

**TITLE III OF THE JOBS ACT: CONGRESS INVITES  
INVESTOR ABUSE AND LEAVES THE SEC HOLDING THE  
BAG**

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*In an effort to increase the availability of small business start-up capital, Congress recently created a new type of exempt offering under the Securities Act of 1933 (Securities Act), colloquially referred to as “Crowdfunding.” Touting this new equity scheme as a rational modernization of capital formation, both Congress and the Securities and Exchange Commission (SEC) have characterized the new law as striking a fair balance between investor protection and the capital formation requirements of small business entities. However, using a detailed analysis of historical statutory precedent, this paper reveals a strong bias that favors exempt issuers of securities at the expense of investor protections. Through a combination of apparent oversight, ambitious regulatory implementation, and a failure to fully comprehend the nature of modern communications, this new exemption makes wide room for the most vulnerable class of investors to participate in some of the riskiest business ventures imaginable. However, the research also demonstrates that, with very modest changes, this new scheme could easily achieve a balance between the capital needs of small businesses and the protection of investors that more closely aligns with the original intention of the Securities Act.*

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## I. INTRODUCTION

In 1911, Kansas passed the nation’s first securities law, aimed at protecting inexperienced lay investors from the unscrupulous practices of people peddling largely worthless securities. Making outrageous claims and promising impossible returns, these scam artists swindled the unsuspecting public out of millions of dollars. The Stock Market Crash of 1929 and the subsequent Great Depression brought an intense public focus on some of the abuses of the financial system by large institutional players in stocks and securities and ushered in sweeping legislation at the national level. This legislation, not coincidentally, also shared many of the same goals as the Kansas law enacted some twenty years earlier.

The intervening years saw many and varied changes to the regulatory scheme. For the most part, these changes managed to strike a fair balance between the capital needs of business and the protection of investors. However, with the advent of new and emerging technologies and methods of communication, there was a strong push to “modernize” securities legislation. The resultant legislation is, in some ways, a fair extension of the balance between business needs and consumer protection that has historically occurred. However, in other ways, the inexperienced lay investors that warranted protection under the first securities law in 1911 are now losing the bulk of the protections they had previously enjoyed.

This paper first explores the history of securities laws within the United States and the subsequent changes that have been enacted through the years leading up to the passage of the JOBS Act. The research shows that, while Title III of the JOBS Act (the CROWDFUND Act) attempts to paint a portrait of enhanced investor protections, while facilitating increased access to capital for small business, in fact, only the latter was accomplished in any meaningful fashion. In attempting to draft this legislation, Congress and the SEC both failed to recognize numerous areas that are wide open to abuse. Of the provisions that would have provided at least a modicum of protection to the lay investor, perhaps the simplest and most effective one was reduced to a mere recommendation and otherwise left to the

discretion of the proposed intermediaries involved. Lastly, what is characterized as a key investor protection is instead revealed to be largely illusory and tied to metrics that are out of date by nearly forty years.

In short, Congress and the SEC are attempting to present this legislation as a rational modernization of fundraising for small businesses via an exemption. What we have instead is a rollback of some of the most basic of investor protections. This new exemption removes those protections at the expense of a vulnerable class of investors. Whether Congress or the SEC were aware of this, or were simply acting in ignorance, is impossible to determine. However, the results are readily demonstrable and the central purpose of this paper. Perhaps more importantly, this paper will also show that very modest amendments to these regulations can significantly increase investor protection and more closely align it with statutory precedents.

## II. HISTORY OF SECURITIES LAW AND EXEMPTIONS

In 1933, the United States Congress enacted the first national legislation to regulate the sale of securities.<sup>1</sup> This new legislation was similar in many regards to then existing state “blue sky laws,” as noted in *Shonts v. Hirliman*, which was one of the first cases to test the then-new law.<sup>2</sup> As Judge Yankwich noted in *Shonts*, blue sky laws derive their name from “their object, which is to prevent the promoters of corporate securities from selling ‘the blue sky’ to investors, or at least, from promising it to them.”<sup>3</sup> Despite the assertion by the judge of the origin of the name, there was, until recently only anecdotal evidence of the true origin of the term “blue sky” in relation to the sale of securities. In 1917, the United States Supreme Court in *Hall v. Geiger Jones, Co.* stated, “The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, ‘speculative schemes which have no more basis than so many feet of blue sky.’”<sup>4</sup>

Obviating the need to dig further through the citations, the North American Securities Administrators Association (NASAA) in their commemorative *A Century of Investor Protection, 1911–2011* seems

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1. See *Shonts v. Hirliman*, 28 F. Supp. 478, 481 (S.D. Cal. 1939) (comparing the Securities Act of 1933 to the blue sky laws).

2. *Id.*

3. *Id.*

4. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).

to have laid the matter to rest, noting that the term originated from a man named Mr. Joseph N. Dolley, a former State Bank Commissioner of Kansas.<sup>5</sup> Mr. Dolley was the driving force behind the 1911 Kansas blue sky law, which was essentially the first of its kind in the United States.<sup>6</sup> On the origins of the term, Mr. Dolley wrote in a Topeka, Kansas newspaper in 1935 that the name was derived from an earlier fraud perpetrated against Mr. Dolley and his associates by confidence men from Chicago.<sup>7</sup>

That particular scheme involved the confidence men selling “rain-making” equipment to desperate farmers during a severe drought in the 1890s.<sup>8</sup> These tricksters had set up an elaborate device, which they then let run for several days. With the contraption failing to produce the desired results, the purchasers sought out the men, only to discover that they had absconded from the district with everyone’s money, leaving the useless equipment behind.<sup>9</sup> Naming the act in memory of the “blue sky artist” that had perpetrated the earlier swindle, Mr. Dolley helped to convince the Kansas legislature in 1911 to pass the newly constructed “blue sky” legislation.<sup>10</sup>

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5. RICK A. FLEMING, WHAT’S IN A NAME?, N. AM. SEC. ADMIN. ASS’N (2011), reprinted in N. AM. SEC. ADMIN. ASS’N, A CENTURY OF INVESTOR PROTECTION (2011) [hereinafter NASAA].

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* Quoting from the Topeka Daily State Journal, Mr. Dolley wrote of the time:

Crops were burning up. Stock water and even water for domestic use was disappearing. It was the day of professional rain makers and some of our people felt we should make every effort to get rain. So we raised the necessary money and contracted with some Chicago slicker to supply us with the necessary quantity of moisture. They arrived at Maple Hill with two barrels of chemicals, a string of iron pipe and some mysterious mechanical doo-dad. They set up their equipment on a platform within an enclosure to which no one was admitted. Their iron pipe pointed toward the sky. At length it began to emit a light milk colored spray. The machinery was set it (sic) motion. The milky spray was cast up for four days and four nights. But there was no sign of rain. The fifth day our committee visited the rain makers plant, to discover that the rain makers had disappeared, leaving their equipment behind. When I appeared before the judiciary committee. . .one of the senators asked me what to call the law. Remembering our experience with the blue sky artist in trying to make rain, I suggested ‘the blue sky law.

*Id.*

10. *Id.*

Clarence A. Dykstra, in an article for *The American Political Science Review*, wrote that the law “has attracted wide attention and so many States have considered or are considering the question of investment company regulations that the subject demands some notice.”<sup>11</sup> Mr. Dykstra went on to say, “[t]he object of the Kansas law is to give the average investor every possible protection against the numerous companies which sell stock, bonds or securities of little or no value,”<sup>12</sup> and was widely promoted by Mr. Dolley as such. Those promotional efforts lead to similar enactments in several states, as well as several provinces in Canada.<sup>13</sup> The next twenty or so years found the various blue sky legislative schemes gaining wider acceptance throughout the United States, as well as surviving a constitutional attack,<sup>14</sup> and noted that by 1931 “every state had adopted a securities law.”<sup>15</sup>

The essence of these laws was to protect investors within each sovereign jurisdiction from unscrupulous individuals peddling all manner of securities, the majority of which were of questionable values, if not outright fiction, as noted by Will Payne in a 1911 article in *The Saturday Evening Post*.<sup>16</sup> The fraud listed within almost would ring comically today, bearing in mind of course, that this was a period in which information wasn’t quite as readily available as it is in our current era. However, authors Macey & Miller in *Origin of Blue Sky Laws* have questioned the extent of the fraud during this time, noting in part that court records are bereft of a large number of cases dealing with securities frauds arising during this period.<sup>17</sup> Right at the outset this assertion is suspect, as this condition is to be expected, especially with regards to civil and criminal prosecutions for fraud. This is because, just by their nature, only a small fraction of those cases, if any, may have merited publication.<sup>18</sup>

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11. Clarence A. Dykstra, *Blue Sky Legislation*, 7 AM. POL. SCI. REV. 181, 230 (1913).

12. *Id.*

13. *Id.* at 231–233; see also Jonathan R. Macey & Geoffrey P. Miller, *Origin of Blue Sky Laws*, 70 TEX. L. REV. 347 (1991) (arguing that blue sky laws were mistakenly attributed to consumer protection).

14. See, *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

15. RICK A. FLEMING & BOB WEBSTER, *TAMING THE WILDCATS* (2011), reprinted in NASAA.

16. Will Payne, *How Kansas Drove Out a Set of Thieves*, THE SATURDAY EVENING POST, Dec. 2, 1911, reprinted in NASAA.

17. See Macey & Miller, *supra* note 13, at (noting there has not been enough cases in order to properly determine the amount of fraud during the early 1900s).

18. See generally, ADVISORY COUNCIL ON APPELLATE JUSTICE, STANDARDS FOR

Furthermore, an extensive record of fraud convictions exists that was obtained after the passage of the Securities Act in 1933. In the SEC's Ninth Annual Report to Congress in 1943, it notes that up to that point "a total of 2,223 defendants have been indicted in cases developed by the Commission," which resulted in 1,013 convictions.<sup>19</sup> It is scarcely worth noting that the likelihood of there being fewer frauds perpetrated absent a law to the contrary is remote at best. Even were there an absence of an authoritative record, one could easily deduce the depth of the problem from anecdotal records of the time. As such, the aforementioned *Post* article<sup>20</sup> details several examples of the various schemes put forth within the state of Kansas at that time, with the large majority comprised of mining concerns, followed by oil companies, irrigation schemes, Central and South American plantations, transportation enterprises, and land development deals.<sup>21</sup>

Oftentimes, the dealers in these offerings targeted people in vulnerable positions, such as the impoverished and recent widows and orphans, by capitalizing on their lack of sophistication.<sup>22</sup> The latter characterization was also noted as suspect by Macey & Miller, saying that the claim was "far-fetched" and that "[w]idows, orphans, and poor people did not have the money to buy speculative securities."<sup>23</sup> However, contrasting this point of view, Mr. Payne notes that life insurance payouts were a favorite target of stock swindlers, noting, "just about the time the life-insurance money is paid over—and these fellows are so well up in the game they can calculate it to a day—Mr. Agent drops in."<sup>24</sup> According to Payne, the sales agent then informs the widow that the interest she would collect on the insurance money by leaving it in the bank is but a fraction of the "thirty-five percent a

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PUBLICATION OF JUDICIAL OPINIONS (1973).

19. SEC. & EXCH. COMM'N, NINTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 57 (1943).

20. Payne, *supra* note 16.

21. See generally the SEC's Annual Reports from 1935 to 1950. These reports, while perhaps a bit dry, do offer a fair insight into the variety and imaginative nature of the investment schemes offered during the period. Of note, each of the individual reports has a "litigation" heading, under which mining interests and oil companies tend to be featured quite prominently. However, the frauds detailed within encompass everything imaginable, from manipulating bond sale prices to the sale of live Chinchillas. The time period chosen was arbitrary, as the sources are only intended to illustrate the broad nature of the schemes encountered by the SEC.

22. Payne, *supra* note 16, at 6.

23. Macey & Miller, *supra* note 13, at 391.

24. Payne, *supra* note 16, at 7.

year” windfall she would make investing in the confidence man’s scheme.<sup>25</sup> Of course, that windfall would fail to materialize, often leaving the purchaser penniless.<sup>26</sup>

Of these schemes, Mr. Dolley goes on to note, “the undertakings described in these applications [to sell securities in Kansas after the passage of the 1911 law] dot the Western Hemisphere from the Equator to the Arctic circle.” The Arizona Department of Mines and Mineral Resources echoes the depth of fraudulent activity, at least those associated with mining concerns, in their 2002 report on mining scams in the late 20th century.<sup>27</sup> They note humorously in the introduction “A gold miner is a liar standing next to a hole in the ground.”<sup>28</sup> They then go on to state, “A time-honored method to bilk the public out of millions of dollars is the ubiquitous mining scam.”<sup>29</sup> And, while it’s not necessarily dispositive of the amount of fraud during the time previous, within the first ten months of the federal requirement to register securities in 1934, 1,533 registrations were on file with the SEC.<sup>30</sup> Of those, 91 stopped or refused orders issued, 225 were withdrawn, with an additional 123 awaiting either amendment or examination.<sup>31</sup> With stops, refusals and withdrawals accounting for more than twenty percent of registration attempts, it doesn’t stretch the imagination too far in assuming that a great many more offerings would have been abandoned entirely, rather than face the scrutiny of this new regime.

None of this is to say that the Securities Act was limited to the numerous scams perpetrated at the state and local level, and the facts show the reality is quite the contrary. The 1920s featured numerous high-profile stock swindles by some of the biggest names in finance at the time, as revealed by the Pecora Investigations, so named for the lead investigator Ferdinand Pecora, which began in 1932 and became the source of intense focus in the press.<sup>32</sup> The result of these

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25. *Id.*

26. *Id.*

27. W. SCOTT DONALDSON, ARIZ. DEP’T OF MINES & MINERAL RES., ARIZONA MINING SCAMS AND UNASSAYABLE ORE PROJECTS OF THE LATE 20TH CENTURY 2 (2002).

28. *Id.* at 3.

29. *Id.*

30. SEC. & EXCH. COMM’N, FIRST ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 1, 29 (1935).

31. *Id.*

32. See generally FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS (1939) (investigating the nation’s most influential bankers and stockbrokers to determine the cause of the Wall Street Crash of 1929).

investigations was detailed extensively by the United States Senate in 1934 and incentivized legislators to enact securities legislation,<sup>33</sup> even beyond the widespread frauds being perpetrated at the state level.<sup>34</sup> As such, the Act itself states that it is there “[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.”<sup>35</sup>

While the Securities Act could fairly be categorized as largely in response to the prevailing conditions that led to the Stock Market Crash of 1929, it was also inclusive of investor protections at all levels. In *Shonts*, there was a notable addition to most of the regulations under the state blue sky laws, in that, with the Securities Act, Congress specified an action for making misrepresentations in the sale of securities. Judge Yankwich noted that under the state schemes, a person “who feels defrauded, by any misrepresentation relating to the stock, must resort to the law action of deceit or to the equity suit of rescission.”<sup>36</sup> This sentiment is repeated in the aforementioned *Post* article, where it said “[i]n every state, of course, a purchaser of fake stock may sue for the recovery of his money—which is about as satisfactory as the privilege of suing a pickpocket for the recovery of your watch.”<sup>37</sup> Mr. Dolley echoes this sentiment a few paragraphs later, decrying a land stock swindle one of his acquaintances had fallen victim to, saying, “[t]here was no law to reach the sharks—except, of course, that a man might sue them or prosecute them for getting money under false pretenses; but a man couldn’t do either until after he had lost his money.”<sup>38</sup>

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33. See, e.g., S.REP. NO. 73-1455 (1934) (Senate report created to investigate practices of buying and selling securities).

34. See JERRY MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION 62–66 (2013) (offering overview of fraudulent institutional practices).

35. The Securities Act of 1933, Pub. L. No. 73-22, 38 Stat. 74, 74 (1933).

36. *Shonts v. Hirliman*, 28 F. Supp. 478, 481 (S.D. Cal. 1939).

37. Payne, *supra* note 13, at 6.

38. Mr. Dolley relates the tale:

An old farmer I used to know came up to Topeka to see me. He’d sold his Kansas farm and had the money in the bank. A couple of smooth gentlemen came along and persuaded him to invest the money in developing a magnificent tract in New Mexico that was just about to be irrigated. He invested; and, after waiting patiently a good many months for the promised returns, he came up to see me. I advised him to invest some more money in a railroad ticket and go down and look at his land

However, with the new laws in place, consumers now had a specific statutory remedy at the federal level. This was important in two regards. First, even with the state blue sky laws in place, local enforcement officials had no means by which to prosecute offenders outside of their jurisdiction, leaving the fraudsters free to commit their scams via the mail.<sup>39</sup> While the Postal Service was empowered to act against frauds made via the mail at the time, “the level of enforcement was minimal.”<sup>40</sup> With the now federal character of the law, the confidence men involved in these schemes were no longer able to engage in interstate sales and marketing via the postal service without running afoul of the new regulations. Second, rather than leaving a consumer to wait until after a fraud had been perpetrated to seek relief from the authorities, the Securities Act designated two important duties for those who wished to issue securities, notably the duty of registration and the concomitant duty of disclosure of material facts regarding, generally, the solvency and legitimacy of that offering.<sup>41</sup> The latter condition is of noteworthy consequence to the present discussion, as those disclosures are also necessary in exempt offerings, of which this article is in exploration.

The following year, Congress then enacted the Regulation of Securities Exchanges, known as the Securities Exchange Act of 1934, “[t]o provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.”<sup>42</sup> As one can plainly see from the text, the overriding crux of both of these statutes is the legislative attempt to mitigate fraud and unfair dealing within the realm of securities trading. The Securities Exchange Act was also the genesis of the SEC; as the Federal Trade Commission was first

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personally. He did go down there. He got off at the railroad station that was to be their shipping point and walked half a day through the sagebrush, and then climbed some bare, mountainous hills until his wind gave out. The land he'd invested was still higher up. The only way to irrigate it would be from the moon.

*Id.*

39. *Id.* at 1.

40. Macey & Miller, *supra* note 13, at 348 (citing Forrest B. Ashby, Federal Regulation of Securities Sales, 22 ILL. L. REV. 635 (1928)).

41. See Securities Act of 1933 § 7, 15 U.S.C. § 77g (2015).

42. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881, 881 (1934).

envisioned as the securities regulating body.<sup>43</sup> The Securities Exchange Act transferred rulemaking authority to the newly formed SEC. Among other things, the changes added prohibitions against false or misleading statements in the inducement of a sale, expanding on a similar theme found in section 10 “Information Required in Prospectus” of the Securities Act.<sup>44</sup> As one might imagine, the implementation of regulations involving such an enormous industry was no small task. The first rules that the Congress wrote after the definition of terms were those detailing the types of securities that would be exempt under the new law.

By and large, these exemptions were fairly benign, as they excluded from registration such issues as those from federal and state governments, those for non-profit purposes, such as churches and charitable organizations, as well as those offered by common carriers already regulated by the Interstate Commerce Act, among others.<sup>45</sup> Of particular note to this article, under section 3(b) of the Securities Act the SEC was also granted the authority to “add any class of securities” to the list of exemptions if the protection afforded under the Act is not necessary “by reason of the small amount involved or the limited character of the public offering.”<sup>46</sup> This authority was bound by a hard limit at the upper end of \$100,000 in aggregate securities that could be issued to the public in a given year.<sup>47</sup> In its first annual report to Congress in 1935, the SEC stated that it had encountered some difficulty in implementing effective regulations, noting that exemptive provisions “have presented questions of particular difficulty”<sup>48</sup> with numerous problems “exempting certain types of transactions, such as private offerings.”<sup>49</sup> To that end, it wasn’t until 1938 that the SEC began making tentative forays into finding workable solutions to meaningfully address the issue of exempt offerings by testing a new rule designated “Regulation A.”<sup>50</sup>

The SEC notes in its fourth annual report to Congress that “[t]he primary condition of this new exemption is the compliance with the

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43. Securities Act of 1933 § 2(5), 15 U.S.C. § 77b(a)(5).

44. *Id.* § 9(a)(4), 15 U.S.C. § 77j(a)(4).

45. *Id.* § 3(a)(2)–(8), 15 U.S.C. § 77c(a)(2)–(8).

46. *Id.* § 3(b)(1), 15 U.S.C. § 77c(b)(1).

47. The limit now is \$5,000,000. *Id.* § 3(b)(1), 15 U.S.C. § 77c(b)(1).

48. SEC. & EXCH. COMM’N, *supra* note 30, at 9.

49. *Id.*

50. SEC. & EXCH. COMM’N, FOURTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 44 (1938).

blue sky laws of all states in which the securities are offered, sold, or delivered after sale.”<sup>51</sup> Under this rule, a “notice of intention” was to be filed with the SEC, along with the admonition that “copies of all prospectuses, letters or other communications used at the commencement of the public offering” were to be filed with the agency prior to use.<sup>52</sup> They go on to state that “an integral part of this effort [is] to ascertain if alteration of these requirements would assist particularly the small business enterprise in obtaining new capital more simply and economically.”<sup>53</sup> That sentiment reflects a theme that persists throughout the decades, right up to and including the new rules published under the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,<sup>54</sup> known as the CROWDFUND Act.<sup>55</sup>

The tentative rules proposed in 1938 were codified in 1941 and remained in place until 1945, when the SEC decided to expand the upper limit allowable under the exemption to \$300,000.<sup>56</sup> Within their eleventh annual report and fully more than a decade after the passage of the Act, the SEC makes clear that exemption from registration “is not complete exemption from all provisions of the Act.”<sup>57</sup> They unequivocally state that issuers of exempt securities are bound by the prohibitions against misleading or fraudulent statements to the same degree they would be if the securities were registered.<sup>58</sup>

The following years would see the SEC continuing to apply small, regulatory “patches” to Regulation A. For instance, in 1950, as the \$300,000 limit was officially made part of the rules, the SEC also amended the language “to correct an erroneous impression in some quarters that if the initial offering price did not exceed that amount,

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51. *Id.*

52. *Id.*

53. *Id.*

54. Jumpstart Our Business Startups Act, tit. III, 15 U.S.C. § 77a (2015).

55. *SEC Adopts Rules to Permit Crowdfunding*, SEC. & EXCH. COMM’N (Oct. 31, 2015, 7:59 PM), <https://www.sec.gov/news/pressrelease/2015-249.html>.

56. SEC. & EXCH. COMM’N, ELEVENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 5 (1945).

57. *Id.* at 5.

58. *Id.* (“It is further pointed out that the exemption from registration permitted by Section 3 (b) is not complete exemption from all provisions of the Act. It is limited by express provisions in Section 12 which impose civil liability on persons who sell securities in interstate commerce or through the mails by means of untrue statements or misleading omissions, and by Section 17 which makes it unlawful to sell securities by such means or by other types of fraud. Sections 12 and 17 are applicable even though the securities involved are exempted under Section 3 (b).”)

the entire offering might be sold for an actual aggregate price to the public exceeding \$300,000.”<sup>59</sup> This again highlights the scope of the difficulty in regulating these affairs. The next major revision of the Act wouldn’t occur until 1970, when the SEC proposed an amendment to raise the \$300,000 limit to \$500,000, noting that, “[c]osts have risen throughout the economy since the last amendment with the result that the \$300,000 of 1945 has substantially less purchasing power today.”<sup>60</sup> The Commission supported the amendment, reiterating that “the original purpose of Section 3(b) was to aid small businesses in raising capital.”<sup>61</sup>

The period starting in 1978 and lasting well into the late 1980s saw a large uptick in the both the depth and breadth of changes to the rules for exempt offerings. In 1978, the upper limit was again raised from \$500,000 (which had only been finalized three years previous) to \$1.5 million.<sup>62</sup> That same year also saw a series of nationwide hearings where “[t]he commentators discussed a number of deletions, additions, and modifications of registration and reporting requirements in an effort to aid small businesses and new ventures.”<sup>63</sup> Two years later, President Jimmy Carter signed into law the Small Business Investment Incentive Act of 1980 (The Incentive Act),<sup>64</sup> which was largely aimed at easing regulations for venture capital firms.<sup>65</sup> A 1981 paper by Richard G. Tashjian reflecting on the Act posited that “[f]or small, developing companies, especially those engaged in the discovery of new technology and services, access to [bank financing or public stock issuance] is effectively barred, because the risks associated with these companies may be quite substantial.”<sup>66</sup>

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59. SEC. & EXCH. COMM’N, SIXTEENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 20 (1950).

60. SEC. & EXCH. COMM’N, 36TH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 19 (1970).

61. *Id.*

62. SEC. & EXCH. COMM’N, 44TH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 17 (1978).

63. *Id.*

64. President Jimmy Carter, Small Business Investment Act of 1980 Statement on Signing H.R. 7554 Into Law (Oct. 21, 1980), in The American Presidency Project, *Jimmy Carter: Small Business Investment Incentive Act of 1980 Statement on Signing H.R. 7554 Into Law*, (Oct. 31, 2015 10:07 PM), <http://www.presidency.ucsb.edu/ws/?pid=45341>.

65. Richard G. Tashjian, *The Small Business Investment Incentive Act of 1981 and Venture Capital Financing*, 9 FORDHAM URB. L.J. 865, 868–69 (1981).

66. *Id.*

For the most part, venture capital firms are distinguished from their more traditional investment firm counterparts in several ways. Generally venture capital companies view their investments with an aim towards long-term capital gains, as the companies being funded are not generally well suited to offer as securities in a public market.<sup>67</sup> Mr. Tashjian outlines two distinct reasons for this, the first being that new companies often require frequent injections of capital to continue their early operations, rather than having a surplus to pay out as dividends.<sup>68</sup> The second being, “the risks of investing in new companies are extremely high, and consequently, investors demand a higher return on their investment. Such returns do not come from dividends but from capital gains.”<sup>69</sup> Venture capital firms are further distinguished by the fact that their officers will often sit on the board of the investee company and they do this not only because of the depth of their capital investment, but perhaps more importantly, because “the personnel of the investee companies are typically entrepreneurs unskilled in the essential phases of corporate management.”<sup>70</sup> As noted above, the Incentive Act was largely designed to alleviate some of the conflicts that arose from venture capital firms attempting to operate under restrictions imposed by the Investment Company Act of 1940. This demonstrates the high-risk nature of investments in this type of activity and the level of relative sophistication that is evidenced by these professional investment participants.

While the overarching goal of the Incentive Act was largely related to venture capital, it also ushered in another change to the Securities Act of 1933, specifically the addition of section 19(c).<sup>71</sup> This section was to effect “the development of a uniform exemption from registration for small issuers which can be agreed upon among several states or between the states and the federal government.”<sup>72</sup> As such, at the end of 1980, the SEC published for comment proposed changes in accord with their newly enacted duties under the aforementioned section, and it is here that the modern rules under

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67. *Id.*

68. *Id.* at 869 n.23.

69. *Id.*

70. *Id.* at 869–70.

71. SEC. & EXCH. COMM’N, 44TH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 21 (1981).

72. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477 § 505, 94 Stat. 2275, 2293 (1980).

“Regulation D” were first introduced.<sup>73</sup> As noted early on in those proposed changes, “Regulation D is intended to result in a more coherent pattern of exemptive relief, particularly as it relates to the capital formation needs of small business.”<sup>74</sup> To this end, the SEC recounted how the current scheme of exempt offerings had come into being, citing some of the various patchwork changes noted above and stated that, “[i]t is the declared policy of this subsection that there should be greater Federal and State cooperation in securities matters,”<sup>75</sup> with the stated intent being to maximize the effectiveness and uniformity of the regulations, while incurring a, “minimum of interference with the business of capital formation,” as well as a substantial reduction in paperwork and government induced costs.<sup>76</sup>

The Incentive Act also first proposed the term “accredited investor”, with the initial definition of, “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>77</sup> These proposed changes also outlined the six rules that would eventually govern this regulation, specifically Rules 501–506.<sup>78</sup> With various and relatively modest changes in the years following the 1981 proposal, Regulation D and Rules 501–506 came to be the predominant means for the raising of small business capital in the United States. These rules wouldn’t again see major revisions until the Jumpstart Our Business Startups Act (JOBS Act) of 2012.

### III. CURRENT STATUS OF EXEMPT OFFERINGS

The JOBS Act introduced several substantial changes to U.S. securities regulations. Notably, Regulation A offerings were divided into two tiers with limits of \$20 million and \$50 million respectively, and Regulation A added certain provisions that were intended to “modernize the Regulation A filing process for all offerings, align practice in certain areas with prevailing practice for registered

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73. Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, 46 Fed. Reg. 41,791 (Aug. 18, 1981).

74. *Id.* at 47,791.

75. *Id.*

76. *Id.*

77. *Id.* at note 5.

78. *Id.* sec. II.

offerings, create additional flexibility for issuers in the offering process, and establish an ongoing reporting regime for Regulation A issuers.”<sup>79</sup> The JOBS Act also included significant changes to Regulation D, Rules 504, 505,<sup>80</sup> and 506,<sup>81</sup> as well as introducing a new scheme under Title III, known as the CROWDFUND Act.<sup>82</sup> Rule 506 offerings were, and still are as of this writing, far and away the largest form of exempt offering.<sup>83</sup> Rule 506 allows for an unlimited dollar amount offering, but the JOBS Act modified the rule to allow general solicitation to the public, provided that any purchaser was an “accredited investor.”<sup>84</sup> The allowance of general solicitation is of particular importance in this scheme, as Rule 506 also preempts state level blue sky laws.<sup>85</sup>

A 2013 paper from the SEC’s Division of Economic and Risk Analysis (DERA) noted that fully 50% of nonfund Rule 506 offerings “were for \$1 million or less and therefore may have qualified for the Rule 504 exemption based on offering size” and further noted that another 20% were offerings for less than \$5 million.<sup>86</sup> The DERA paper goes on to state that blue sky preemption seems to be the motivating factor in utilizing Rule 506 in lieu of other exemptions and “[w]ith the adoption of rules under Title II of the JOBS Act that remove the ban on general solicitation . . . there will be even greater incentive for issuers to use Rule 506.”<sup>87</sup> As noted, the concept of an

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79. Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), 80 Fed. Reg. 21,806, 21,807 (2015).

80. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69,786, 69,800 (2015) [hereinafter SEC, *Proposed 504 & 505 Amendments*].

81. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,774–75 (2013) [hereinafter SEC, *Rule 506 Amendment*].

82. Jumpstart Our Business Startups Act, tit. III, § 302 Crowdfunding Exemption, Pub.L. 112-106, § 302, 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d); Crowdfunding; Final Rule, 80 Fed. Reg. 71,388 (2015) [hereinafter SEC, *Crowdfunding*].

83. SEC, *Rule 506 Amendment*, *supra* note 81, at 44,788 (“Offerings conducted in reliance on Rule 506 account for 99% of the capital reported as being raised under Regulation D from 2009 to 2012 and represent approximately 94% of the number of Regulation D offerings.”).

84. *Id.* at 44,793. Rule 506 is broken into two sub-categories of offerings, 506(b) and 506(c). 506(b) offerings continue to bar general solicitation, but with the subsequent allowance of up to 35 “non-accredited” investors that may participate in the offering.

85. VLADIMIR IVANOV & SCOTT BAUGUESS, DIV. ECON. & RISK. ANALYSIS, U.S. SEC. & EXCH. COMM’N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, at 7 (2013).

86. *Id.*

87. *Id.* at 7–8.

accredited investor was first put forth in the Incentive Act of 1980. Today, the current rules set forth a number of criteria that would allow for that particular qualification, including banks and certain other types of organizations. However, the characterization most germane to the present discussion is “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000,”<sup>88</sup> or “[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years . . . and has a reasonable expectation of reaching the same income level in the current year.”<sup>89</sup>

This criterion excludes a person’s primary residence from being listed as an asset, and any indebtedness secured by the investor’s primary residence is to be further noted as a liability.<sup>90</sup> Of course, such characteristics don’t necessarily impute a level of financial sophistication to an individual actor, not to mention that these are the same standards that were in the aforementioned Incentive Act of 1980. Regarding Rules 504 and 505, as of this writing, the proposed changes to those rules are still within the sixty day comment period and are not yet finalized.<sup>91</sup> The proposed changes contemplate raising the limit on Rule 504 offerings from \$1 million to \$5 million, as well as opening Rule 505 to public suggestion for improved utility, or in the alternative, rescission as an unnecessary rule.<sup>92</sup> Neither Rule 504 nor 505 currently enjoy much utilization in comparison to Rule 506, and as such, the changes as proposed are not significant to the discussion at hand. With that said, we may now turn our attention to Title III of the JOBS Act, known as the “CROWDFUND Act.”<sup>93</sup>

#### IV. CROWDFUNDING

In the simplest and plainest sense of the word, “crowdfunding” is precisely that, the collection of monies from a group of people that are used in the aggregate to pay for something. This this type of fundraising can be used for everything from a church raffle to selling \$30,000 tickets to a presidential campaign dinner. There are obvious

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88. Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501(a)(5)–(a)(6) (2015).

89. *Id.*

90. *Id.*

91. See SEC, *Proposed 504 & 505 Amendments*, *supra* note 80.

92. *Id.* at 69,800–02.

93. SEC, *Crowdfunding*, *supra* note 82.

practical limitations on the number of people that can feasibly be involved in the fundraising effort. As such, it is here that the term is distinguished, as the crowdfunding contemplated under Title III refers to a more recent phenomenon that utilizes the internet and social media channels to promote the fundraising activity.<sup>94</sup>

A recent paper by Steven Bradford notes that there are currently several different methods of attracting investors via crowdfunding that are “distinguished by what investors are promised in return for their contributions . . . .”<sup>95</sup> The enticements can range from goodwill, rewards, the ability to pre-purchase funded products, and the possibility of an equity stake in the proposed venture.<sup>96</sup> However, the latter was not typically available because the profit-sharing model “could trigger the application of the federal securities laws because it likely would involve the offer and sale of a security. Under the original Securities Act of 1933, the offer and sale of securities is required to be registered unless an exemption is available.”<sup>97</sup> As noted, the most common exemption utilized to date has been under Regulation D, Rule 506, which also limits the offering to accredited investors.<sup>98</sup> This is distinctive in that the SEC estimates that only 7.4% of all U.S. households would qualify for participation under those criteria.<sup>99</sup> However, Title III added a new section to the Securities Act, “which provides an exemption from the registration requirements of Securities Act Section 5 for certain crowdfunding transactions,” as well as allowing non-accredited investors to participate.<sup>100</sup>

Under the rules as published, equity crowdfunding seems to draw upon a central mechanism currently employed under the goodwill, reward, or pre-purchase methods of crowdfunding, notably the use of a funding portal.<sup>101</sup> A funding portal is defined by the SEC as:

[A]ny person acting as an intermediary in a transaction

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94. *Id.* at 71,388.

95. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 14 (2012).

96. *Id.* at 14–15.

97. *Id.*

98. *Id.* at 8 n.5.

99. SEC, *Rule 506 Amendment*, *supra* note 81, at 44,793.

100. SEC, *Crowdfunding*, *supra* note 82, at 71,389.

101. *Id.*

involving the offer or sale of securities for the account of others, solely pursuant to Securities Act Section 4(a)(6), that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the Commission, by rule, determines appropriate.<sup>102</sup>

Of note within the statutory definition above is the notion that the securities will be offered via a website or portal.<sup>103</sup> The idea of a funding portal being envisioned as primarily internet based is further supported by the SEC, which explains that, “[t]he provisions also permit Internet-based platforms to facilitate the offer and sale of securities in crowdfunding transactions without having to register with the Commission as brokers.”<sup>104</sup> As such, an internet-based platform for funding activities is a similar structure to the one employed by the aforementioned non-equity methods of crowdfunding, as the top ten non-equity crowdfunding companies all employ a central website from which the funding activity occurs.<sup>105</sup>

While each differs slightly in the types of offerings that may be made, all of them utilize the same general premise in that the fund seeker registers an account, provides information about the request for funds and then can use the resulting webpage to direct people to donate or give money.<sup>106</sup> Similarly, the aforementioned crowdfunding

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102. *Id.* at 71,428.

103. *Id.*

104. *Id.* at 71,389.

105. *Top 10 Crowdfunding Sites*, GOFUNDME (Nov. 11, 2015, 12:17 PM), <http://www.crowdfunding.com/>. The site lists Kickstarter, GoFundMe, Indiegogo, and TeeSpring as the current top four websites for rewards or prepurchase portals for crowdfunding, based on United States web traffic data supplied by two independent sources. The remainder of listed sites represents significantly less overall traffic volume. As TeeSpring is a relatively specialized site (for T-shirts only), the top three sites are utilized for the following examples.

106. *Getting Started*, KICKSTARTER (Nov. 14, 2015, 12:29 PM) [https://www.kickstarter.com/help/handbook/getting\\_started](https://www.kickstarter.com/help/handbook/getting_started); *How It Works*, GOFUNDME (Nov. 14, 2015, 12:29 PM) <https://www.gofundme.com/tour/>; *How It Works*, INDIEGOGO (Nov. 14, 2015, 12:30 PM) <https://www.indiegogo.com/learn-how-to-raise-money-for-a-campaign>.

platforms don't typically offer recommendations or advice on the individual offerings, or do they compensate their employees for advice or sales in that fashion.<sup>107</sup> They are essentially intermediaries that facilitate funding transactions by providing a central website and then implementing various rules and safeguards intended to protect both the facilitators and the users of the service. This would seem to correlate with what the SEC envisions for the proposed funding portals, at least as stated within the rules noted above. As the sale of equities to "non-accredited" investors are potentially involved, the SEC notes that "Congress included a number of provisions intended to protect investors who engage in these transactions, including investment limits, required disclosures by issuers, and a requirement to use regulated intermediaries."<sup>108</sup>

The SEC provides two main criteria for crowdfunding offerings. First, issuers are limited to a total fund raise of \$1 million per twelve-month period.<sup>109</sup> Secondly, individual investors are also limited to an absolute maximum of \$100,000 worth of contributions within any twelve-month period.<sup>110</sup> Investors are also constrained by income and net-worth calculations that serve to further limit their exposure to crowdfunding investments.<sup>111</sup> The general threshold is \$100,000 in income or net worth, with those participants who fall beneath the threshold limited to "the greater of \$2000 or 5% of the lesser of their annual income or net worth."<sup>112</sup> Of those participants with both an annual income in excess of \$100,000 and a net worth above that amount, they are limited to ten percent of the lesser of their annual income or net worth, and are potentially further constrained by the aforementioned absolute maximum per annum contribution.<sup>113</sup>

As to disclosures required by issuers, the rules are fairly benign in their overall nature. They require identifying information about the officers and directors, as well as stakeholders owning "20 percent or

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107. *About Us*, KICKSTARTER (Nov. 14, 2015, 12:56 PM), <https://www.kickstarter.com/about?ref=nav>; *About Us*, GOFUNDME (Nov. 14, 2015, 12:56 PM), <https://www.gofundme.com/about-us/>; *About Us*, INDIEGOGO (Nov. 14, 2015, 12:56 PM), <https://www.indiegogo.com/about/our-story>.

108. SEC, *Crowdfunding*, *supra* note 82, at 71,388–89.

109. *Id.* at 71,391.

110. *Id.*

111. *Id.* at 71,393–95.

112. *Id.* at 71,389.

113. *Id.*

more of the issuer.”<sup>114</sup> Furthermore, the rules require a general business description, what the proceeds will be used for, the price of the security and how that price was arrived at, how much the issuer is trying to raise and the deadline for such, as well as whether or not the issuer will accept more than the requested amount.<sup>115</sup> Lastly, the issuer must include a “discussion of the issuer’s financial condition” as well as the release of financial statements with varying levels of independent verification.<sup>116</sup> The degree of verification necessary depends on the relative amounts offered as well as the amount of time the entity has been engaged in business.<sup>117</sup>

This brings us to the last set of major provisions outlined by Congress under the CROWDFUND Act, the requirement that equity crowdfunding transactions utilize a registered intermediary. The SEC notes that the aforementioned requirement is “[o]ne of the key investor protections of Title III” and that offerings under the regulations “must be conducted exclusively through a platform operated by a registered broker or a funding portal, which is a new type of SEC registrant.”<sup>118</sup> While touted as a “key investor protection,” the rules themselves are, in actuality, quite tepid. The SEC states that the rules require intermediaries to “[p]rovide investors with educational materials[,] [t]ake measures to reduce the risk of fraud[,] [m]ake available information about the issuer and the offering[,] [p]rovide communication channels to permit discussions about offering on the platform[,] and [f]acilitate the offer and sale of crowdfunded securities.”<sup>119</sup>

Funding portals are also prohibited from offering investment advice, soliciting or selling securities, or providing compensation for sales or solicitation of securities. Lastly, funding portals may not be “[h]olding, possessing, or handling investor funds or securities.”<sup>120</sup> Beyond those broad provisions outlined above, the SEC does offer further details and refinement of those concepts. One can hopefully see that the rules and regulations regarding the sales of securities have been extensively refined, reviewed, and updated since the first Kansas blue sky law came into existence at the beginning of the last century.

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114. *Id.* at 71,399.

115. *Id.*

116. *Id.* at 71,407.

117. *Id.*

118. *Id.* at 71,390.

119. *Id.*

120. *Id.*

But, as is readily evident, incremental changes to rules implemented over long time frames and through widely varying economic and social conditions, can often inadvertently create results that fly contrary to the intentions of the original drafters.

#### V. REGULATORY ANALYSIS

Under section 3(b) of the Securities Act, the SEC was granted the authority to “add any class of securities” to the list of exemptions, if the protection afforded under the Act is not necessary “by reason of the small amount involved or the limited character of the public offering,” with an upper limit on those offerings fixed at \$100,000.<sup>121</sup> Of course, if one were to simply apply that \$100,000 limit to the current state of economic affairs within the United States, the result would be terribly misleading. As such, it is necessary to determine what that value might reflect today. Such a calculation is not necessarily simple, nor straightforward.<sup>122</sup>

In measuring relative values in U.S. dollars, using the year 1933 and the \$100,000 noted above as a starting point, the results returned show a range of approximately \$1.5 million to \$30 million, depending on the computation utilized.<sup>123</sup> Attempting to narrow the range by using only the listed comparators for commodities, income or wealth, or if a projects fails to produce meaningfully different results.<sup>124</sup> However, stepping back a bit, if one were to accept the range of \$1.5

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121. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b)(1) (2015).

122. Fortunately, there are websites that calculate values through various time periods dating back to 1774. *See, e.g.*, Measuring Worth, MEASURINGWORTH.COM, <https://measuringworth.com/> (last visited March 3, 2016).

123. Samuel H. Williamson, *Seven Ways to Compute the Relative Value of a U.S. Dollar Amount—1774 to Present*, MEASURINGWORTH.COM (2015) [hereinafter Williamson, *Relative Values*] (Nov. 14, 2015, 6:29 PM) <http://www.measuringworth.com/uscompare/index.php> (last visited March 3, 2016). Mr. Williamson notes “Determining the *relative* value of an amount of money in one year compared to another is more complicated than it seems at first. There is no single “correct” measure, and economic historians use one or more different indicators depending on the context of the question.” He goes on to state that “[t]he context of the question, however, may lead to a preferable measure other than *real price* as measured by the Consumer Price Index (CPI), which is used far too often without thought to its consequences.” Further on, he says “The best measure of the relative value over time depends on the type of thing you wish to compare.” He then breaks values down into three broad categories: *Commodities*, *Income or Wealth*, and *Projects*, with each having distinct standards of measurement. The narrowest swing is generated by the *Commodity* comparators and results in a \$1.8 million to \$11 million range, while the other two result in swings from \$1.8 and \$1.5 million respectively, to \$30 million at the top end.

124. *Id.*

million to \$30 million as a trustworthy measurement overall that range correlates surprisingly well to the actual fund raising practice under Regulation D exemptions. From 2009 to 2012, the average mean of securities offered under Regulation D was nearly \$30 million, while the average median was \$1.5 million.<sup>125</sup> In recognizing the significantly lower median number, the DERA Study states that this is “indicating a large number of small offerings, consistent with the original regulatory objective to target the capital formation needs of small business.”<sup>126</sup> It would seem that the current regulatory scheme and the limits employed in exempt offerings are a fair and modern representation of the \$100,000 limit originally envisioned by Congress in 1933.

#### *A. Issuer and Investor Limits*

Turning now to the major provisions of the CROWDFUND Act, the first set of provisions in the Act deals with the limits imposed upon both the fund-raising entity, as well as any potential investor. To recap, issuers are limited to a total fund raise of \$1 million in any twelve-month period.<sup>127</sup> This amount correlates well with the current practice under Rule 506, in that, as the SEC states, half of non-fund Rule 506 offerings “were for \$1 million or less.”<sup>128</sup> With the aforementioned median of Rule 506 offerings coming in at \$1.5 million, this seems to indicate that the \$1 million limit contemplated by Title III will be well suited to a large number of potential issuers.<sup>129</sup> Title III also expands the potential pool of investors by allowing so called “unaccredited” investors to participate.

While Congress and the SEC have both noted several times over the last eighty years that helping small businesses raise capital under section 3(b) exemptions is important, one must not forget that the primary purpose of the whole scheme is to protect the investors above all else. Obviously, it could be endlessly debated that the entire concept of “accredited” or “unaccredited” investors based on income levels or net worth calculations is an arbitrary exercise. Yet, it is hard to refute the notion that a person making \$200,000 a year at least has a higher likelihood of being able to mitigate the effects of a poor

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125. IVANOV & BAUGUESS, *supra* note 85, at 4.

126. *Id.* at 5.

127. SEC, *Crowdfunding*, *supra* note 82, at 71,389.

128. IVANOV & BAUGUESS, *supra* note 85, at 7.

129. *Id.* at 4.

investment choice than someone making only \$40,000 a year. Leaving that argument aside for the moment, the SEC has chosen to codify the idea of an accredited investor, so if nothing else, that is the benchmark available. As such, it is a curious thing that Congress chose to introduce a third class of investor in the CROWDFUND Act.

Crowdfunding investors are separated into two groups; those making or owning less than \$100,000 and those above that amount in assets and income.<sup>130</sup> Yet, the distinction begs the question why? If an “accredited” investor is one that has sufficient financial sophistication, net worth, knowledge, and experience in financial matters that they require no protection under an exemption at all, why not simply leave the line there for participants in crowdfunding? To reiterate, the rules allow for a maximum of either \$2000 or 5% of annual income for those investors under the \$100,000 threshold, whereas investors above that amount are limited to 10% of the lesser of their income or net worth.<sup>131</sup>

The replies to comments in the SEC’s *Crowdfunding* paper fail to shed much light on the question, as for the most part, the comments related to the limits as proposed, rather than questioning their addition entirely. Where accredited investors were mentioned, the comments were often requesting that those participants not be subject to any limits at all.<sup>132</sup> As the SEC is largely silent on the issue, the simplest explanation would seem to be that, lowering the bar to \$100,000 allows for a significant increase in the amount of investors that can contribute at the higher 10% rate. As noted above, accredited investors comprise only around 7.4% of U.S. households, which is roughly 8.5 million investors that would qualify for that designation.<sup>133</sup> However, households making more than \$100,000 account for nearly 23% of U.S. households,<sup>134</sup> which represents an additional 18 million potential participants.<sup>135</sup> With that in mind, the addition of this new income measurement nearly triples the number of

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130. SEC, *Crowdfunding*, *supra* note 82, at 71,390.

131. *Id.*

132. *Id.* at 71,438–41.

133. SEC, *Rule 506 Amendment*, *supra* note 81, at 44,793.

134. *2014 Household Income: All Races*, UNITED STATES CENSUS, [http://www.census.gov/hhes/www/cpstables/032015/hhinc/hinc01\\_000.htm](http://www.census.gov/hhes/www/cpstables/032015/hhinc/hinc01_000.htm) (last accessed March 3, 2016).

135. U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORTS: PROJECTIONS OF THE NUMBER OF HOUSEHOLDS AND FAMILIES IN THE UNITED STATES: 1995 TO 2010, at 3 (1996). The numbers above were calculated based on the estimates in this report and are intended only as a rough approximation for illustrative purposes.

households in the available investor pool, yet it does so with very little justification for the seemingly arbitrary selection of a \$100,000 threshold. One might note that, the 10% amount quoted above is 10% of the lesser of income or net worth. As such, if an investor makes \$100,000 a year, but only has a net worth of \$5000, they would be relegated to the “greater of \$2000 or 5% of the lesser of their annual income or net worth”<sup>136</sup> threshold, which would obviously serve to limit exposure to these types of investments.

One might discern that there are a couple of problems with the whole notion, the first of which being the definition of income. The SEC actually struggled a bit in determining how to measure income when they first attempted to codify the concept of an accredited investor. Oddly enough, the proposed threshold for an accredited investor back in 1982 was originally \$100,000, but was then raised to \$200,000 after some deliberation.<sup>137</sup> Before we cross that bridge however, we must first determine how to calculate income.

A 1982 supplemental memo from the SEC notes that “[c]ommentators recommended use of the term ‘income’ since the proposed standard utilizing ‘adjusted gross income’ does not include certain deductions or exempt income and would thereby exclude from accredited investor status many sophisticated investors who can reduce their gross income below \$100,000 through legitimate tax planning.”<sup>138</sup> It appears that the commentators held some sway, though perhaps not as they intended or hoped. Noting that using a flexible approach to measuring income that “will permit inclusion of additional items of income from that proposed, and the impact of inflation on such a test, that the \$100,000 income figure may be too low to reflect a level of sophistication and an ability to fend [sic] appropriate to accredited investors.”<sup>139</sup> As such, it was here that the level was raised to \$200,000, with the caveat that “[t]hese decisions are not subject to empirical certainty and must necessarily represent ‘judgment calls’ by the Commission.”<sup>140</sup> Thus, with the new threshold of \$200,000 imposed, the SEC again wanted to base this level on

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136. SEC, *Crowdfunding*, *supra* note 82, at 71,389.

137. See Supplemental Memorandum from the Division of Corporation Finance to the Securities and Exchange Commission (Mar. 1, 1982) [hereinafter SEC Reg. D Supplemental], [http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1980/1982\\_0301\\_SECD CF.pdf](http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1980/1982_0301_SECD CF.pdf).

138. *Id.* at 1.

139. *Id.*

140. *Id.*

adjusted gross income as reported to the IRS.

However, the SEC states that “[c]ommentators objected to that formulation for three reasons,”<sup>141</sup> with those reasons being the potential exclusion of foreign investors, issues in determining income for joint filers, or those who live in community property states, as well as the aforementioned ability to lower income through legitimate tax planning.<sup>142</sup> As might be expected in rulemaking, definitional problems can manifest quite quickly. The SEC states that “[t]he rule as adopted does not define the term ‘income,’” and goes on to say that “the Commission has determined to utilize a flexible approach, thereby avoiding the issues raised by the inclusion in the rule of federal tax law concepts.”<sup>143</sup> But just two lines later and apparently concerned that this could be misconstrued, the SEC concedes that “[t]he determination of what is and is not ‘income’ is important in establishing the type of investor intended to be included in this category of accredited investor.”<sup>144</sup> Yet, rather than offering concrete guidance, the writers simply go on to note two examples of why it might be difficult to determine income and then rather unhelpfully offer a “possible method of computing income,” which derives its entire model from data supplied to the Internal Revenue Service (IRS).<sup>145</sup> Data supplied to the IRS, must of a necessity, be inclusive of the federal tax-law concepts that the flexible income approach sought to avoid in the first place.

This is all further compounded by the second problem present, which is the fact that the current value of money has not been taken into consideration here. But \$100,000 in 1982 would roughly correlate to \$250,000 today, with \$200,000 predictably coming in at nearly \$500,000.<sup>146</sup> Thus, even removing the difficulties in determining income from the equation, we are still left with threshold limits that do not in any way correlate to what was envisioned when they were first proposed. Additionally, the Incentive Act of 1980 states that accredited investors are people who have sufficient financial sophistication, net worth, knowledge, and experience in financial matters, but these criteria were tied to an income calculation

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141. *Id.* at 1–3.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 3.

146. *See* Williamson, *supra* note 123.

that would be the equivalent of \$500,000 today. Under the rules in the CROWDFUND Act, a person with both an income and assets above \$100,000 can potentially invest up to 10% of their money.

Yet, if one were to follow the logic that put forth an accredited status to begin with, he or she would have to conclude that, if the terms of the CROWDFUND Act were being proposed in 1982, the dividing line noted above would have been set at a rate that would correspond to \$250,000 today. As such, at that level, even someone who qualifies as an accredited investor today would have still been potentially barred from investing at the higher 10% rate. To put this further in perspective, \$100,000 today would roughly equate to \$40,000 in 1982.<sup>147</sup> If \$100,000 in 1982 “may be too low to reflect a level of sophistication and an ability to fend,”<sup>148</sup> what does that impute to a person who makes less than half that amount? This is especially troubling, because the SEC states that “[a] number of commenters expressed concerns about investors potentially incurring unaffordable losses under the proposed rule, and we find these comments persuasive given the risks involved.”<sup>149</sup>

First, stating that keeping investors under the \$100,000 threshold to the greater of \$2000 or 5% limit “will potentially limit investment losses in crowdfunding offerings for investors who may be less able to bear the risk of loss,” the SEC goes on to say that “[t]he startups and small businesses that we expect will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies.” Yet, it provides no evidence to show that someone above that \$100,000 threshold will be more able to bear the risk of loss. The only benchmark they do provide is that of an accredited investor, but as was demonstrated above, even this designation does not reflect the intentions of the Act that created it. This leaves a large swath of investors above the arbitrary \$100,000 threshold who lack the alleged sophistication of an accredited investor, yet are still exposed to potentially “unaffordable losses” in investments that “are likely to experience a higher failure rate than more seasoned companies.”<sup>150</sup>

At the end of the day, the protections contemplated under the CROWDFUND Act are largely limited to the specific limits detailed

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147. *Id.*

148. SEC Reg. D Supplemental, *supra* note 127, at 1.

149. SEC, *Crowdfunding*, *supra* note 82, at 71,394.

150. *Id.*

above, and yet even this is largely illusory. How many people will realistically invest more than five or ten percent of their total net worth in a speculative business venture that they're not actively controlling?

While the SEC and Congress seem to have kept the dollar amount of offerings in step with the original intention of assisting capital formation under an exemption, they have failed to do the same for investors. If it is appropriate to increase the limits on the amount issuers are allowed to raise under an exemption, there is no rational basis to not do the same for accreditation standards. If accreditation is the standard to be employed, there is no rational basis to arbitrarily draw further distinctions below that standard without evidence to support it. Therefore, it would seem, if Congress and the SEC were to hold true to the mandate of protecting investors under an exemption, accreditation by income should rightly be adjusted for inflation and set at \$500,000 per year. Further, the higher ten percent limit in crowdfunding transactions should have also been limited to those with an accredited status at the aforementioned level, unless of course, there were some objective proof that a lower threshold might be warranted.

*B. Required Disclosures and Limitations on Advertising by Issuer*

Beyond a simple expediency, it will be demonstrated that the limits on advertising are tied to the notion that investors will receive all of the required disclosures once they arrive at the funding portal. At any rate, issuers seeking an exemption under the CROWDFUND Act have a duty to supply specific disclosures to the SEC, and the relevant broker or portal and must make those disclosures available to potential investors. These disclosures are not overly intrusive and are mostly of an identifying nature. These include such things as the name, legal status, address and website of the issuer, as well as the names of the major players and large stakeholders. As to the financial disclosures, the SEC requires:

A description of the business of the issuer and the anticipated business plan of the issuer; a description of the financial condition of the issuer; a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount; the target offering amount, the deadline to reach the

target offering amount and regular updates about the progress of the issuer in meeting the target offering amount; the price to the public of the securities or the method for determining the price; and a description of the ownership and capital structure of the issuer.<sup>151</sup>

The identifying information is not of much consequence as that information is fairly ubiquitous with almost any financial activity. Beyond being a broad-stroke measure against outright fraud, those disclosures are essentially a formality. In the realm of investor protections, the financial disclosures would seem to hold the most weight. Of the business plan requirements, the SEC is fairly relaxed in this as it notes that “[w]e anticipate that issuers engaging in crowdfunding transactions may have businesses at various stages of development in different industries, and therefore, we believe that the rules should provide flexibility for these issuers regarding what information they disclose about their business.”<sup>152</sup> This flexible approach seems a reasonable fashioning of the rule and doesn’t outwardly appear to either positively or negatively impact investor protections. This disclosure requirement is further buttressed with the requirement to disclose the intended use of proceeds, which requires issuers to “provide a reasonably detailed description of the purpose of the offering, such that investors are provided with enough information to understand how the offering proceeds will be used.”<sup>153</sup> The SEC further notes that the purpose of this disclosure is to “provide investors with sufficiently information to evaluate the investment” and then they list several different examples.<sup>154</sup> This again seems a logical provision and doesn’t engender a lot of apprehension regarding the impact on investors.

Lastly, the Commission considered both some additional disclosure requirements and disclosures of the financial condition of the issuer. Of the additional disclosures, those most germane to the present discussion are the requirement to discuss “material factors that make an investment in the issuer speculative or risky,” the disclosure of the issuer’s current state of indebtedness, any other exempt offerings they have conducted in the three years previous, and

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151. *Id.* at 71,398.

152. *Id.* at 71,401.

153. *Id.*

154. *Id.*

disclosure of “related-party transactions” in the previous fiscal year that were in excess of five percent of the total offer.<sup>155</sup> The disclosure-of-material-risks requirement could be called the heart of investor protections envisioned by the Securities Act and as such, seems a proper requirement for this type of offering. The disclosure of indebtedness also seems a valid requirement to enable an investor to make an informed decision, as would knowing how often an entity is trying to raise funds or what other third parties might be benefiting from the offering. The requirement for a “discussion of the financial condition” of the issuer is also fairly benign, as the rule states that a crowdfunding issuer must “provide a narrative discussion of its financial condition.”<sup>156</sup>

The SEC again notes that, due to the wide range of entities potentially involved and the concomitant variety in sophistication, the rule as fashioned is fairly flexible and makes wide allowances for many different issuers. Regarding financial disclosures, owing to the nature of the entities that the SEC envisions participating in crowdfunded transactions, the SEC separated the requirements into three tiers based on offering size. The tiers are set at thresholds of \$100,000 or less, \$100,000 to \$500,000 and those that are in excess of \$500,000, with correspondingly increasing levels of independent verification.<sup>157</sup> At the bottom rung, an issuer must provide to both the Commission and the intermediary a self-certified disclosure of total income, taxable income, and total tax in the issuer’s most recent tax return, as well as “financial statements that are certified by the principal executive officer to be true and complete in all material respects.”<sup>158</sup> Next up, those financial statements must be first reviewed by an independent accountant, with the highest tier necessitating an independent audit by an accountant, unless it is their first time raising capital under the CROWDFUND Act. Should that be the case, the reviewed financial statements will then suffice.<sup>159</sup> As with most disclosure rules, these too are well constructed and seem to strike an appropriate balance between the unique needs of a potentially wide base of issuers, as well as providing some important information that will allow investors to make an informed decision

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155. *Id.* at 71,403.

156. *Id.* at 71,407.

157. *Id.* at 71,412–14.

158. *Id.* 71,420.

159. *Id.*

regarding these exempt offerings. Having said that, the broad nature of these rules also diminishes their utility somewhat, especially when discussing investors that are unsophisticated in financial matters, and perhaps even some that are extraordinarily sophisticated.

To this end, let us turn to a hypothetical independent film venture. This is a fair target in that, on both of the two largest, non-equity crowdfunding sites,<sup>160</sup> film projects account for roughly twenty to twenty five percent and thirty percent of the total projects launched on those platforms.<sup>161</sup> Let us suppose that our hypothetical filmmaker is a twenty-seven-year-old film school graduate. She decides to independently produce and finance a feature length film using equity crowdfunding as her sole source of financing and contemplates a \$1,000,000 fund raise. She currently has no business entity, but plans on forming a limited liability company to make the film and discloses such in accordance with the rules.

She has a three-year work history as a “for-hire” television director and last year made \$90,000. She has her accountant review the materials and then submits that to the SEC and her funding portal. She states in her business plan that she is going to use the money to buy the rights to a script from a former classmate, as well as hiring two well-known television actors that she has worked with before to be the leads. The remainder will be devoted to hiring the rest of the cast and crew, paying to shoot the film, and finish it in post-production. When she is done, she plans to submit the film to film festivals, where she hopes that it will find distribution. From that potential sale she has calculated the cost of the shares and is otherwise in good financial condition with no debt or other obligations.

She also makes sure to disclose prominently on the funding portal that films are risky business and this film is no different, stating “If you invest in my film, you could very easily lose all of your money and that is the most likely outcome.” Then she goes on to say that she has experience directing television shows, she’s got a “great”

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160. See *Top 10 Crowdfunding Sites*, GOFUNDME (Nov. 11, 2015, 12:17 PM), <http://www.crowdfunding.com/>.

161. Jonathan Lau, *Dollar for Dollar Raised, Kickstarter Dominates Indiegogo SIX Times Over*, MEDIUM.COM (Nov. 21, 2015, 7:04 PM), <https://medium.com/@jonchiehlau/dollar-for-dollar-raised-kickstarter-dominates-indiegogo-six-times-over-2a48bc6ffd57#.fsr0gla9j>. The Kickstarter film project number shows a range because the current data, is closer to 19%. *Stats*, KICKSTARTER.COM, <https://www.kickstarter.com/help/stats?ref=footer> (last visited Jan. 15, 2016). The Lau data above is about two years old as of this writing. Indiegogo does not publish statistics, which is why the estimation provided by Lau was used.

crew that she has worked with before and that has a lot of experience, as well as disclosing the two well-known television actors signed up to play the leads. With that, she launches her fundraising campaign, it is quickly successful, and she makes the movie. However, when she submits the movie to film festivals, no one accepts it. She then tries to find a distributor on her own but is unsuccessful. As a last resort, she puts the film on Amazon.com and Vimeo as a rental and recoups about \$1,500. In other words, the film is a complete flop and all the investors lose everything they put in.

Our hypothetical filmmaker has complied with every rule, her statements seem reasonable enough, and it would be hard to argue that this was anything but an above-board fund raise that simply didn't work out. That is, of course, barring the fact that the endeavor had almost no chance of succeeding before it even began. A recent article is illustrative in that the first words on the page are “[m]ost films lose money.”<sup>162</sup> Author Schuyler M. Moore goes on to state that “[t]he poor investment performance of films has been a fact of life for a very long time” and that “while approximately 600 to 700 films are produced each year, only about 200 movies obtain the type of release that could lead to any return at all, much less a profit.”<sup>163</sup> The 600 to 700 films Mr. Moore is referencing are aligned in some regard to the movie studio system, as the number of films produced like the one in our hypothetical number in the thousands per year. For instance, at just one major film festival in Utah, they receive around 4,000 feature film submissions per year.<sup>164</sup> This is not even mentioning that in the U.S. alone, there are some 1,500 film festivals.<sup>165</sup> As such, it is no surprise when Mr. Moore describes investing in films as the equivalent of “gambling akin to wildcat oil drilling.”<sup>166</sup> He then goes on to note that “the film business continues to attract gamblers. Only those with a high tolerance for risk invest equity in a single film, or even in a small slate of films, particularly when the film company

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162. Schuyler M. Moore, *Financing Drama: The Challenges of Film Financing Can Produce as Much Drama as Takes Place on Screen*, L.A. LAW., May 2008, at 26, 32.

163. *Id.*

164. See *Festival History*, SUNDANCE FILM FESTIVAL, <http://www2.sundance.org/festivalhistory/> (last visited Nov. 21, 2015). The history of the festival shows that 4,057 feature length films were submitted during that year. The year before saw 4,044, and 2012 had 4,042.

165. See List of film festivals, FILMFREEWAY, <https://filmfreeway.com/festivals> (click “Browse Festivals” hyperlink; then filter the results by including “Film Festivals With Live Screenings” and excluding “Outside the USA Only.”)

166. Moore, *supra* note 162.

does not control distribution.”<sup>167</sup>

The point of the hypothetical is not demonstrate that investments can go wrong, but rather to illustrate that even an offering that sounds plausible and is carried out in an ethical fashion by an issuer with good intentions can easily be for an investment that has no possibility of making a return. According to the SEC, at its essence, crowdfunding allows people to share information “to decide whether to fund the campaign based on the collective ‘wisdom of crowd.’”<sup>168</sup> Yet, one need not look too far in history to see the results of the wisdom of the crowd when equities are at stake. The recent collapse of the housing market and the associated real-estate bubble springs to mind, especially when talking about the relative wisdom of retail investors. On the commercial side, that same “bubble” fed an almost maniacal pursuit of profits in essentially fictitious mortgage backed securities that nearly destroyed the entire world economy.<sup>169</sup>

The trouble within lies not just with the disclosures themselves but also with the information an investor may be influenced by before seeing those disclosures. This brings us to the limitations on advertising as envisioned by the SEC, which state that an issuer shall “not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker.”<sup>170</sup> Those notices are to be limited in their scope, allowing only a notice of the offering that names the funding portal and directs investors there, the terms of the offering, as well as identifying information about the issuer, including a brief description. As to the terms of the offer, they are limited to the barest of information and can only include the amount of securities, their nature and price, and the closing date of the offering.<sup>171</sup> The SEC notes that there are no limitations on how the notices may be published and state that “[w]e believe the final rules will allow issuers to leverage social media to attract investors, while at the same time protecting investors by limiting the ability of issuers to advertise the terms of the offering without directing them to the required disclosure.”<sup>172</sup>

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167. *Id.* at 27.

168. Crowdfunding, Release Nos. 33-9974, 34-76324, 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274 (2015) [hereinafter SEC, Crowdfunding Final Rule].

169. *See generally* FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT (2011).

170. SEC Crowdfunding Final Rule, *supra* note 168 at 6.

171. *Id.*

172. *Id.* at 140.

Once at the funding portal, issuers are allowed to expand on the terms, provided that all such communications go through “communication channels provided by the intermediary on the intermediary’s platform.”<sup>173</sup> The SEC again reiterates here that “one of the central tenets of the concept of crowdfunding is that the members of the crowd decide whether or not to fund an idea or business after sharing information with each other.” The SEC also makes provisions for paid promoters to operate within the intermediary’s communication channel, so long as they identify themselves and what they are doing every time they do promotions. While this scheme might appear logical on its face, it underestimates the nature of modern communications, especially in the social media sphere.<sup>174</sup>

The SEC states that “the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer,”<sup>175</sup> which would be barred under the rules. With that in mind, let us return to our previous hypothetical independent film for a moment. Suppose one of the lead actors has a friend that is a famous movie star, and that star has 400,000 people “following” her on a large social media site such as Twitter.<sup>176</sup> In conversation, the lead tells the star about the movie and the proposed crowdfunding. The star then, on her own accord, sends a link to the funding portal and the following message to her fans: “Check out this new movie my friend is in, you can be part of it and I think that you’ll make a fortune if you invest! Go now!” Then that message gets republished by her followers to their own networks, resulting in that same promotion being published 1 million times across a few hundred social media sites in less than a day.

Is this a violation? Would the issuer be liable, even though they had nothing to do with the promotion? How could they prove that they weren’t involved in the scheme other than by vigorous protest? Is the wisdom of the crowd still intact when a celebrity marshals her fans? And, this is just one example. What is to prevent a promoter from using “anonymizing” software such as Tor and then conducting

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173. *Id.* at 141.

174. *Id.*

175. *Id.* at 142.

176. *Twitter Usage/Company Facts*, TWITTER, <https://about.twitter.com/company> (last visited Nov. 20, 2015) (listing 320 million monthly active users).

promotions in violation of the rules?<sup>177</sup> Or paying a promoter to secretly do the exact same thing? How many resources does the SEC realistically have to address this if it becomes widespread? If the National Security Agency has difficulty in tracking terrorists utilizing Tor,<sup>178</sup> what possible recourse could the SEC utilize that would be more effective in identifying these “bad actors”?

Perhaps the SEC could impose strict liability for advertising conduct, but then what about malicious attackers seeking to discredit the funding? Or businesses in competition with the proposed venture violating the terms on purpose? Or, even absent strict liability, what is to prevent that conduct from happening anyway? What prevents malicious actors from deliberately promoting the fundraising to put the issuer in violation? All of this conduct is seriously curtailed under Rule 506 offerings in that those offerings are generally limited to investors holding “accredited” status. So, even if an issuer were to abuse the limitations on advertising, unsophisticated investors would still be barred. Under Rule 504 or 505, the aforementioned advertising conduct would be barred, as neither of those schemes makes allowances for any type of general solicitation.

But, as noted above, this is not true in the crowdfunding sphere as contemplated. Therefore, there seems to be some fairly serious concerns regarding the use of social media in advertising crowdfunding transactions that have apparently not even been recognized by Congress or the SEC, let alone provisioned for. The fact that this process is so wide open to potential abuse and once abused, the only barrier to the unsophisticated investor are disclosures is troubling. This is especially so, as the SEC is already aware that “[i]t is clear that many investors do not read disclosure documents for companies and funds in which they invest, and those that do spend relatively little time reviewing these documents, considering the breadth of information they contain.”<sup>179</sup> Bear in mind that the previous statement applies only to the twenty to twenty-six percent of U.S. households that own stock or mutual funds outside of employer retirement plans.<sup>180</sup> With that in mind, is it really plausible that an unsophisticated investor will spend more time reading disclosures

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177. *See generally* TOR HOME, <https://www.torproject.org> (last visited Nov. 22, 2015).

178. NATIONAL SECURITY AGENCY, *Making Things Measurable—Technology Trending Challenges and Approaches* (2012), <http://www.spiegel.de/media/media-25525.pdf>

179. ABT SRBI, MANDATORY DISCLOSURE DOCUMENTS TELEPHONE SURVEY, iv (2012) (survey conducted by Abt SRBI and submitted to SEC).

180. *Id.* at 12.

than people who already own stocks or mutual funds? The whole system seems to be a recipe for egregious abuses that may be scattered far and wide, and would likely strain what resources the SEC may have available to police this new scheme.

*C. Registered Intermediaries*

This brings us to the last major set of provisions in the CROWDFUND Act, the use of registered intermediaries, or funding portals. Funding portals are defined as

any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others. . . . [T]hat does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the Commission, by rule, determines appropriate.<sup>181</sup>

The vast majority of the rules regarding registered intermediaries revolve around the structure of the entity and the vetting process of issuers. The gist of the regulations are to ensure transparency and clear distinctions between issuers and the intermediary as well as the stated desire to implement procedures to reduce the risk of fraud, mostly by doing background and regulatory compliance checks on issuers. As to the effects on investors, background and regulatory checks will obviously weed out known bad actors or criminals, yet being nefarious in nature, these actors are often quite creative in avoiding regulatory compliance.

The simplest, readily observable method of avoiding a background or compliance check is to simply have a third party register the offering. The final rule as adopted allows for an intermediary to have a reasonable basis for determining an issuer is in compliance, and those intermediaries may “reasonably rely on representations of the issuer, unless the intermediary has reason to

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181. SEC, Crowdfunding Final Rule, *supra* note 168 at 155.

question the reliability of those representations.”<sup>182</sup> While at first blush, this might seem a sort of open-door invitation to bad actors, coupled with the issuer identification requirements noted above, there is at the very least a strong deterrent. It is one thing to potentially convince a third party to register, but quite another to get them to produce identification linking them to the entity, especially if a fraud is contemplated. The larger issue is with the anonymity of the internet in general. As noted above, software such as Tor can offer a high degree of anonymity to a user, and there is a well-known issue with identity theft and the resultant frauds that occur.

Ostensibly, a criminal or other bad actor could make use of this technology in an attempt to gain access to crowdfunded money. Yet, that also would necessarily imply that they would be able to draw sufficient attention and interest to their endeavor. However, that isn’t necessarily an absolute barrier, as anyone familiar with Bernie Madoff could attest.<sup>183</sup> With all this in mind, criminal fraud is obviously a problem not just in the realm of securities, but throughout society in general. As such, the nature of trying to prevent that sort of crime is beyond the scope of this paper. To frame the distinction within the scope of this paper, it might be suitably drawn as the difference between being mugged and being hustled, the latter of which being the primary focus here.

There are a couple of attributes that directly correlate to the use of an intermediary and investor protection. The first attribute is the requirement that the intermediary prevents an investor from exceeding his or her annual investment limits. The second is that the intermediary insures that each investor acknowledges the risks involved. Of the former, the SEC again utilizes a “reasonable basis” test and says that “[t]he proposed rule would allow an intermediary to rely on an investor’s representations concerning annual income, net worth, and the amount of the investor’s other investments in securities sold in reliance on Section 4(a)(6) through other intermediaries unless the intermediary has a reasonable basis to question the reliability of the representation.”<sup>184</sup> They also noted that a central database of investors to help facilitate this endeavor was essentially a good idea, though they declined to require such a database be created “in part to

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182. *Id.* at 171.

183. See Plaintiff’s Complaint, Sec. & Exch. Comm’n v. Madoff, 08 CIV 10791 (2008) (S.D.N.Y. Dec. 11, 2008).

184. Security and Exchange Commission, *supra* note 49 at 208.

help minimize the obstacles that intermediaries may face in getting this newly formed marketplace up and running.”<sup>185</sup> While noting that an intermediary that allowed an investor to invest in multiple offerings on a site they control, where that investor subsequently exceeded the annual investment limits, would be subject to regulatory action, there is no other mechanism to prevent such activity other than self-certification.

As such there is no meaningful barrier to prevent an investor from investing far above the aforementioned statutory limits on multiple platforms. The failure to require a central database that would prevent unsophisticated investors from exceeding the statutory limits is not only irresponsibly lazy, it is simply inexcusable. As noted above, those limits, illusory as they may be, are the only real protection afforded by the Act. Considering the amount of time, and resources already devoted to writing the Act, as well as creating the rule structures and all the other associated bureaucracy involved in this endeavor, the creation of a database hardly seems a noteworthy obstacle, especially when we are dealing with the protection of the most vulnerable class of investors.

Regarding acknowledgment of risk, in essence, the rules require that the intermediary be able to positively affirm that the investor “reviewed the intermediary’s educational materials,” that they understand that they could lose their entire investment and that they are capable of withstanding that loss. Lastly, the rules require investors to complete “a questionnaire demonstrating an understanding of the risks of any potential investment and other required statutory elements.”<sup>186</sup> Of the published rules discussed thus far, this one seems to be the first to place the protection of investors ahead of the needs of capital seekers. While leaving the business of choosing the content and the format of presentation to the intermediary, the SEC notes that “[t]here are many ways, especially on a web-based system, to convey information to, and obtain effective acknowledgment from, investors. As explained in the Proposing Release, the requirements of the rule would not be satisfied if, for example, an intermediary were to pre-select answers for an investor.”<sup>187</sup> Noting that an intermediary is free to expand on the information, the SEC adds a further requirement that investors affirm

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185. *Id.* at 214.

186. *Id.* at 217.

187. *Id.* at 218.

receipt of this information before every transaction they make.<sup>188</sup> And while disclosures may rarely be read, here the SEC finally utilizes the capabilities of a web-based platform to provide a modicum of protection to the lay investor.

## VI. CONCLUSION

At first blush, the notion of allowing equity crowdfunding seems to be a logical progression in utilizing technology to facilitate the raising of small business capital. Yet, upon closer analysis, there are clearly extensive issues that Congress and the SEC have not only failed to address, they seemingly failed to recognize them at all. While couched in the language of protection, the bulk of these regulations are simply window dressing on what is otherwise a naked expansion of exempt fund-raising, without any meaningful additional investor protections. In fact, quite the opposite is true and the CROWDFUND Act makes enormous room for lay people, unsophisticated in the ways of finance, to participate in some of the riskiest equity ventures imaginable.

Hollow statements proposing that these lay investors are protected by limiting the amount that they may invest, but then failing to require a database that would have easily prevented abuse of that limitation because it presents a minor obstacle is simply unconscionable. This is especially true if one has a clear mandate to protect investors above all else and has ample resources to accomplish routine administrative tasks, such as creating a database. It is clear from the record that the last thirty or forty years have seen an increasing push to give small businesses more access to capital. And while not perfect, there was at least an attempt to limit exposure to those most able to handle the risk of loss by creating an accreditation standard. That Congress and the SEC both allowed this new legislation to come into existence while still tying the concepts of accreditation to income and net-worth standards that have no meaningful relationship to current economic conditions is simply inexcusable.

The most insidious part of the whole notion of equity crowdfunding is not so much that it is open to abuse, but more that it appears likely to act as a way of decentralizing losses in questionable ventures with no recourse for the “suckers” who fall for the play. If a

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188. *Id.*

lay investor decides to buy a speculative security, such as in a film venture and pays \$500 for the equity stake, but then the film takes two years to complete and never recoups, is that investor realistically going to file a complaint? And, what happens if there are 250,000 “little guys” all lined up with similar complaints? Does the SEC even have sufficient resources to pursue issues of that magnitude? And, in the case of something like the hypothetical film venture noted above, would there even be a violation at all?

This legislation serves the needs of business speculators quite well, but it does so on the backs of those who can least afford it. This flies in the face of the history and origins of the various securities laws that date back to 1911 and represents a clear reversal of policy that is couched in language artfully drafted to falsely give the impression of rational modernization. There is ample space here to provide for the capital needs of small business and modernization efforts should be applauded. Yet, as demonstrated in the research above, there are some very rudimentary steps that would result in much clearer legislation and stronger investor protections. A strong first step would be to require the creation and use of a central database to ensure that investors are not exceeding statutory limits. Second, accreditation standards must be modernized as well and should reflect the current value of money, rather than relying on a formula from 1980. Third, if there is to be a dividing line based on income, it should either solely be applied to the accreditation standard or have a rational basis for introducing a lower threshold, rather than arbitrarily drawing a line out of thin air. Lastly, the restraints on general solicitation require serious attention, as in their current state, they are a standing invitation to egregious abuse.

The CROWDFUND Act amounts to little more than a “small business lottery” with about as much investor protection as might be found in any other lottery. And, while those other lotteries might not have investment caps, at least they don’t potentially have a promoter offering investors a piece of the “blue sky” in exchange for a ten percent of the investor’s net worth.