer stated that:

Social media is word of mouth on steroids and is beginning to morph from a fun and easy way to stay socially connected with friends into a dynamic and interactive way of doing business and practicing law. Businesses must now interact with their customers and other stakeholders in an entirely different way . . . .

*Id.*

11. See Bradford, *Crowdfunding*, *supra* note 8, at 27–28.

12. Tina Rosenberg, *Crowdsourcing a Better World*, N.Y. TIMES OPINIONATOR (Mar. 28, 2011, 9:15 PM), <http://www.opinionator.blogs.nytimes.com/2011/03/28/crowdsourcing-a-better-world>.

13. See Bradford, *Crowdfunding*, *supra* note 8, at 11–13; Freed, *supra* note 9, at 14; Isabel Isidro, *List of Crowd Funding Sites*, POWERHOMEBIZ (Jan. 10, 2011), <http://www.powerhomebiz.com/blog/2011/01/list-of-crowd-funding-sites> (listing dozens of websites that offer businesses a platform to crowdfund capital for their venture).

14. C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 196 (2012) [hereinafter Bradford, *Promise Unfulfilled*].

crowdfunded ventures have been legal in the United States.<sup>15</sup> This means that when investors give money to a crowdfunded venture, they are not allowed to profit monetarily from their contribution without the offering first conforming to the federal securities laws.<sup>16</sup> Thus, if monetary profits are realized from an investment contribution, it would likely be deemed an exchange of securities and would trigger the federal securities registration and disclosure requirements.<sup>17</sup> A non-equity crowdfunded investment is therefore more comparable to that of a donation or early product purchase.<sup>18</sup>

In response to the growing need for business funding, and in an attempt to stimulate the economy and job growth, President Barack Obama signed the Jumpstart Our Business Startups Act ("JOBS Act")<sup>19</sup> into law on April 5, 2012.<sup>20</sup> Part of the JOBS Act revises sections of the Securities Act of 1933 ("Securities Act")<sup>21</sup> to create an exemption from registration and decrease the disclosure requirements of certain securities issuers<sup>22</sup> in order to increase businesses' access to financing.<sup>23</sup>

Title III of the JOBS Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("CROWDFUND Act"),<sup>24</sup> specifically targets the process of crowdfunding.<sup>25</sup> The CROWDFUND Act increases a small business's access to capital by permitting these companies to sell securities<sup>26</sup> to

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15. See *id.* at 197; 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, 1749 (2012) [hereinafter Hazen, *Fraudfunding*]; Obama, Remarks, *supra* note 7.

16. See Bradford, *Promise Unfulfilled*, *supra* note 14, at 196-97.

17. *Id.*

18. See *id.* at 197; Bradford, *Crowdfunding*, *supra* note 8, at 14-16 (explaining the crowdfunding categories: "the donation model," "the reward model," and "the pre-purchase model").

19. Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306 (2012) (to be codified in various sections of 15 U.S.C. §§ 77a-aa, 78a-pp).

20. See Obama, Remarks, *supra* note 7.

21. 15 U.S.C. §§ 77a-77aa (2006).

22. See 15 U.S.C. § 77b(a)(4). An "issuer" is generally "every person who issues or proposes to issue any security." *Id.*

23. See § 302(a)-(b), 126 Stat. at 315-20 (to be codified in various sections of 15 U.S.C. §§ 77d, 77d-1).

24. § 301, 126 Stat. at 315.

25. See § 302(a), 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d(a)(6)).

26. See 15 U.S.C. § 77b(a)(1). The definition of a "security" in the Securities Act covers a wide range of transactions or options. See *id.* Generally, a "security" is defined as "[a]n instrument that evidences the holder's ownership rights in a firm [or] . . . an interest based on an investment in a common enterprise rather than direct participation in that enterprise." BLACK'S LAW DICTIONARY 1475-76 (9th ed. 2009).

both accredited<sup>27</sup> and non-accredited<sup>28</sup> investors without registering or completing the full disclosure requirements usually required for public offerings.<sup>29</sup> The CROWDFUND Act legalizes equity-based crowdfunding to a certain extent, essentially creating a watered-down version of a public offering.<sup>30</sup> An investor's contribution to a crowdfunded venture can now result in monetary returns without issuer registration or the burdensome disclosures typically required by the federal securities laws and the Securities Exchange Commission ("SEC").<sup>31</sup>

On its face, the CROWDFUND Act seems to be exactly what both entrepreneurs and investors need. However, since enactment of the JOBS Act, numerous critics have been outspoken about the possibility of increased instances of investor fraud.<sup>32</sup> The problem that the CROWDFUND Act raises is based upon the difficulty of balancing a deregulated offering registration exemption, thus increasing a business's access to capital, and protecting sophisticated and unsophisticated investors from fraud. This Note will proceed in four Parts and will

27. "Accredited" investors generally consist of a class of persons or entities with high levels of financial sophistication or net worth. See 15 U.S.C. § 77b(a)(15). The SEC has set specific parameters for an individual to qualify as an accredited investor under § 2(a)(15)(ii) of the Securities Act. 17 C.F.R. § 230.501(a) (2012).

28. All investors that are not accredited within the definition of the Securities Act fall into the category of non-accredited. See 15 U.S.C. § 77b(a)(15).

29. See § 302(a)-(b), 126 Stat. at 315-20 (to be codified in various sections of 15 U.S.C. §§ 77d, 77d-1); Bradford, *Promise Unfulfilled*, *supra* note 14, at 197.

30. See § 302(a)-(b), 126 Stat. at 315, 319 (to be codified at 15 U.S.C. §§ 77d(a)(6), 77d-1(c)) (legalizing an issuer to raise up to one million dollars from the sale of securities to the public and limiting the resale on those securities to certain types of buyers if sold within a year of being purchased).

31. Compare § 302(b), 126 Stat. at 317-18 (to be codified at 15 U.S.C. § 77d-1(b)) (allowing an investor to participate in equity crowdfunding with limited issuer disclosures), with 15 U.S.C. § 77aa(1)-(32) (listing the significant disclosures that an issuer would traditionally be required to produce in a registration statement).

32. Letter from Charles V. Rossi, President, Securities Transfer Ass'n, Inc., to Elizabeth M. Murphy, Sec'y, SEC (Sep. 17, 2012), available at <http://www.sec.gov/comments/jobs-title-i/general/general-207.pdf> (warning of the potential for increased fraud specifically based on the CROWDFUND Act); Jesse Hamilton & Phil Mattingly, *Job-Creation Bill Seen Eviscerating U.S. Shareholder Protections*, BLOOMBERG (Mar. 13, 2012), <http://www.bloomberg.com/news/print/2012-03-13/job-creation-legislation-seen-eviscerating-shareholder-protections-in-u-s-.html>; Ben Popper, *JOBS Act Becomes Law, but Questions Linger About Potential for Fraud*, VENTUREBEAT (Apr. 5, 2012, 12:46 PM), <http://www.venturebeat.com/2012/04/05/crowdfunding-bill-becomes-law-but-questions-linger-about-potential-for-fraud> (commenting on some possible cases of investor fraud that have already occurred on crowdfunding platforms); Matt Taibbi, *Why Obama's JOBS Act Couldn't Suck Worse*, ROLLING STONE TAIBBLOG (Apr. 9, 2012), <http://www.rollingstone.com/politics/blogs/taibblog/why-obamas-jobs-act-couldnt-suck-worse-20120409?print=true> (discussing potential for fraud as a result of enactment of the JOBS Act).

investigate these seemingly conflicting goals in light of the enactment of the CROWDFUND Act.

Part II of this Note will examine the history of the federal securities laws with a specific emphasis on how securities legislation balances the conflicting goals of increasing access to capital while deterring investor fraud. The analysis will continue by describing the history of crowdfunding in the United States and abroad. Finally, this Part will introduce the JOBS Act and the CROWDFUND Act, and will discuss how this legislation changes the landscape of the federal securities laws.

Part III of this Note will investigate the specific provisions of the CROWDFUND Act that amend the long-standing parts of the federal securities laws that provide higher levels of investor protection. Three specific issues with the CROWDFUND Act that could, potentially both individually and together, increase cases of fraud will be addressed, including: (1) allowing non-accredited investors to partake in equity crowdfunding; (2) packaging the decreased amount of issuer disclosures to investors in a way that reduces issuer transparency; and (3) setting the ceiling amount of an investment in a crowdfunded opportunity too low.

Part IV of this Note will detail a workable solution that properly balances the goals of the federal securities laws—the facilitation of capital formation through transparent securities offerings and the deterrence of investor fraud.<sup>33</sup> Part V of this Note will briefly recrystallize the central themes of this Note and again show the viability of the proposed solution under the CROWDFUND Act.

## II. THE FEDERAL SECURITIES LAWS, CROWDFUNDING, AND THE JOBS ACT

In order to fully realize the groundbreaking impact that the CROWDFUND Act has on the U.S. economy, capital formation, and the federal securities laws, it is valuable to see the historical progression of the main concepts rooted in the CROWDFUND Act. This Part will continue by giving an overview of the traditional federal laws relating to

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33. The proposed solution suggests that the SEC create a new class of investors—"Semi-Accredited" investors. *See infra* Part IV.B. This class of investors will be allowed to participate in equity-based crowdfunded investments after achieving "Semi-Accredited" status in one of two ways. The first way to become a Semi-Accredited investor would be to have prospective members educate themselves about crowdfunding, investing in general, and fraud, through an online course or tutorial. *See infra* Part IV.B.1. This instructional tutorial will be constructed either by each intermediary and approved by the SEC or by the SEC itself. *See infra* Part IV.B.1.a–b. The second way to achieve "Semi-Accredited" classification would be to meet a lower level of financial sophistication than that of an accredited investor, coupled with the filing of a simple online form with the SEC. *See infra* Part IV.B.2.

securities, the concept of crowdfunding, and the JOBS Act, with an emphasis on Title III—the CROWDFUND Act.

*A. The Foundation of Securities Regulation and the Pressure to Defend Against Investor Fraud*

During the 1920s, the booming U.S. economy and new technological developments led to a massive influx in unpredictable stock market investments.<sup>34</sup> In trying to remedy the “speculative frenzies” that eventually caused the stock market to crash in 1929, and, in turn, caused the Great Depression, Congress passed the Securities Act and the Securities Exchange Act of 1934 (“Exchange Act”).<sup>35</sup> The Securities Act and the Exchange Act will be referred to collectively as the “Federal Securities Acts.” The Securities Act was enacted in an effort to restore tranquility to the volatile stock market by endorsing two main objectives: (1) require investors to receive all significant information necessary to make an informed decision regarding the purchase of a security; and (2) “prohibit deceit, misrepresentations, and other fraud in the sale of securities.”<sup>36</sup> The Securities Act regulates the primary market of securities—initial offerings—while the Exchange Act provides guidelines mainly for the secondary market, or the exchange of securities after the initial offering.<sup>37</sup> The Exchange Act also created the SEC.<sup>38</sup> The SEC is a regulatory organization delegated broad authority over all aspects of a securities sale, including the parties to the sale.<sup>39</sup> The Exchange Act perpetuates the desire to protect investors by empowering the SEC to “require periodic reporting of information by companies with publicly traded securities.”<sup>40</sup>

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34. See Larry Bumgardner, *A Brief History of the 1930s Securities Laws in the United States—And the Potential Lesson for Today*, <http://www.jgbm.org/page/5%20Larry%20Bumgardner.pdf> (last visited July 18, 2013) (describing the economic climate in the United States during the 1920s and how stock market indexes “roughly tripled” in a period of four years).

35. 15 U.S.C. §§ 78a–78pp (2006 & Supp. IV 2010); see Deepa Sarkar, *Securities Law History*, CORNELL U. L. SCH. LEGAL INFO. INST., [http://www.law.cornell.edu/wex/securities\\_law\\_history](http://www.law.cornell.edu/wex/securities_law_history) (last visited July 18, 2013).

36. *The Laws that Govern the Securities Industry*, SEC, <http://www.sec.gov/about/laws.shtml> (last visited July 18, 2013); see 15 U.S.C. § 77b(b) (2006) (requiring the SEC to consider “whether an action is . . . in the public interest, . . . the protection of investors, [and] whether the action will promote efficiency, competition, and capital formation”).

37. THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATIONS* § 1.1[4] (6th ed. 2009). See Bumgardner, *supra* note 34.

38. 15 U.S.C. § 78d(a) (2006); *The Laws that Govern the Securities Industry*, *supra* note 36.

39. *The Laws that Govern the Securities Industry*, *supra* note 36. The SEC’s authority “includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self regulatory organizations (SROs).” *Id.*

40. *Id.*

The Securities Act attempts to accomplish the two main objectives by setting forth in-depth guidelines regarding the sale and regulation of securities.<sup>41</sup> The Securities Act delineates two types of transactions regarding the sale of securities: public and private offerings.<sup>42</sup> The Securities Act requires an issuer to create and submit a valid “registration statement” to the SEC prior to offering a security.<sup>43</sup> Registration with the SEC requires an issuer to divulge a significant amount of information relating to the company and its executives in an effort to not only help the SEC find potentially fraudulent offerings, but also to better inform investors as to the dependability of the security.<sup>44</sup> The entire list of required information is extensive and includes owner, underwriter, and director background information,<sup>45</sup> a description of the business,<sup>46</sup> a balance sheet,<sup>47</sup> and a profit and loss statement.<sup>48</sup>

The Securities Act lays out types of transactions that are exempted from the registration requirements.<sup>49</sup> The SEC also has the power to create additional transactions that are exempt from the registration requirements.<sup>50</sup> The three main registration exemptions created by the SEC are contained in Rules 504, 505, and 506 of Regulation D, and were made to facilitate businesses’ access to capital by exempting some private placements of securities.<sup>51</sup> Basically, by creating the Regulation D exemptions, the SEC bypassed the registration requirements and minimized required issuer disclosures in order to enable businesses to raise capital.<sup>52</sup>

Despite sacrificing some investor protections against fraud, the SEC was comfortable with providing Regulation D exemptions because

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41. *See id.*

42. *See* 15 U.S.C. § 77d(2).

43. *Id.* § 77e(c).

44. *The Laws that Govern the Securities Industry*, *supra*, note 36; *see* 15 U.S.C. § 77aa.

45. 15 U.S.C. § 77aa(4)–(6).

46. *Id.* § 77aa(8).

47. *Id.* § 77aa(25).

48. *Id.* § 77aa(26). The complete, mandatory disclosure requirements of the Federal Securities Acts are embodied in two SEC-created forms: Form S-K and Form S-X. 17 C.F.R. §§ 229.10–aa.703, 210.1-01–.12-29 (2012); Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 346 (2012).

49. 15 U.S.C. § 77d.

50. *Id.* § 77z-3. There are three statutory bases for exemption from the Securities Act’s registration requirements. Either the category of security is exempt, the transaction can qualify for an exemption, or the SEC has created an exemption through its rulemaking power under § 28 of the Securities Act. HAZEN, *supra* note 37, § 4.1[1].

51. 17 C.F.R. §§ 230.504–.506 (2012); *The Laws that Govern the Securities Industry*, *supra* note 36.

52. *See* 17 C.F.R. § 230.502(b)(1)–(2); *The Laws that Govern the Securities Industry*, *supra* note 36.



Rules 505 and 506 required most buyers of such securities to be “accredited” investors.<sup>53</sup> Rule 504 does not carry the same accredited investor requirement as Rules 505 and 506; however, such offerings do not permit general solicitation of investors unless they are subject to a state registration requirement or a state exemption that limits the offering to accredited investors only.<sup>54</sup> The SEC exempted offerings to accredited investors based on the theory that such an investor’s financial sophistication or high net worth enables her to evaluate the merits and risks of the prospective investment, and, in the case that the investment turns sour, bear the risk of total loss.<sup>55</sup> The SEC also required exempt transactions and securities to continually be subject to the primary anti-fraud provision in the Exchange Act—a private right of action under Rule 10b-5—providing further measures to prevent fraud.<sup>56</sup>

The class of accredited investors includes certain financial institutions<sup>57</sup> or “any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.”<sup>58</sup> The SEC has determined that an individual is an accredited investor if that person has: (a) an individual or joint net worth (including their spouse’s income) of over \$1,000,000; or (b) the person has an individual income in excess of \$200,000 (or \$300,000 joint income with their spouse) in each of the two most recent years and

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53. 17 C.F.R. § 230.505(b)(2)(ii) (permitting no more than thirty-five purchasers in such offerings); *see id.* § 230.506(b)(2)(i) (restricting an offer under this regulation to a maximum of thirty-five purchasers); *see also id.* § 230.501(e)(1)(iv) (excluding accredited investors from the calculation of purchasers in offerings made under Rules 505 and 506).

54. Bradford, *Crowdfunding*, *supra* note 8, at 47; *see* 17 C.F.R. § 230.504(b)(1)(iii).

55. Michael L. Monson, *The Evolution and Future of the Accredited Investor Standard for Individuals*, UTAH B. J., Nov.–Dec. 2010, at 36, 38.

56. HAZEN, *supra* note 37, §§ 12.4[1]–[2].

57. 15 U.S.C. § 77b(a)(15)(i). Financial institutions that are accredited investors are defined as:

[A] bank as defined in section 77c(a)(2) of this title whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser . . .

*Id.* (citations omitted).

58. *Id.* § 77b(a)(15)(ii).

has a “reasonable expectation of reaching the same income level in the current year.”<sup>59</sup>

While these exemptions are often adequate avenues for capital formulation, there has recently been a call for an additional exemption from registration.<sup>60</sup> As technology progresses and as entrepreneurs find more creative ways to start businesses, the registration exemptions seem increasingly insufficient. The recent surge of crowdfunding has led to new legislation providing an exemption for crowdfunding.<sup>61</sup>

### B. History of Crowdfunding

Crowdfunding is the result of the amalgamation of the concepts of crowdsourcing and microfinancing.<sup>62</sup> Crowdsourcing is a process that harnesses a large number of individuals, each making a small contribution, to complete a larger goal.<sup>63</sup> Microfinancing involves the lending of small amounts of money to an individual or entity that is in need.<sup>64</sup> Crowdsourcing and microfinancing have been around for many years in a variety of different contexts.<sup>65</sup> Together, the concepts create

59. 17 C.F.R. §§ 230.215(e)–(f) (2012).

60. Heminway & Hoffman, *supra* note 9, at 930-31 (describing the current problems with small business capital formation and discussing crowdfunding as a potential solution); see *Crowdfunding, or Raising Capital Over the Internet – Wave of the Future?*, LATHROP & GAGE (Oct. 7, 2011), <http://www.lathropgage.com/newsletter-25.html>; *White House Press Release: Legalize Crowdfunding, STARTUP EXEMPTION* (Jan. 31, 2011), <http://www.startupexemption.com/archives/220#axzz2KoD9m3vt>.

61. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315-23 (2012) (to be codified in various sections of 15 U.S.C. §§ 77a–aa, 78a–pp).

62. Bradford, *Crowdfunding*, *supra* note 8, at 27; see Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd* 6-7 (Int’l Conference of the Fr. Fin. Ass’n., Apr. 25, 2012), available at <http://www.ssm.com/abstract=1836873> (defining crowdfunding as a subset of crowdsourcing but with the added financial aspect).

63. Belleflamme et al., *supra* note 62, at 6; Bradford, *Crowdfunding*, *supra* note 8, at 27.

64. Bradford, *Crowdfunding*, *supra* note 8, at 28-29.

65. *Id.* at 27-29. Perhaps the most prominent example of modern crowdsourcing is Wikipedia. *Id.* at 27. Wikipedia is an online encyclopedia created, edited, and maintained by members of the general public. *Id.* Wikipedia not only crowdsources its content, but can also be viewed as utilizing “Donation” crowdfunding for donations in order to keep the site active. See *Wikipedia’s Fund-Raising: Free but Not Easy*, ECONOMIST, Nov. 5, 2011, available at <http://www.economist.com/node/21536580>; see *infra* text accompanying notes 71-73. Wikipedia’s funding model was described in a banner stretching across the top of the webpage when it was soliciting for donations, saying:

Wikipedia is non-profit, but it’s the #5 website in the world. With 450 million monthly users, we have the same costs as any top site: servers, power, rent, programs, staff and legal help.

To protect our independence, we’ll never run ads. We take no government funds. We run on donations: \$5 is the most common, the average is about \$30.

If everyone reading this gave \$5, our fundraiser would be done within an hour. Please help us forget fundraising and get back to Wikipedia.

crowdfunding, which utilizes small contributions from a large number of individuals to raise large amounts of financing.<sup>66</sup>

Recently, crowdfunding has been increasingly utilized as a method of raising capital for business ventures.<sup>67</sup> Entrepreneurs have harnessed the low costs and ease of using the internet to raise capital for many different types of start-up ventures.<sup>68</sup> According to Professor C. Steven Bradford, current crowdfunding opportunities can be divided into five different categories based on the type of return an investor expects after submitting their contribution.<sup>69</sup> The five different types of crowdfunding websites currently utilized are: (1) donation; (2) pre-purchase; (3) reward; (4) lending; and (5) equity.<sup>70</sup>

“Donation” crowdfunding is characterized by investors contributing funds without any expected actualized return.<sup>71</sup> Charities have utilized donation crowdfunding to raise money to support medical research, fund disaster relief, and to provide life essentials to those in need.<sup>72</sup> Politicians also utilize donation crowdfunding by soliciting small contributions from many supportive individuals and entities to help finance election campaigns.<sup>73</sup>

“Pre-Purchase” and “Reward” crowdfunding platforms are arguably the most widely used and successful platforms currently in the United States.<sup>74</sup> “Pre-Purchase” offerings do not offer investors monetary

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Paul Wallis, *Op-Ed: Wikipedia's Fundraiser Also Raises Big Issues for Users*, DIGITAL J. (Nov. 2, 2012), <http://www.digitaljournal.com/article/336085>; see also FauxCapitalist, *Don't Donate to Wikipedia Until They Live Up to Their Stated Guidelines*, EXPOSING FAUX CAPITALISM (Nov. 20, 2012), <http://www.fauxcapitalist.com/2012/11/20/don't-donate-to-wikipedia-until-they-live-up-to-their-stated-guidelines>.

66. Bradford, *Crowdfunding*, *supra* note 8, at 10.

67. Freed, *supra* note 9, at 14; Heminway & Hoffman, *supra* note 9, at 880-83.

68. Bradford, *Crowdfunding*, *supra* note 8, at 10-13; see, e.g., *About Fundrise*, FUNDRISE, <https://www.fundrise.com/about> (last visited July 18, 2013) (providing crowdfunded commercial real estate ventures); *Fund & Follow Creativity*, KICKSTARTER, <http://www.kickstarter.com/> (last visited July 18, 2013) (helping start-up companies crowdfund capital for ventures in the arts, comics, dance, design, fashion, film and video, food, games, music, photography, publishing, technology, and theater); *The Startup Is You*, UPSTART, <http://www.upstart.com> (last visited July 18, 2013) (providing a platform where investors can crowdfund by investing in individual people).

69. Bradford, *Crowdfunding*, *supra* note 8, at 14-15.

70. *Id.*

71. *Id.* at 15.

72. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1434 (2012); see, e.g., *Explore Causes*, CROWDRISE, <http://www.crowdrise.com/search/projects> (last visited July 18, 2013) (providing a platform for donation crowdfunding for charity projects in animal welfare, the arts, culture and recreation, civil rights and social action, crisis intervention, disease and disorders, education, environment, human services, worldwide fundraisers, poverty, religion and spirituality, and youth development).

73. Bradford, *Crowdfunding*, *supra* note 8, at 11; Cohn, *supra* note 72, at 1434.

74. See Bradford, *Crowdfunding*, *supra* note 8, at 16; see, e.g., *Kickstarter Stats*, KICKSTARTER, <http://www.kickstarter.com/help/stats?ref=footer> (last updated Apr. 12, 2013, 4:18

returns; however, they guarantee investors will receive the product being made with the aggregated funds, once completed.<sup>75</sup> For example, an investor in a musician's campaign to create a new album might be guaranteed a copy of the CD when it is finished. Similarly, the "Reward" models allow investors to contribute money in return for non-monetary rewards tiered according to the size of the investment.<sup>76</sup> Using the same example, a musician's campaign to make a new album may also offer rewards for higher contribution amounts including meeting the musician, receiving a free private concert, or backstage VIP tickets to a future event. Kickstarter and Indiegogo are arguably the largest and most utilized "Reward" and "Pre-Purchase" crowdfunding platforms in the United States.<sup>77</sup> Start-up ventures on Kickstarter and Indiegogo range from up-and-coming musicians looking to make a new album, to foodies seeking to launch a new edible treat, to manufacturers trying to create ingenious products to make our lives easier.<sup>78</sup>

Another type of crowdfunding website provides the ability for individuals to solicit peer-to-peer crowdfunded loans.<sup>79</sup> "Lending"

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PM) (indicating that a total of \$565 million has been contributed to 94,011 total projects on Kickstarter, and that 43.81% of projects received full funding).

75. Bradford, *Crowdfunding*, *supra* note 8, at 16.

76. *See id.*

77. *Kickstarter Stats*, *supra* note 74 (providing impressive statistics of over a 43% target amount success rate with more than \$565 million raised for over 94,000 projects); Tommy Swanson, *Indiegogo: A Serious Competitor to Kickstarter*, WASH. TIMES COMMUNITIES (July 18, 2012), <http://communities.washingtontimes.com/neighborhood/networking-without-faces/2012/jul/18/indiegogo-a-serious-competitor-to-kickstarter> (citing Indiegogo as having over 100,000 overall projects being crowdfunded, 5000 active campaigns per month, and describing the Internet-famous charity retirement fund campaign for Karen the Bus Monitor, which received over \$449,000 in donations).

78. *See, e.g., Browse Campaigns: Food*, INDIEGOGO, [http://www.indiegogo.com/projects?filter\\_category=Food](http://www.indiegogo.com/projects?filter_category=Food) (last visited July 18, 2013) (providing a platform for CustomWhey—customizable protein powder flavors—to raise funds); *Browse Campaigns: Music*, INDIEGOGO, [http://www.indiegogo.com/projects?filter\\_category=Music](http://www.indiegogo.com/projects?filter_category=Music) (last visited July 18, 2013) (hosting a crowdfund campaign for a new concept album and comic book by the musicians, The Architects); *Browse Campaigns: Technology*, INDIEGOGO, [http://www.indiegogo.com/projects?filter\\_category=Technology](http://www.indiegogo.com/projects?filter_category=Technology) (last visited July 18, 2013) (crowdfunding a project for a "USB Sock-IT Plug-In Outlet"); *Discover / Food*, KICKSTARTER, <http://www.kickstarter.com/discover/categories/food?ref=sidebar> (last visited July 18, 2013) (hosting a campaign to raise money for "The DUB Pies Food Truck"); *Discover / Music*, KICKSTARTER, <http://www.kickstarter.com/discover/categories/music?ref=sidebar> (last visited July 18, 2013) (providing a platform for musician David Erick Ramos to crowdfund funds for an album of music played on the ocarina); *Discover / Technology*, KICKSTARTER, <http://www.kickstarter.com/discover/categories/technology?ref=sidebar> (last visited July 18, 2013) (hosting a campaign for a "Flat Hat Tripod Board" to make filming on uneven terrain easier).

79. Bradford, *Crowdfunding*, *supra* note 8, at 20.

platforms offer crowdfunded loans where investors expect repayment either with or without interest on the initial contribution.<sup>80</sup>

The last type of crowdfunding website has been utilized internationally but has only recently been legalized in the United States.<sup>81</sup> "Equity" crowdfunding platforms allow investors to contribute funds in exchange for a portion of ownership of the venture.<sup>82</sup> Essentially, investors are buying company stock and can share in the profits, and losses, of the business that they choose to help fund.<sup>83</sup> Equity crowdfunding is widespread internationally and has received high praise for successfully raising funds for businesses while simultaneously avoiding fraud.<sup>84</sup> Equity crowdfunding in the United States is akin to public offerings, which require an issuer to register with the SEC and make substantial disclosures prior to offering securities.<sup>85</sup> It is from this form of fundraising—the sale of securities without issuer registration and sufficient disclosures—that the Federal Securities Acts sought to protect individuals (sophisticated or not).<sup>86</sup> However, the enactment of the JOBS Act on April 5, 2012 made equity crowdfunding in the United States a legal reality.<sup>87</sup>

### C. Title III of the JOBS Act: The CROWDFUND Act

In an attempt to jumpstart entrepreneurship, spark job growth, increase access to capital for small business, and deter the fraudulent

80. *Id.*

81. See Jason Best & Sherwood Neiss, *Crowdfunding Delayed Again, Blasted as a 'Top Danger,'* VENTUREBEAT (Aug. 22, 2012, 5:10 PM), <http://www.venturebeat.com/2012/08/22/crowdfunding-delayed-again-blasted-as-a-top-danger> (describing the impact of crowdfunding in Australia and the United Kingdom); see, e.g., *Funded Artists*, SELLABAND, <https://www.sellaband.com/en/news> (last visited July 18, 2013) (listing numerous musicians who have reached their funding target amounts through an equity crowdfunding website based in Germany).

82. Bradford, *Crowdfunding*, *supra* note 8, at 24.

83. See *id.* at 24, 33.

84. Best & Neiss, *supra* note 81 ("In the seven years crowdfund investing has been legal in Australia and in the two years it has been legal in the UK, no cases of successful fraud have been discovered."); *How the Crowd Detects Fraud*, CROWDFUND CAPITAL ADVISORS, <http://www.crowdfundcapitaladvisors.com/resources/26-resources/120-crowd-detects-fraud.html> (last visited July 18, 2013) (detailing the success of equity crowdfunding in Australia and the United Kingdom without any reported cases of fraud); Simona Strimaityte, *Crowdfunding Opens Up to the Market*, KERNEL (May 22, 2012), <http://www.kernelmag.com/features/report/2262/crowdfunding-goes-global> ("[T]here have not yet been any big incidents of fraudulent trading or scams which have taken place on crowdfunding platforms.").

85. See Freed, *supra* note 9, at 14.

86. *The Laws that Govern the Securities Industry*, *supra* note 36; see Bradford, *Crowdfunding*, *supra* note 8, at 42, 45.

87. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315-23 (2012) (to be codified in various sections of 15 U.S.C. §§ 77a–aa, 78a–pp).

sale of securities, President Obama signed the JOBS Act into law on April 5, 2012.<sup>88</sup> The JOBS Act accomplishes these goals by amending the Federal Securities Acts in several ways. Title I of the JOBS Act generally reduces the financial reporting obligations of a new class of issuers called “Emerging Growth Companies.”<sup>89</sup> Title II permits general solicitation and advertising for securities offerings made pursuant to Rule 506 of Regulation D and Rule 144A of the Securities Act.<sup>90</sup> Title III of the JOBS Act creates a registration exemption and lessens required issuer disclosures for certain companies seeking to crowdfund up to one million dollars over the course of a twelve-month period.<sup>91</sup> Title IV grants the SEC the responsibility of crafting a new exemption for small private offerings of under fifty million dollars.<sup>92</sup> Finally, Titles V and VI amend the number of record holders of a security permitted before mandatory registration requirements are triggered under the Securities Acts.<sup>93</sup>

Although many of these Titles raise concerns regarding the offering of securities,<sup>94</sup> Title III of the JOBS Act has received significant attention.<sup>95</sup> Title III legalizes limited equity crowdfunding in the

88. 158 CONG. REC. H1275 (daily ed. Mar. 8, 2012) (statement of Rep. Cantor); Obama, Remarks, *supra* note 7. The President referred to the downturn of the economy as a reason behind reforming securities laws to encourage capital formation. Obama, Remarks, *supra* note 7. Specifically, the President acknowledged that “[c]redit’s been tight” for entrepreneurs and that “no matter how good their ideas are, if [they] can’t get a loan from a bank or backing from investors, it’s almost impossible to get their businesses off the ground.” *Id.* The President also encouraged the passage of the JOBS Act due to the aged securities laws that have remained in place for “nearly eight decades.” *Id.*

89. See Jumpstart Our Business Startups Act § 102, 126 Stat. at 308-13 (to be codified in various sections of 15 U.S.C. §§ 77a–aa, 78a–pp). Emerging Growth Companies are entities that have had total gross revenues in the past fiscal year of under one billion dollars. *Id.* § 101, 126 Stat. at 307 (to be codified at 15 U.S.C. § 77b(a)(19)). Emerging Growth Companies are subject to less burdensome registration requirements including only having to provide no more than two years of audited financial statements with respect to a public offering. See *id.* §§ 101–108, 126 Stat. at 307-13 (to be codified at 15 U.S.C. § 77g(a)(2)(A)).

90. See *id.* § 201, 126 Stat. at 313-15 (to be codified in various sections of 15 U.S.C. § 77d).

91. See *id.* §§ 301–305, 126 Stat. at 315-23 (to be codified in various sections of 15 U.S.C. §§ 77a–aa, 78a–pp).

92. See *id.* §§ 401–402, 126 Stat. at 323-25 (to be codified at 15 U.S.C. §§ 77c(b), 77r(b)(4)).

93. See *id.* §§ 501–602, 126 Stat. at 325-27 (to be codified in various sections of 15 U.S.C. § 78l(g), 78(o)).

94. Dea Mirando-Gould, *What You Should Know About the JOBS Act*, MORGANFRANKLIN, <http://www2.morganfranklin.com/webmail/10392/108198935/64be8aa77ed0790e6e2ac97036048d0a> (last visited July 18, 2013). Concerns include lower valuations, measuring IPO performance through aftermarket trading, relaxing regulations designed to prevent fraud, and undermining the independent accounting and auditing standards. *Id.*

95. See Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WALL ST. J., Jan. 18, 2013, at C1 (“[S]ome regulators are concerned that forthcoming rules to relax existing controls might present opportunities for fraud.”); *Repeal Crowdfunding from JOBS Act? Advocates Say It Will Hurt Small Business*, CROWDFUND INTERMEDIARY REG. ADVOCATES (Sep. 13, 2012, 5:31 PM),

United States.<sup>96</sup> A closer look at the CROWDFUND Act will tell us exactly why equity crowdfunding is a significant concern regarding investor protection.

The CROWDFUND Act amends section 4 of the Securities Act to create an exemption for raising capital through equity crowdfunding.<sup>97</sup> The purpose of this exemption was to facilitate a small business's access to capital by removing or minimizing costly regulations.<sup>98</sup> The CROWDFUND Act will add the new exemption at Section 4(a)(6) of the Securities Act and will also create Section 4A, which will detail the requirements of some of the parties involved in a transaction under the new exemption.<sup>99</sup>

The new exemption is limited to transactions where the aggregate amount of securities sold to all investors over a twelve-month period does not exceed one million dollars.<sup>100</sup> Additionally, the contribution amount of each individual investor is limited to:

- (i) the greater of \$2,000 or 5 percent of the annual income or net worth of the investor, [provided that] either the annual income or net worth of the investor is less than \$100,000; and
- (ii) 10 percent of the annual income or net worth of an investor, not to exceed a total amount of \$100,000, if either the annual income or net worth is more than \$100,000 . . . .<sup>101</sup>

Section 302(a) of the CROWDFUND Act also requires the transaction to be conducted through a "broker" or "funding portal" that complies with certain disclosure requirements.<sup>102</sup> Additionally, issuers must comply with the disclosure requirements set forth in Section 302(b) of the CROWDFUND Act.<sup>103</sup>

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<http://www.cfira.org/?p=1159> (discussing a Congressman's proposed bill to protect investors from crowdfunding by repealing the CROWDFUND Act provision from the JOBS Act); John Wasik, *JOBS Act Not Ready for Prime Time; Could Be a Fraud Portal*, FORBES (Oct. 11, 2012, 11:08 AM), <http://www.forbes.com/sites/johnwasik/2012/10/11/jobs-act-not-ready-for-prime-time-could-be-a-fraud-portal> ("The JOBS Act, which would allow public stock offerings through crowdfunding on the Internet, is not ready for public consumption. The SEC's proposed rule . . . needs to be improved if it's going to prevent the JOBS Act from becoming another fraud portal.").

96. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315-23 (2012) (to be codified in various sections of 15 U.S.C. §§ 77a-aa, 78a-pp).

97. See *id.* § 302(a), 126 Stat. at 306 (to be codified in various sections of 15 U.S.C. §§ 77d(a)(6), 77d-1).

98. *The Laws that Govern the Securities Industry*, *supra* note 36.

99. See Jumpstart Our Business Startups Act § 302(a)-(b), 126 Stat. at 315-21 (to be codified at 15 U.S.C. § 77d, 77d-1).

100. *Id.* (to be codified at 15 U.S.C. § 77d(a)(6)(A)).

101. *Id.* (to be codified at 15 U.S.C. § 77d(a)(6)(B)).

102. *Id.* (to be codified at 15 U.S.C. § 77d(a)(6)(C)).

103. *Id.* (to be codified at 15 U.S.C. § 77d(a)(6)(D)).

The requirements on intermediaries and issuers are a departure from traditional federal securities laws.<sup>104</sup> The intermediary in a crowdfunding transaction is the website, platform, broker, or funding portal that hosts the issuer's offer and completes the transactions for the offering of securities.<sup>105</sup>

In fact, intermediaries are the party that is required to register as either a "broker" or a "funding portal" under the CROWDFUND Act.<sup>106</sup> A "broker" is any person engaged in the business of effecting transactions for securities for the account of others.<sup>107</sup> Whereas a "funding portal" is any person acting as an intermediary in a securities transaction only under Section 4(a)(6) of the Securities Act that does not: (A) offer investment advice; (B) solicit offers to buy or sell the security listed on its website or portal; (C) compensate employees or other persons for such solicitation or based on securities sold on the website or portal; (D) control, manage, or handle investor funds or securities; or (E) engage in other activities as determined by SEC rules.<sup>108</sup> Section 302(b) of the CROWDFUND Act also places significant other responsibilities on intermediaries involved in a transaction conducted under the crowdfunding exemption.<sup>109</sup>

Particularly, the intermediary is responsible for making disclosures regarding "risks and other investor education materials" as determined by SEC rules.<sup>110</sup> Additionally, and most notably, intermediaries are required to ensure that each investor in an equity crowdfunded transaction:

- (A) reviews investor-education information, in accordance with standards established by the Commission, by rule;
- (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and
- (C) answers questions demonstrating—
  - (i) an understanding of the level of risk generally applicable to

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104. Compare 15 U.S.C. § 77aa (2006) (listing the information required by an issuer in its registration statement), with Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 315-20 (to be codified at 15 U.S.C. § 77d-1) (listing the disclosure requirements for intermediaries and issuers in crowdfund transactions).

105. See Hazen, *Fraudfunding*, *supra* note 15, at 1759; see also Bradford, *Promise Unfulfilled*, *supra* note 14, at 197.

106. Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 315-16 (to be codified at 15 U.S.C. § 77d-1(a)(1)).

107. 15 U.S.C. § 78c(a)(4)(A).

108. Jumpstart Our Business Startups Act § 304(b), 126 Stat. at 322 (to be codified at 15 U.S.C. § 78c(a)(80)).

109. See *id.* § 302(b), 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d-1(a)).

110. *Id.* 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d-1(a)(3)).



investments in startups, emerging businesses, and small issuers;  
(ii) an understanding of the risk of illiquidity; and  
(iii) an understanding of such other matters as the Commission determines appropriate, by rule.<sup>111</sup>

The CROWDFUND Act also contains a general provision that requires all intermediaries to attempt to reduce the risk of fraud relating to crowdfunded transactions by complying with rules that the SEC has yet to promulgate.<sup>112</sup> One condition that has been detailed, to be found in Section 4A(a)(5) of the Securities Act, requires intermediaries to conduct background and security enforcement regulatory history checks on all officers, directors, and twenty percent shareholders in the prospective issuer.<sup>113</sup> Congress also left intermediaries the responsibilities of overseeing the distribution of capital raised in the transaction, ensuring that no investors exceed their statutory financial limit on investing, taking steps to protect the privacy of information, not compensating finders for providing the intermediary with potential investors, prohibiting its prominent members from having a financial interest in an issuer, and any other requirement as determined by SEC rule.<sup>114</sup> Intermediaries must also distribute any information provided by the issuer to the SEC and potential investors three weeks prior to the first day securities of that issuer are sold.<sup>115</sup>

The CROWDFUND Act also provides what disclosures must be made by issuers seeking to offer securities under the new exemption.<sup>116</sup> The requirements of Section 302(b) of the CROWDFUND Act for issuers are significantly different from the traditional required disclosures in a registration statement for an offer or sale of securities.<sup>117</sup>

Issuers who offer or sell securities pursuant to the crowdfunding exemption must make available the following information: (A) background information pertaining to the issuer; (B) background information on any director, officer, and each person holding more than twenty percent of the shares of the issuer; (C) a description of the business and anticipated business of the issuer; (D) a description of the financial condition of the issuer including other recent offerings; (E) a summary of the intended use of the proceeds; (F) an outline and regular updates regarding the target contribution amount and the deadline for

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111. *Id.* 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d-1(a)(4)).

112. *Id.* 126 Stat. at 316 (to be codified at 15 U.S.C. § 77d-1(a)(5)).

113. *Id.*

114. *Id.* 126 Stat. at 316-17 (to be codified at 15 U.S.C. §§ 77d-1(a)(7)–(12)).

115. *Id.* 126 Stat. at 316 (to be codified at 15 U.S.C. § 77d-1(a)(6)).

116. *Id.* 126 Stat. at 317-18 (to be codified at 15 U.S.C. § 77d-1(b)).

117. Compare *id.*, with 15 U.S.C. § 77aa (2006).

reaching that amount; (G) the price of the securities or a description of the formula used to calculate that price; (H) a summary of the ownership and structure of the issuer; and (I) other information as deemed necessary by the SEC.<sup>118</sup>

Thus, the CROWDFUND Act's new exemption and disclosure requirements break new ground in the federal securities laws.<sup>119</sup> As designed, the crowdfunding exemption has the ability to greatly facilitate small businesses' access to capital.<sup>120</sup> However, arising from the new exemption comes an important legal issue.

### III. DOES ALLOWING ISSUERS TO RAISE MONEY FROM NON-ACCREDITED INVESTORS INCREASE THE CHANCE OF INVESTOR FRAUD?

As discussed previously, the federal securities laws strive to both provide potential investors with all material information necessary to make well-informed investment decisions and prevent fraudulent dealings by issuers.<sup>121</sup> The responsibility entailed in achieving these goals is certainly significant. In addition to carrying out the two traditional goals of the federal securities laws, enactment of the CROWDFUND Act now also requires lawmakers to perform a balancing act.<sup>122</sup>

One of the main purposes of the JOBS Act is to increase small businesses' access to capital.<sup>123</sup> The CROWDFUND Act attempts to achieve this goal by decreasing the number of regulatory hoops that

118. Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 317-18 (to be codified at 15 U.S.C. § 77d-1(b)).

119. Susan Deutschle, *JOBS Act Puts Stamp of Approval on Crowdfunding*, TRIANGLE BUS. J. (June 8, 2012, 6:00 AM), <http://www.bizjournals.com/triangle/print-edition/2012/06/08/jobs-act-puts-stamp-of-approval-on.html?page=all> ("This is really groundbreaking. It's a significant relaxing of the rules to make it much simpler for businesses to generate capital . . ." (internal quotation marks omitted)).

120. See Obama, Remarks, *supra* note 7.

121. *The Laws that Govern the Securities Industry*, *supra* note 36; see *supra* Part II.A.

122. Hazen, *Fraudfunding*, *supra* note 15, at 1738, 1765; Tim Worstall, *The JOBS Act, Kickstarter, Crowdcube and the Delicate Balancing Act*, FORBES (Mar. 26, 2012, 11:21 AM), <http://www.forbes.com/sites/timworstall/2012/03/26/the-jobs-act-kickstarter-crowdcube-and-the-delicate-balancing-act>. Worstall noted that:

[T]here is always a delicate balance between getting new ventures funded and people being ripped off by the pretence of new ventures getting funded.

The new technologies, this internet we're all on, the various tests of crowdsourcing and crowdfunding that have been done might have changed what is that appropriate balance.

*Id.*

123. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315-23 (2012) (to be codified in various sections of 15 U.S.C. §§ 77a-aa, 78a-pp); Obama, Remarks, *supra* note 7.

parties must jump through in order to participate in an exempted crowdfunded offering.<sup>124</sup> To make matters more complicated, several provisions of the CROWDFUND Act make drastic changes to the established federal securities laws regarding securities offerings and requisite disclosures.<sup>125</sup>

As a result, investors involved in a securities transaction under the crowdfund exemption are potentially exposed to an increased risk of fraud.<sup>126</sup> Specifically, the possibility of more investor fraud is rooted in three areas: (1) allowing unsophisticated investors to participate in unregistered crowdfunded offerings; (2) distributing the reduced number of issuer disclosures to investors in a dense and difficult-to-understand way, thus decreasing issuer transparency; and (3) setting the ceiling investment amounts for investors too low to allow for economically viable recovery in instances of fraud.<sup>127</sup> This Part will proceed by detailing each of the potential sources of investor fraud in the CROWDFUND Act listed above.

#### A. *Less Sophisticated Investors*

The ability to solicit investments from the general public is the core of crowdfunding.<sup>128</sup> The chief problem with offering securities to the general public is that most people are non-accredited investors and thus, financially illiterate and in need of the protections provided by state and federal securities laws.<sup>129</sup>

Traditional models of raising business capital permit offering unregistered securities to only accredited investors because their wealth allows them to bear the risk of loss or their financial sophistication helps them to better understand the risks associated with such investments.<sup>130</sup> However, the CROWDFUND Act is aimed at attracting small investors, who are likely less sophisticated, and in need of greater protections.<sup>131</sup>

124. *The Laws that Govern the Securities Industry*, *supra* note 36.

125. *Compare id.*; § 302(a)–(b), 126 Stat. at 315–18 (to be codified in various sections of 15 U.S.C. § 77d, 77d-1) (describing a new crowdfunding exemption and the disclosures required of intermediaries and issuers), *with* 15 U.S.C. § 77d(1)–(5) (2006) (listing exemptions currently available under the Securities Act), *and id.* § 77aa (providing a list of information required to be included in a registration statement for the offering of securities).

126. Hazen, *Fraudfunding*, *supra* note 15, at 1765–68.

127. *See* Jumpstart Our Business Startups Act § 302(a)–(b), 126 Stat. at 315–20 (codified in various sections of 15 U.S.C. § 77d, 77d-1) (permitting non-accredited investors to participate in the sale of unregistered securities, decreasing the disclosures required by issuers, and limiting how much an investor can invest in a crowdfunded offering).

128. *See* Bradford, *Crowdfunding*, *supra* note 8, at 103–04.

129. *Id.* at 104, 109.

130. Monson, *supra* note 55, at 38.

131. Hazen, *Fraudfunding*, *supra* note 15, at 1766.

Professor Bradford highlights this problem by summarizing several studies.<sup>132</sup> He concludes that the general public is largely financially illiterate and thus, likely unprepared for participation in crowdfunding investments.<sup>133</sup> Specifically, Professor Bradford reviewed a 2005 study of over 3500 adults and 2200 high school students which found that 66% of the adults and 91% of the students received grades of “C” or worse on a twenty-four question financial literacy test.<sup>134</sup> A 2009 study that Professor Bradford reviewed yielded similar results and found that American adults averaged 2.72 correct answers out of 5 financial literacy questions.<sup>135</sup>

A SEC study on financial literacy, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>136</sup> reinforces Professor Bradford’s findings.<sup>137</sup> In this report, the Library of Congress reviewed many financial literacy studies and concluded that many retail investors lack basic financial literacy.<sup>138</sup> Specifically, the report determined “that investors do not understand the most elementary financial concepts . . . [and] that investors lack critical knowledge that would help them protect themselves from investment fraud.”<sup>139</sup> The surveys also concluded that classes of people (including women, African-Americans, Hispanics, older investors, and poorly educated investors) are even less financially literate than the average member of the general population.<sup>140</sup> The outcome of the study was quickly relayed and reinforced by many news sources.<sup>141</sup>

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132. Bradford, *Crowdfunding*, *supra* note 8, at 109-12.

133. *Id.* at 112.

134. *Id.* at 110.

135. *Id.*

136. Pub. L. No. 111-203, 124 Stat. 1376, 1836 (2010).

137. See SEC, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS 15 (2012), available at <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf> (finding retail investors to have inadequate financial literacy and proposing implementation of several initiatives to promote greater investor education).

138. *Id.*

139. *Id.* (footnote omitted).

140. *Id.*

141. Matt Levine, *SEC Finds Retail Investors Too Stupid to Invest Without SEC Assistance*, DEALBREAKER (Aug. 30, 2012, 5:35 PM), <http://www.dealbreaker.com/2012/08/sec-finds-retail-investors-too-stupid-to-invest-without-sec-assistance>; Donald Marron, *Investors Lack Basic Financial Literacy, Study Finds*, CHRISTIAN SCI. MONITOR (Sep. 4, 2012), <http://www.csmonitor.com/Business/Donald-Marron/2012/0904/Investors-lack-basic-financial-literacy-study-finds>; Kevin Roose, *SEC Study Proves that Stock-Picking Should Probably Be Left to the Professionals*, DAILY INTELLIGENCER (Aug. 30, 2012, 3:53 PM), <http://www.nymag.com/daily/intelligencer/2012/08/sec-study-nobody-knows-anything.html>.

While investor sophistication may be integral to deterring fraud, some hold an alternate view.<sup>142</sup> Even Professor Bradford believes that some level of fraud will happen regardless of an investor's level of sophistication.<sup>143</sup> Some critics also point to international crowdfunding and domestic non-equity crowdfunding campaigns already in effect to show the absence of fraud.<sup>144</sup> After all, fraudsters do not care whether the investor receives equity or not; the money they invest is still money for the taking.<sup>145</sup>

Regardless, the lack of investor education is especially alarming in the context of crowdfunding.<sup>146</sup> Even though most investors will be unknown to the issuer, unsophisticated investors have a harder time understanding the risks associated with crowdfund investing.<sup>147</sup> While including non-accredited investors in the crowdfund exemption is necessary to help small businesses raise capital, the SEC must carefully construct guidelines to protect all investors from fraud.

### B. Issuer Disclosures Preventing Transparency

Another source of possible investor fraud in the CROWDFUND Act stems from the disclosures required of issuers before commencing a crowdfunding campaign.<sup>148</sup> Mandatory disclosures are the hallmark of the federal securities laws.<sup>149</sup> Traditionally, a public offering of securities requires registration with the SEC coupled with extensive disclosures.<sup>150</sup> Realizing the need for small businesses to easily raise capital and their difficulty complying with all the regulatory restraints in place, Congress and the SEC have permitted limited deregulated

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142. Compare Bradford, *Crowdfunding*, *supra* note 8, at 112 (concluding that unsophisticated investors are more susceptible to potential risky investments), with Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 748 (2009) (arguing that the level of sophistication an investor has is irrelevant since wealthy investors can be insolvent at the time of purchase and just as vulnerable to fraudulent brokers as unsophisticated investors).

143. Bradford, *Crowdfunding*, *supra* note 8, at 112.

144. See *id.* at 105; Best & Neiss, *supra* note 81; Strimaityte, *supra* note 84.

145. See Bradford, *Crowdfunding*, *supra* note 8, at 105.

146. See *id.* at 112.

147. *Id.*; Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 399 (2012).

148. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315-20 (2012) (to be codified in various sections of 15 U.S.C. §§ 77d-1) (describing the required disclosures of an issuer); Hazen, *Fraudfunding*, *supra* note 15, at 1766-67 (discussing the potential pitfalls of requiring inadequate disclosure requirements for issuers taking advantage of crowdfunding to raise capital).

149. See Heminway, *supra* note 48, at 346.

150. See 15 U.S.C. §§ 77e(a)(1)-(2), 77e(c), 77aa.

offerings.<sup>151</sup> Continuing under this logic, Congress enacted the CROWDFUND Act.<sup>152</sup> However, the nature of the disclosures outlined by Congress in the CROWDFUND Act may be especially dangerous in the context of crowdfunding.<sup>153</sup>

Crowdfunding requires the use of the general, unsophisticated public to be an effective means to raise capital.<sup>154</sup> By requiring less issuer disclosures, as compared with those of registered public offerings, the CROWDFUND Act is essentially reducing the transparency of crowdfunding issuers.<sup>155</sup> Furthermore, issuer disclosures are usually disseminated to investors and other interested parties in an extremely dense form, often containing financial verbiage unknown to an unsophisticated investor.<sup>156</sup> As Joan Macleod Heminway points out, “If . . . investors cannot fully comprehend and digest correct and complete information that is fully disclosed to them, they cannot use it to assess investment risks . . . .”<sup>157</sup>

Professor Susanna Kim Ripken also speaks directly on this issue.<sup>158</sup> She argues that “the disclosure[s] that we see today . . . [are] often too long and complex to be of much use to the ordinary investor.”<sup>159</sup> She continues this point by proclaiming that “[i]nvestors faced with this flood of information often lack the skills to identify what the information means or how to use it effectively.”<sup>160</sup> Thus, the already naïve crowdfunding investors have even less of a basis to rely on in making a decision of whether to invest or not.

While some argue that the issuer disclosure requirements of the CROWDFUND Act are still too burdensome to effectively promote small business capital formation, it is impossible to ignore the necessity of protecting investors.<sup>161</sup>

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151. Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 3-4, 10-15, 24 (2007).

152. Palmiter, *supra* note 147, at 391.

153. Hazen, *Fraudfunding*, *supra* note 15, at 1766-67.

154. Bradford, *Promise Unfulfilled*, *supra* note 14, at 196.

155. See Hazen, *Fraudfunding*, *supra* note 15, at 1766-67.

156. Heminway, *supra* note 48, at 348.

157. *Id.* at 348-49.

158. Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 185 (2006).

159. *Id.*

160. *Id.*

161. See Cohn, *supra* note 72, at 1444; see also Bradford, *Promise Unfulfilled*, *supra* note 14, at 217.

*C. Small Investment Amount Ceilings Do Not Allow for Economically Viable Recovery in Instances of Fraud*

An additional potential problem with the CROWDFUND Act that could increase the occurrence of investor fraud revolves around the maximum investment amounts individual investors are allowed to contribute to ventures.<sup>162</sup> The nature of crowdfunding limits the amount each individual investor can contribute, which can result in investments being made on a blind or leap-of-faith basis.<sup>163</sup>

The CROWDFUND Act limits the aggregate amount an investor can give to issuers in a twelve-month period based on that investor's annual income or net worth.<sup>164</sup> For investors that have either an annual income or net worth less than \$100,000, they can only contribute the greater of either \$2000 or five percent of their annual income or net worth.<sup>165</sup> Investors that have either an annual income or net worth above \$100,000 are permitted to invest ten percent of that annual income or net worth, not to exceed an aggregate amount of \$100,000.<sup>166</sup>

The potential for increased fraud from these investment amount limits lies in the defrauded investors inability to litigate and recover their lost investment.<sup>167</sup> Even though a private right of action is enumerated in the CROWDFUND Act, it is not practical.<sup>168</sup> Since the most an individual investor can have at stake in a crowdfunded venture is between \$10,000 and \$100,000, and probably no more than \$2000, the costs associated with hiring an attorney to litigate a securities fraud claim would not be economically worthwhile.<sup>169</sup> The reward amounts are also too low to appeal to an attorney that litigates a fraud claim on a contingency fee basis.<sup>170</sup> Additionally, a successful lawsuit might still

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162. Mike Liles, Jr., *Raising Small Business Capital over the Internet*, KARR TUTTLE CAMPBELL (Apr. 2012), <http://www.karrtuttle.com/news/id/225/crowdfunding-using-the-internet-to-raise-small-business-capital.aspx> ("[A]mounts raised in crowdfunding offerings will be too small for investors to economically recover their investments through civil litigation . . .").

163. See Hazen, *Fraudfunding*, *supra* note 15, at 1765-67.

164. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (to be codified at 15 U.S.C. §§ 77d(a)(6)(B)).

165. *Id.*

166. *Id.*

167. Diamond Kaplan & Rothstein, *Crowdfunding May Increase the Likelihood of Fraud*, FINDLAW (Nov. 1, 2012), <http://knowledgebase.findlaw.com/kb/2012/Aug/754419.html>; Liles, *supra* note 162.

168. § 302(b), 126 Stat. at 318 (to be codified at 15 U.S.C. § 77d-1(c)); Palmiter, *supra* note 147, at 416; Diamond Kaplan & Rothstein, *supra* note 167.

169. Palmiter, *supra* note 147, at 416.

170. *Id.* at 417-18.

not be recoverable since it is likely that those engaged as crowdfunding issuers are “uncollectible.”<sup>171</sup>

For similar reasons, class action litigation is also an unlikely remedy to crowdfunding fraud.<sup>172</sup> Since the total offering amount for a crowdfund exemption is capped at one million dollars, a damages award would be paltry.<sup>173</sup> Thus, the attorney’s fee associated with litigating such a claim under either an hourly rate or a contingency fee (of typically twenty to thirty percent of the award) would be unappealing to both the investors and the attorney.<sup>174</sup>

Therefore, when crafting appropriate rules and regulations, the SEC needs to consider either an increased fraud prevention mechanism specifically tailored to this source of potential fraud, or institute a method of providing defrauded investors with streamlined economically viable recovery.

#### IV. PROPOSED SOLUTION

In order to reconcile the potential for investor fraud in the CROWDFUND Act, the SEC needs to draft a regulatory framework that incorporates the legislative intent behind the enactment of the Federal Securities Acts: (1) ensuring that all material information is available to prospective purchasers of a security; and (2) preventing fraud, deceit, and misrepresentations in the purchase or sale of securities.<sup>175</sup> However, in the unique context of crowdfunding, where the parties involved are not necessarily able or willing to bear significant time or monetary burdens, it is integral that the SEC also consider the purpose of the CROWDFUND Act.<sup>176</sup>

The general purpose of the CROWDFUND Act, as embodied in its long-form name, is to provide small businesses with an easy, manageable way to raise capital while deterring fraudulent practices.<sup>177</sup> The way to accomplish all of these objectives is for the SEC to distribute

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171. Diamond Kaplan & Rothstein, *supra* note 167.

172. Palmiter, *supra* note 147, at 417-18.

173. *Id.* at 417.

174. *See id.* at 417-18.

175. *The Laws that Govern the Securities Industry*, *supra* note 36.

176. *Cf. Hazen, Fraudfunding*, *supra* note 15, at 1767 (pointing out that investors in crowdfunded offerings are likely to be strangers to the business, have limited funds, and lack an ability to tolerate high investment risk, and demonstrating that the SEC has a duty to “strike the appropriate balance” between investor protection and raising money when implementing the JOBS Act).

177. *See Jumpstart Our Business Startups Act*, Pub. L. No. 112-106, § 301, 126 Stat. 306, 315 (2012). The long-form name of the CROWDFUND Act is the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012. *Id.*



oversight of the legislative goals to the parties in the best positions to carry them out.<sup>178</sup> The framework for this has been laid out in the CROWDFUND Act, but delicate rulemaking will make or break the effectiveness of this legislation.<sup>179</sup>

Subpart A will briefly describe where the SEC derives the rulemaking authority necessary to implement the proposed solution discussed in Subpart B. Subpart B will recommend a dual solution to the latent possibility of increased investor fraud in crowdfunded offerings. Each solution requires potential investors to attain “Semi-Accredited” status before investing. The first method of achieving Semi-Accredited status would be attainable in two ways, each way primarily consisting of an educational requirement for potential investors. The second method of achieving Semi-Accredited status would require a certain level of wealth, calculated in terms of net worth or annual income.

#### A. *The Source of the SEC’s Rulemaking Authority*

The SEC has the authority to promulgate new rules and regulations pursuant to several sections of the Securities Act and the JOBS Act—authority that is necessary to implement the solution that this Note proposes.<sup>180</sup> Section 19(a) of the Securities Act provides the SEC with extremely broad rule-making power.<sup>181</sup> This Section states that the SEC “shall have [the] authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter . . . .”<sup>182</sup> This extensive rule-making power is likely sufficient to implement the class of Semi-Accredited investors detailed below.<sup>183</sup>

The SEC was also granted expansive rule- and regulation-making powers in several sections of the CROWDFUND Act.<sup>184</sup> With regard to the requirements of intermediaries in equity crowdfunded offerings, the SEC is permitted to issue rules detailing the content of various required disclosures, setting the standards for investor-education information, and creating questions, which the intermediary must ensure the potential

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178. See Palmiter, *supra* note 147, at 399, 416.

179. See *id.*

180. See 15 U.S.C. § 77s(a); § 302(b), 126 Stat. at 316-18 (to be codified at 15 U.S.C. §§ 77d-1(a)(3), 77d-1(a)(4)(A), 77d-1(a)(4)(C)(iii), 77d-1(a)(5), 77d-1(a)(12), 77d-1(b)(1)(I)).

181. See 15 U.S.C. § 77s(a).

182. *Id.*

183. See *infra* Part IV.B.

184. See Jumpstart Our Business Startups Act § 302(b), 126 Stat. 316-18 (to be codified at 15 U.S.C. §§ 77d-1(a)(3), 77d-1(a)(4)(A), 77d-1(a)(4)(C)(iii), 77d-1(a)(5), 77d-1(a)(12), 77d-1(b)(1)(I)).

investor reviews and understands before investing.<sup>185</sup> Additionally, the SEC can require, by rule, intermediaries to “take such measures to reduce the risk of fraud with respect to [equity crowdfunded] transactions.”<sup>186</sup> Finally, with respect to intermediaries, Congress created somewhat of a catchall and granted the SEC the power to issue rules that require intermediaries to “meet such other requirements as the [SEC] may, by rule, prescribe, for the protection of investors and in the public interest.”<sup>187</sup>

Congress also incorporated a catchall rulemaking power with respect to the requirements of issuers in equity crowdfunded ventures.<sup>188</sup> This section provides that issuers are required to make available to potential investors “such other information as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.”<sup>189</sup>

The SEC should thus have sufficient rule-making power to carry out the solution that this Note proposes, whether under the general power granted to them in section 19(a) of the Securities Act or through the above sections of the CROWDFUND Act.

### *B. The SEC Should Create a Class of “Semi-Accredited” Investors*

SEC rules that ensure investors are sophisticated enough to understand the risks and probability of success of their investment are effective.<sup>190</sup> Since the JOBS Act became law, critics have been arguing over whether, and to what extent, increased investor fraud would result from enactment of the CROWDFUND Act.<sup>191</sup> While only time will tell

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185. *Id.* (to be codified at 15 U.S.C. §§ 77d-1(a)(3), 77d-1(a)(4)(A), 77d-1(a)(4)(C)(iii)).

186. *Id.* (to be codified at 15 U.S.C. §§ 77d-1(a)(5)).

187. *Id.* (to be codified at 15 U.S.C. §§ 77d-1(a)(12)).

188. *See id.* (to be codified at 15 U.S.C. §§ 77d-1(b)(1)(I)).

189. *Id.*

190. *See* Palmiter, *supra* note 147, at 400.

191. Compare Hazen, *Fraudfunding*, *supra* note 15, at 1765-67 (describing the potential for increased fraud in transactions conducted under the crowdfunding exemption and the burden placed on the SEC to craft rules which greatly impact the effectiveness of the goals of facilitating capital raising while promoting investor protection), and Letter from Charles V. Rossi to Elizabeth M. Murphy, *supra* note 32 (warning of the potential for increased fraud specifically based on the CROWDFUND Act), and Tim Worstall, *Will the JOBS Act Increase Investment Fraud? Sure: So What?*, FORBES (Apr. 6, 2012, 1:09 PM), <http://www.forbes.com/sites/timworstall/2012/04/06/will-the-jobs-act-increase-investment-fraud-sure-so-what> (admitting that there will likely be increased fraud as a result of relaxing federal securities laws but placing more emphasis on the potential societal benefit that could emerge from such an exemption), with *How the Crowd Detects Fraud*, *supra* note 84 (arguing that there will be no increase of investor fraud as a result of Title III and that Australia and the United Kingdom have reported no cases of fraud in equity crowdfunding despite being around for several years in each country), and *Ignore the Naysayers—The JOBS Act Will*

who is correct, the SEC could most effectively prevent investor fraud resulting from unsophisticated investors participating in crowdfunded ventures by constructing rules that create a new class of “Semi-Accredited” investors. The SEC should then limit participation in equity crowdfunding transactions to individuals holding at least Semi-Accredited status (a status that should include all accredited investors).

Prospective investors should be able to achieve Semi-Accredited status in one of two ways under SEC rules and regulations. The first approach is preventative and focuses on permitting only those investors that are educated and financially literate to participate in crowdfunded offerings.<sup>192</sup> This approach is bifurcated and provides potential investors with two ways to attain the requisite level of education sufficient to responsibly participate in crowdfunded offerings.

The second approach aims to qualify certain investors as eligible to participate in crowdfunded offerings based on their financial security as measured by their annual income or net worth. The proposed solution described in this Note is one piece of the regulatory puzzle that would make the CROWDFUND Act an efficient and effective piece of legislation.

### 1. Semi-Accredited Status Determined by Investor Education

As discussed previously, the lack of financial literacy by potential investors is alarming in the context of crowdfunding.<sup>193</sup> Uneducated investors are more susceptible to fraud and are unaware of the risks associated with crowdfund investing.<sup>194</sup> As a result, Congress requires intermediaries participating in an equity crowdfund exemption to ensure that investors review financial education material and understand the risks associated with crowdfund investing.<sup>195</sup> Thus, limiting participation in these transactions to investors that are educated would likely reduce unforeseen investment risks and occurrences of fraud.<sup>196</sup>

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*Create Jobs*, UNDER30CEO (Oct. 7, 2012), <http://www.under30ceo.com/ignore-the-naysayers-the-jobs-act-will-create-jobs> (arguing that concerns of investor fraud surrounding the JOBS Act are misplaced, that the amount of fraud, if any, will be miniscule in comparison to the financial crisis, and echoing the report that there have been zero cases of crowdfunding fraud in Australia and the United Kingdom).

192. Cf. Bradford, *Crowdfunding*, *supra* note 8, at 138.

193. See *supra* Part III.A.

194. See Bradford, *Crowdfunding*, *supra* note 8, at 112; Hazen, *Fraudfunding*, *supra* note 15, at 1765-66.

195. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315-16 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(4)).

196. Palmiter, *supra* note 147, at 400-01.

The SEC can most effectively educate investors by requiring them to attain Semi-Accredited status before being permitted to invest in crowdfunded ventures. Under this proposal, a potential investor would be able to attain Semi-Accredited status by undergoing one of two educational requirements.

a. Semi-Accredited Status Attained after Completion of an Intermediary's Investor Education Course

A potential investor should be able to attain Semi-Accredited status *for a particular funding portal or intermediary* by reviewing investor education materials constructed by that funding portal or intermediary in accordance with SEC rules and regulations.<sup>197</sup> The SEC should set specific, but flexible guidelines for intermediaries to follow in creating their investor education materials.<sup>198</sup> Specifically, an intermediary's investor education materials should include a list of basic financial terms and their definitions, techniques for spotting and evaluating risks (specifically tailored to the disclosures required of issuers), ways of proactively preventing fraud, and a summary of remedies available to the investor in the case of a fraudulent venture. This system also allows the intermediaries and funding portals to craft a class or tutorial specific to their brand.

This method would benefit both investors and intermediaries. Investors benefit because they could become immediately acquainted with the specifics of the intermediary they choose to use. The intermediary's investor education materials could introduce the investor to the terms of art associated with that specific industry and funding portal. For example, an intermediary specifically tailored to hosting equity crowdfunded offerings for up-and-coming musicians can begin to educate the investor pool specifically about the music business without wasting time discussing the intricacies of other industries. Basically, this method would be a combined course on investment education and a tutorial for how to best utilize the intermediary.

Intermediaries would also benefit from this method because better informed investors are happier investors.<sup>199</sup> Investors that are well-versed in the platform they choose to use can better utilize all of the

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197. Cf. Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 316 (to be codified at 15 U.S.C. § 77d-1(a)(4)).

198. Cf. Palmiter, *supra* note 147, at 416.

199. See Elana Fine, *The Feedback*, WASH. POST (Feb. 12, 2012), [http://articles.washingtonpost.com/2012-02-12/business/35443612\\_1\\_local-search-service-providers-consumers](http://articles.washingtonpost.com/2012-02-12/business/35443612_1_local-search-service-providers-consumers) ("Keep your investors happy by keeping them informed. Investors expect bumps, but they don't like surprises.").

services that the intermediary offers. Intermediaries could also parlay the newfound knowledge of each of their investor-users to cultivate a close-knit investing community.<sup>200</sup> By providing an open forum of engaged, educated investors, the users themselves would also be able to spot and communicate to each other both potentially good and potentially fraudulent ventures.<sup>201</sup>

However, an integral component of this method is that an investor's Semi-Accredited status is applicable to that specific funding portal or intermediary only. If the investor chooses to migrate to a different intermediary or funding portal, they would have to complete the new intermediary's investor education materials before investing. For the investors that plan on utilizing multiple intermediaries and funding portals, this Note suggests a second method of achieving Semi-Accredited status by inspecting investor education materials universally applicable to crowdfunded offerings.

#### b. Semi-Accredited Status Attained After Completion of a Government-Offered Investor Education Course

The second way a potential investor should achieve Semi-Accredited status by consulting investor education material is by completing a very in-depth investor education course available through and created by the SEC.<sup>202</sup> Under this approach, the investor would be required to complete an online course, offered on an SEC-mandated website, which covers more material than that of courses provided by intermediaries under the first approach discussed in this Note.<sup>203</sup> Investors would be expected to learn significantly more information about general investment knowledge, different types of risks, fees and costs associated with investing, and the proactive steps integral to avoid fraud.<sup>204</sup>

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200. Cf. Bradford, *Promise Unfulfilled*, *supra* note 14, at 219.

201. *Id.*

202. STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS, *supra* note 137, at 182. The SEC staff survey regarding retail investor financial literacy suggested the creation of "www.Investor.gov" to serve as a centralized location where all investors can refer to when in need of investment education materials. *Id.* Investor.gov is currently live and provides extensive investor education materials including introductory information, advice on researching and managing investments, calculators, quizzes, worksheets, and news updates. See INVESTOR.GOV, <http://www.investor.gov> (last visited July 18, 2013).

203. See *supra* Part IV.B.1.a. This approach is open to the idea that the government could outsource the in-depth investor education test preparation to private companies such as Kaplan or The Princeton Review as long as the end-of-course test remained available through a government portal. Cf. Bradford, *Crowdfunding*, *supra* note 8, at 138-39.

204. General investment knowledge, different types of risks, fees, and costs associated with investing, and proactive steps for avoiding fraud were identified in the SEC staff survey about

Upon successful completion of an end-of-course test—which would be offered on the government website—the investor would receive an identifying number or code that could be entered during registration at all intermediaries. This code would give such investors the option to bypass that intermediary’s specific investor education material. However, a solution that only permits investors to attain Semi-Accredited status by reviewing educational materials is inefficient and undesirable. The second method of obtaining Semi-Accredited status is based on the investor’s level of wealth.

## 2. Semi-Accredited Status Determined by Investor’s Wealth

The SEC should also offer potential investors a way to attain Semi-Accredited status as a result of their level of wealth. Just as they had accomplished in Regulation D, the SEC should set net worth and annual income standards which function to classify certain qualifying investors as Semi-Accredited in regard to an equity crowdfunded offering.<sup>205</sup> The functionality of this proposed approach is based upon the same reasoning used by the SEC in creating the class of accredited investors permitted to invest in exempted offerings under Regulation D.<sup>206</sup> The SEC permitted accredited investors to participate in exempted offerings because they had either the “sophistication or the resources to obtain disclosure[s] and to evaluate the merits of [unregistered] offerings.”<sup>207</sup>

Likewise, this solution posits the creation of a class of investors pursuant to certain net worth or annual income standards. Lower wealth standards (as compared to the “accredited” investor standards) are a functional possibility since crowdfunding issuers are only permitted to raise a total of one million dollars in their offering, and since individual investor’s investment sizes are capped according to their net worth or annual income.<sup>208</sup>

The practical implementation of such a standard would be easy and beneficial to all interested parties for several reasons. First, individual investors are already given the responsibility of calculating their net worth and annual income to determine the maximum investment amount they are permitted to contribute to crowdfunded ventures annually.<sup>209</sup>

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financial literacy as content areas that should be promoted to improve financial literacy of investors. STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS, *supra* note 137, at 180.

205. See 17 C.F.R. § 230.501(a)(5)–(6) (defining the requirements to be considered an accredited investor).

206. See *id.*; Monson, *supra* note 55, at 38.

207. Monson, *supra* note 55, at 38.

208. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (to be codified at 15 U.S.C. § 77d(a)(6)(A)–(B)).

209. See *id.*, 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d(a)(6)(B)). RocketHub, an entity

This same calculation of total net worth and annual income could then be submitted to the SEC for verification in order to qualify as a Semi-Accredited investor. This makes it extremely easy on investors who wish to proactively prevent fraud by relying on their wealth and sophistication instead of undergoing an in-depth educational course or tutorial.<sup>210</sup>

Second, upon receiving such information from potential investors, the SEC could share that information with intermediaries, making it easier for intermediaries to monitor the annual investment amounts of investors.<sup>211</sup> Intermediaries are required to do this under the CROWDFUND Act and would benefit greatly from not having to solicit and calculate every investor's annual income and net worth.<sup>212</sup>

Issuers would benefit from this approach as well by offering individuals yet another way to be able to participate in crowdfunded ventures, while promoting the goal of preventing fraudulent offerings. Finally, the SEC would benefit from this method of attaining Semi-Accredited status because they could create such a regulation or rule relatively easily.<sup>213</sup> The SEC created the "accredited" investor class when they promulgated Regulation D, and they have continually utilized it as a method of preventing fraud.<sup>214</sup> Thus, the creation of a new class of Semi-Accredited investors in this way would be easy for the SEC since they have created a similar class of investors previously.<sup>215</sup>

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currently functioning as a platform for non-equity crowdfund offerings, has pointed out that there is a discrepancy in the calculation of an investor's annual investment cap. ROCKETHUB, REGULATION OF CROWDFUNDING 5 (2012). They note in the White Paper that they submitted to the SEC that it is possible for an investor to categorize him/herself under both subsections of § 77d(a)(6)(B) of the U.S. Code, as amended by the JOBS Act. *Id.* "If that investor has an annual income greater than \$100,000 but a net worth less than \$100,000, it is unclear whether the investor should be limited to an annual investment cap of 5% or 10% of the annual income." *Id.* The same ambiguity arises if the situation is reversed. *Id.*

210. Intermediaries are responsible for ensuring that *each* investor reviews investor education materials. Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 316 (to be codified at 15 U.S.C. § 77d-1(a)(4)). As a result, the SEC should include in its rules an exemption for investors who attain Semi-Accredited status as a result of their net worth or annual income.

211. *See id.*, 126 Stat. at 316 (to be codified at 15 U.S.C. § 77d-1(a)(8)).

212. *Id.*

213. *See supra* Part IV.A (describing the broad rulemaking power the SEC has when it comes to exempted transactions in the Securities Act).

214. *See Monson, supra* note 55, at 37-39 (describing how the class of "accredited" investors was created and discussing its unchanged definition for over the past thirty years).

215. *See* 17 C.F.R. § 230.501(a) (2012).

*C. Reconciling the Sources of Potential Fraud in  
the CROWDFUND Act*

The three legal issues that this Note highlighted could all begin to be ameliorated if the SEC adopted the solution detailed above.<sup>216</sup> The potential for fraud resulting from unsophisticated investors participating in crowdfunded offerings is on its way to being resolved if those investors attain Semi-Accredited status. Whether the investor qualifies through participation in an educational course or by way of their affluence, Semi-Accredited investors are in a better position to deal with crowdfunded offerings.<sup>217</sup>

The creation of a class of Semi-Accredited investors also begins to resolve the problems associated with a lesser number of issuer disclosures, which are often filled with sophisticated financial jargon.<sup>218</sup> Investors that qualify as Semi-Accredited through the educational courses will have been taught the terms used in such disclosures and the skills necessary to properly read and evaluate such information.<sup>219</sup> Investors that are classified as Semi-Accredited because of their wealth still have the option to participate in the educational courses, but, by nature, are also in a better position to understand the disclosures or consult with someone who can.<sup>220</sup>

Finally, Semi-Accredited investors will be well versed in the general workings of crowdfunded ventures and should be able to understand what they are getting involved in before their investment ever reaches an issuer.<sup>221</sup> As a result, these investors will be able to intelligently research a potential investment, understand available disclosures, and avoid the potential troubles associated with the individual annual investment cap in crowdfunded offerings, or have the means to consult with someone who can.<sup>222</sup>

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216. See *supra* Parts III.A–C., IV.B.

217. See *supra* Part IV.B.

218. See Hazen, *Fraudfunding*, *supra* note 15, at 1767; Heminway, *supra* note 48, at 348.

219. See *supra* Part IV.B.1.a–b.

220. See *supra* Part IV.B.2.

221. See *supra* Part IV.B.

222. See *supra* Part IV.B.



## V. CONCLUSION

The recent boom of crowdfunding has created tremendous opportunities for entrepreneurs and small businesses.<sup>223</sup> The JOBS Act, and specifically the CROWDFUND Act, facilitates a small company's ability to raise capital by "minimizing regulatory requirements" in public capital markets.<sup>224</sup> However, to be harmonious with the legislative goals behind the Securities Act—increasing access to capital *and* deterring fraud—the SEC needs to promulgate well-crafted rules that create a new class of investors.<sup>225</sup>

Investor protection against fraud is of the utmost importance.<sup>226</sup> By creating a "Semi-Accredited" class of investors, the SEC can begin to effectively prevent fraud. Creating such a class of investors is clearly within the SEC's authority and would be beneficial to all of the parties involved in a crowdfunded offering.<sup>227</sup>

Investors that attain "Semi-Accredited" status by their annual income or net worth will be required to file a simple form with the SEC that demonstrates that they possess a certain level of wealth and acknowledge the possibility of an entire loss of their investment. Any other individual can become a "Semi-Accredited" investor by participating in an online course either offered through an intermediary or a government organization. In becoming a Semi-Accredited investor under this method, individuals will learn how to properly read and understand business documents, evaluate business plans, and ultimately make informed and educated business investments.

By requiring investors to either learn about the niche of equity crowdfunding or reach a certain level of wealth before investing, the SEC is promoting an efficient, safe, and more reliable way for companies to raise necessary capital. While total prevention of fraud is impossible, significant amelioration is very conceivable.<sup>228</sup> However,

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223. See Bradford, *Crowdfunding*, *supra* note 8, at 10-13.

224. *The Laws that Govern the Securities Industry*, *supra* note 36; see Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315-20 (2012) (to be codified at 15 U.S.C. § 77d-1(b)) (requiring issuers to disclose much less information than that required of a registered security offering).

225. *The Laws that Govern the Securities Industry*, *supra* note 36; see 15 U.S.C. § 77b(b) (2006) (requiring the SEC to consider "whether an action is . . . in the public interest, . . . the protection of investors, [and] whether the action will promote efficiency, competition, and capital formation").

226. See *The Laws that Govern the Securities Industry*, *supra* note 36; see also Jumpstart Our Business Startups Act § 302(b), 126 Stat. at 316, 318 (to be codified at 15 U.S.C. §§ 77d-1(a)(5), 77d-1(b)(1)(I)) (delegating to the SEC the rulemaking power necessary to reduce the risk of fraud and to protect investors).

227. See *supra* Part IV.A-C.

228. See Bradford, *Crowdfunding*, *supra* note 8, at 112.

until the SEC promulgates rules for the CROWDFUND Act, we will not know whether the JOBS Act will truly make it easier for American businesses to raise capital.<sup>229</sup>

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229. See Bradford, *Promise Unfulfilled*, *supra* note 14, at 215.

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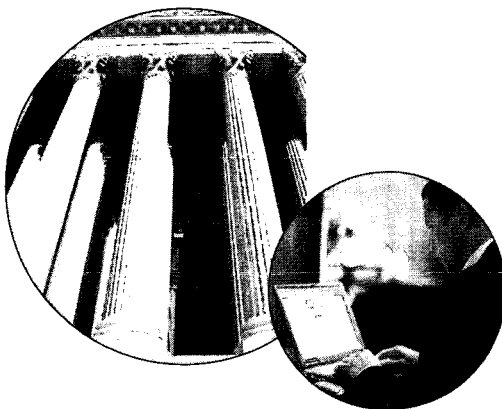
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