

# ROUNDTABLE

## **Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act**

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## INTRODUCTION

Title III of the JOBS Act, known as the CROWDFUND Act, authorizes the “crowdfunding” of securities, defined as raising capital online from many investors, each of whom contributes only a small amount.<sup>1</sup> The Act was signed into law in April 2012, and will go into effect once the Securities and Exchange Commission (“SEC”) promulgates rules and regulations to govern the new marketplace for crowd-funded securities. This Essay offers friendly advice to the SEC as to how to exercise its rulemaking authority in a manner that will enable the Act to achieve its core goals.

The purpose of the CROWDFUND Act was described by President Barack Obama at the signing ceremony in April 2012:

Right now, [start-ups and small businesses] can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it’s time our laws did as well. Because of [the CROWDFUND Act], start-ups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.<sup>2</sup>

In other words, the Act has two primary goals. First, the Act seeks to create an ultralow-cost method for startup companies, small businesses, farmers,<sup>3</sup> and others to raise up to \$1 million per year from the “crowd” (*i.e.*, the public).<sup>4</sup> Second, it aims to democratize the market for speculative business investments by allowing investors of modest means to make investments that had previously been offered

1. See generally Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013). Title III of the JOBS Act “may be cited as the ‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012’ or the ‘CROWDFUND Act.’ ” Jumpstart Our Business Startups Act § 301, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

2. Barack Obama, U.S. President, Remarks at JOBS Act Bill Signing (Apr. 5, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing>.

3. See Andrew A. Schwartz, *Rural Crowdfunding*, 13 U.C. DAVIS BUS. L.J. (forthcoming 2013).

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

solely to wealthy, so-called “accredited” investors. The Act operates by adding a new exemption to the Securities Act’s registration requirement for crowdfunded securities.

Securities crowdfunding holds great promise for entrepreneurs and public investors who will be able to connect without going through the cumbersome and expensive initial public offering (“IPO”) process. A possible downside, however, is that unsophisticated retail investors may be defrauded by con artists posing as entrepreneurs. Charlatans could potentially crowdfund up to \$1 million from unsuspecting folks across the country—and then disappear with the money.

Congress was highly attentive to the possibility of fraud in crowdfunding and included in the Act a private right of action for defrauded investors as well as preserved the power of the SEC and state regulators to bring enforcement actions against wrongdoers. Beyond these traditional techniques, however, Congress also included an innovative structural protection for investors, specifically a strict annual cap on the aggregate amount that a person may invest in any and all crowdfunded securities.<sup>5</sup>

For most people, this cap will be five percent of their annual income, up to \$5,000 per year.<sup>6</sup> So, for a person with the median American income of about \$50,000, her maximum annual investment would be \$2,500 per year. Were she to invest the maximum and lose everything to a judgment-proof con artist, it would be unfortunate, but affordable.

This annual investment cap is designed to shield investors from losses of devastating magnitude. It is practically impossible to lose one’s “life savings” in crowdfunding, no matter how unwise or unlucky one’s choices may be. By contrast, an investor can lose her life savings—quickly, easily, and legally—by investing in the stock market, gambling at a casino, or playing the state lottery.

The CROWDFUND Act’s investment cap differs from the usual type of regulation found in federal securities laws. The usual way that federal law tries to protect investors is by mandating extensive public disclosure, both at the IPO stage and regularly thereafter. And indeed, the Act includes a number of disclosure requirements—and invites the SEC to add more. But for the SEC to mandate a great deal of additional disclosure does not make sense in the crowdfunding context for two reasons.

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5. *Id.* § 77d(a)(6)(B).

6. These limits are for those with incomes below \$100,000. *Id.* § 77d(a)(6)(B)(i). For wealthier individuals, the limits are slightly more liberal. *Id.* § 77d(a)(6)(B)(ii). *See also infra* Part I.B.

First, experience in the IPO market has shown that mandatory disclosures can easily push the cost of a securities offering out of reach for offerings of modest size.<sup>7</sup> For the type of small offerings authorized by the Act (under \$1 million), extensive disclosure is simply not an economically viable option. The only way that crowdfunding can work is if the process is exceedingly inexpensive.

Second, most crowdfunding investors are unlikely to read or take notice of required disclosures in any event. In the context of registered, publicly traded companies, professional securities analysts read and analyze the disclosures they make and then convey the information in plain English to investors. But crowdfunding companies will be far too small to warrant professional analysis, so investors will be on their own to read and understand any disclosures they make. Furthermore, ample experience with consumer contracting teaches that online disclosures (such as “terms of service” to which one must click “I agree”) are ignored by almost everyone.<sup>8</sup>

For both of these reasons, the SEC should resist the temptation to follow its usual course and promulgate long lists of required disclosures for crowdfunded securities. The whole crowdfunding project depends on a very simple and inexpensive process for offering securities, so it is vital that the SEC not burden the CROWDFUND Act with any more rules and regulations than are absolutely necessary. In short, this Essay’s advice to the SEC is to rely primarily on the existing statutory scheme, especially the annual investment cap, and add just a few additional rules and regulations, for that would be the best way to achieve the statutory goals of creating a low-cost method of raising business capital and democratizing the market for investing in startup companies.

The remainder of this Essay proceeds as follows: Part I provides a brief overview of the CROWDFUND Act. Part II catalogues the SEC’s authority under the Act and offers specific direction to the SEC on how to exercise each component of its rulemaking power.

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7. See, e.g., Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 10 (2007) (suggesting that an IPO only makes economic sense when raising \$20 million or more).

8. Florencia Marotta-Wurgler, *Will Increased Disclosure Help? Evaluating the Recommendations of the ALI’s “Principles of the Law of Software Contracts”*, 78 U. CHI. L. REV. 165, 168 (2011) (empirical study showing that fewer than one percent of consumers read end user license agreements); see also, e.g., Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 651 (2011) (“Although mandated disclosure addresses a real problem and rests on a plausible assumption, it chronically fails to accomplish its purpose. Even where it seems to succeed, its costs in money, effort, and time generally swamp its benefits.”). It is possible, however, that consumer-investors may be more interested in crowdfunding disclosures than they have been in contract disclosures.

## I. CROWDFUNDING SECURITIES

The new federal CROWDFUND Act, Title III of the larger JOBS Act, was enacted by Congress and signed into law by President Obama in 2012. The Act provides a new means for companies to raise capital from investors by establishing an exemption to the Securities Act of 1933 for crowdfunded securities.<sup>9</sup> The idea of crowdfunding is to gather capital from large numbers of people and have each individual provide only a very small amount.<sup>10</sup> Securities crowdfunding opens up new opportunities for entrepreneurs, who will now have the ability to raise capital from investors without having to comply with the costly federal registration requirements, as well as for investors of modest means, who now have the ability to invest over the Internet in strangers' startup companies.<sup>11</sup>

Crowdfunding has its origins in “crowdsourcing,” which is “a type of participative online activity in which an individual, an institution, a nonprofit organization, or company proposes to a group of individuals . . . via a flexible open call, the voluntary undertaking of a task.”<sup>12</sup> Wikipedia and Yelp<sup>13</sup> are among the better-known crowdsourced projects to date.

Crowdfunding differs from crowdsourcing in that the crowd is asked to contribute capital, as opposed to labor, to the project. In so-called “reward” crowdfunding, the funding participants receive the fruits of the project, such as a music CD or a consumer product, in return for their investment.<sup>14</sup> Reward crowdfunding has been practiced on websites including Kickstarter and IndieGoGo since about 2009, and its popularity and success has been phenomenal, growing into a \$1.5 billion market in just a couple of years.<sup>15</sup>

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9. Jumpstart Our Business Startups Act §§ 301–05, Pub. L. No. 112-106, 126 Stat. 306, 315–23 (2012) (codified in scattered sections of 15 U.S.C.).

10. See Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) (describing the crowdfunding process).

11. See generally Schwartz, *supra* note 1.

12. Enrique Estellés-Arolas & Fernando Gonzáles-Ladrón-de-Guevara, *Towards an Integrated Crowdsourcing Definition*, 38 J. INFO. SCI. 189, 197 (2012).

13. See *Wikipedia*, WIKIPEDIA, <http://en.wikipedia.org/wiki/Wikipedia> (last modified Mar. 29, 2013) (explaining the purpose of Wikipedia); *What is Yelp?*, YELP, [http://www.yelp.com/faq#what\\_is\\_yelp](http://www.yelp.com/faq#what_is_yelp) (last visited Mar. 31, 2013) (describing the purpose of Yelp).

14. See STEVEN JOHNSON, *FUTURE PERFECT: THE CASE FOR PROGRESS IN A NETWORKED AGE* 35–44 (2012).

15. *Id.*

Securities crowdfunding is a new idea that takes the concept one step further.<sup>16</sup> Rather than receive, say, a copy of an author's to-be-written book, the funding participants receive a share in the profits of the book, or some other security related to the book. This method of fundraising had been previously banned, or effectively so, by the federal securities laws.<sup>17</sup> In the CROWDFUND Act, however, Congress blessed this novel method for selling unregistered securities to the public on the Internet.

### A. *The CROWDFUND Act*

The CROWDFUND Act authorizes issuers of securities (*i.e.*, companies) to crowdfund up to \$1 million annually.<sup>18</sup> Crowdfunding transactions cannot be consummated directly between issuer and investor, but rather must be executed via a financial intermediary registered with the SEC.<sup>19</sup> The intermediary can register either as a broker-dealer,<sup>20</sup> or a "funding portal," which is a new classification of intermediary created by the Act.<sup>21</sup> These financial intermediaries are obliged to educate investors on the risks of investing, including the risk of total financial loss, as well as the problems of illiquidity.<sup>22</sup> Also, directors, officers, or partners of an intermediary may not have any financial interest in an issuer that has listed thereon.<sup>23</sup>

A key purpose of the Act is to lower the cost of raising capital for startups by alleviating burdensome disclosure requirements. Even

16. Securities crowdfunding is indeed a new concept, though it was foreshadowed by what this author has called "consumer contract exchanges" in previous work. Andrew A. Schwartz, *Consumer Contract Exchanges and the Problem of Adhesion*, 28 YALE J. ON REG. 313, 359 (2011) ("Theoretically, a peer-to-peer angel exchange for standardized business loans for hundreds of thousands, or even millions, of dollars, could be organized on the Internet. This would have the positive effect of democratizing entrepreneurship by allowing those who lack access to wealthy investors to have a more equal chance of obtaining sufficient funding for their fledgling business. Unfortunately, no such exchange exists at present.").

17. As a general rule, all offerings of securities made to the broad public must be registered with the government before being sold. This registration process is expensive and time-consuming, however, and may be avoided if securities are offered solely to wealthy investors or friends and family of the issuer. The effect is that issuers seeking modest sums, such as startups and small businesses, practically never offer securities to strangers. *See, e.g.*, Schwartz, *supra* note 1.

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

19. *Id.* § 77d(a)(6)(C).

20. *See* Securities Exchange Act of 1934 § 3(a)(4), (5), 15 U.S.C. § 78c(a)(4), (5) (2006) (defining broker and dealer).

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

22. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(3) to (a)(4).

23. *Id.* § 77d-1(a)(11).

so, the Act requires crowdfunding issuers to file a disclosure document to the SEC, designated intermediaries, and potential investors, which includes:

(A) the name, legal status, physical address, and website address of the issuer; (B) the names of the directors and officers . . . , [and substantial investors]; (C) a description of the business of the issuer and the anticipated business plan of the issuer; (D) a description of the financial condition of the issuer . . . ; (E) a description of the stated purpose and intended use of the proceeds of the offering . . . ; (F) the target offering amount . . . ; (G) the price to the public of the securities or the method for determining the price . . . ; (H) a [detailed] description of the ownership and capital structure of the issuer . . . .<sup>24</sup>

The SEC has authority to expand this list, as described in the next Part.<sup>25</sup>

The disclosure requirement regarding the financial condition of the business ((D) above) varies depending on the size of the offering. For offerings of \$100,000 or less, income tax returns for the last fiscal year and unaudited financial statements certified as accurate by the principal executive officer are required.<sup>26</sup> For offerings of between \$100,000 and \$500,000, financial statements reviewed by an independent public accountant are required.<sup>27</sup> And for offerings of between \$500,000 and the maximum of \$1 million, audited financial statements are required.<sup>28</sup>

Issuers must also provide a description of the purpose and intended use of the proceeds, the target offering amount, the deadline to reach that amount, regular updates regarding the progress of the issuer towards meeting its target amount, the price of the securities to be offered, and a description of the ownership and capital structure of the issuer.<sup>29</sup> Issuers are prohibited from advertising the offering themselves, and any solicitation of the offering must go through the intermediary.<sup>30</sup> Finally, following a crowdfunding round, an issuer must annually file with the SEC and make available to investors financial statements and a report on the results of operations.<sup>31</sup>

The secondary market for crowdfunded securities is sharply limited by the Act, as it provides that such securities may not be

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24. *Id.* § 77d-1(b)(1).

25. *Id.* § 77d-1(b)(1)(I) (requiring that issuers disclose any “other information as the [SEC] may, by rule, prescribe, for the protection of investors and in the public interest”).

26. *Id.* § 77d-1(b)(1)(D)(i).

27. *Id.* § 77d-1(b)(1)(D)(ii).

28. *Id.* § 77d-1(b)(1)(D)(iii). The SEC has authority to fine-tune this rule, as discussed in Part II.

29. *Id.* § 77d-1(b)(1)(E)–(H).

30. *Id.* § 77d-1(b)(2).

31. *Id.* § 77d-1(b)(4).

transferred or sold by investors for one year after the date of purchase unless being transferred to the issuer, an accredited investor, or a family member of the purchaser, or as part of an offering registered with the SEC.<sup>32</sup>

Beyond these federal requirements, the CROWDFUND Act expressly preempts state law regarding registration or qualification of securities, including so-called “Blue Sky” laws.<sup>33</sup> States are not permitted to impose additional regulations upon crowdfunding offerings, issuers, or intermediaries before the securities may be sold.<sup>34</sup>

Investor protection was important to Congress, and the Act includes an innovative way to limit potential losses, as discussed in the next Section.

### *B. The Structural Protection of the Annual Cap*

Because of Congress’s deep concern that investors in crowdfunded securities might be defrauded, the Act includes a structural protection for investors that limits their potential losses. Specifically, the Act establishes a maximum annual aggregate amount of crowdfunded securities that any one investor may purchase, based on a sliding scale. If an investor’s net worth or annual income is under \$100,000, she can invest the greater of \$2,000 or five percent of her annual income in crowdfunded securities each year.<sup>35</sup> Wealthier investors have more liberal limits: if an investor’s net worth or annual income is over \$100,000, she is allowed to invest ten percent of her annual salary (up to a maximum of \$100,000) per year.<sup>36</sup>

The effect of the foregoing rules, for most people,<sup>37</sup> is that the absolute most that they are allowed to invest in any and all crowdfunding offerings is \$5,000 per year. They may split this \$5,000

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32. *Id.* § 77d–1(e). In addition, as a practical matter there will be a very small secondary market for any given crowdfunded security, simply due to the very small number of shares outstanding and the lack of a formal market such as the New York Stock Exchange.

33. 15 U.S.C. § 77r(a) (2006).

34. *Id.* § 77r(a)(1)(A); Jumpstart Our Business Startups Act § 305, 15 U.S.C.A. § 77r(b)(4)(C).

35. Jumpstart Our Business Startups Act § 302, 15 U.S.C.A. § 77d(a)(6)(B)(i).

36. *Id.* § 77d(a)(6)(B)(ii). This statutory section may be ambiguous. For example, a person with an annual income of \$90,000 and a net worth of \$110,000 would seemingly be subject to both limits. The SEC should clarify this ambiguity in its rulemaking.

37. The Census Bureau reports that the great majority (about 80%) of the United States population has an annual household income below \$100,000. CARMEN DENAVAS-WALT, BERNADETTE D. PROCTOR, JESSICA C. SMITH, U.S. CENSUS BUREAU, P60-243, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2011, at 31 tbl.A-1 (2012), available at <http://www.census.gov/prod/2012pubs/p60-243.pdf>.



into fifty \$100 investments, or put the whole \$5,000 into a single company, as they wish. Regardless, thanks to this limit, the maximum that most people can lose to fraudulent crowdfunders is \$5,000 per year.<sup>38</sup> This is a structural protection against losing one's life savings to a crooked crowdfunder.<sup>39</sup>

### C. Other Investor Protections

Beyond the disclosure requirements and investment caps, the CROWDFUND Act attempts to combat the potential for fraud in other ways. Issuers may not directly sell securities, but rather must act through independent intermediaries (either broker-dealers or funding portals).<sup>40</sup> Private civil actions for fraud against an issuer, its directors, and officers are expressly authorized.<sup>41</sup> The SEC is granted "examination, enforcement and other rulemaking authority" over funding portals,<sup>42</sup> and presumably retains authority to enforce the various statutory and regulatory mandates for both issuers and intermediaries. In addition, state authorities retain jurisdiction over issuers or intermediaries that engage in fraud, deceit, or unlawful conduct.<sup>43</sup>

## II. THE SEC'S REGULATORY AUTHORITY AND HOW TO USE IT

As described in the last Part, the CROWDFUND Act establishes a fairly detailed regulatory apparatus for the newly authorized market for crowdfunded securities. Even so, the Act includes a number of provisions that empower the SEC to promulgate additional rules and regulations, or at least to consider doing so.<sup>44</sup> This Part catalogues those items and offers advice on whether and

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38. Wealthy investors with incomes over \$100,000 are permitted to invest (and thus possibly lose) somewhat more, but they too are well protected. A person with an income of, say, \$300,000, will only be allowed to invest \$30,000 in all crowdfunding investments in a given year. Even a billionaire would be limited to \$100,000 per year.

39. It is certainly possible that some crowdfunding investors may find a way to get around the annual caps and actually put their life savings into crowdfunded companies. However, such people would be themselves perpetrating a fraud, and therefore not deserving of much sympathy if the issuers they choose turn out to be deceptive as well.

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

41. *Id.* § 77d-1(c).

42. Jumpstart Our Business Startups Act § 304, 15 U.S.C.A. § 78c(h)(1)(A).

43. 15 U.S.C. § 77r(e)(1) (2006); Jumpstart Our Business Startups Act § 305, 15 U.S.C.A. § 77r(c)(1).

44. Obama, *supra* note 2 ("The SEC is going to play an important role in implementing this bill.").

how each fount of regulatory power should be exercised by the SEC.<sup>45</sup> Section A pertains to issuers, Section B covers intermediaries, and Section C addresses investors.

### *A. Rules for Issuers*

In drafting rules relating to crowdfunding issuers, the SEC must try to advance the congressional goal of creating a new, low-cost way for early-stage entrepreneurs and small businesses to raise small amounts of capital. For crowdfunding to be a realistic financing option, it is imperative that the SEC endeavor to keep costs for issuers extremely low.

Moreover, crowdfunding is only open to small businesses, startup companies, and other relatively unsophisticated entities that are not used to dealing with regulators. So, although the SEC spends much of its time dealing with sophisticated issuers, in drafting rules under the CROWDFUND Act, it must orient itself to the types of issuers for whom crowdfunding is designed. To that end, the rules should be kept simple and straightforward, even if that comes at the expense of some fine-grained policy concerns.

With these two concepts in mind—keeping costs down and the rules simple—let us examine each of the rules the SEC is called upon to draft relating to crowdfunding issuers.

#### 1. Disclosure Document and Financial Statement

Before crowdfunding securities, issuers are required to file a disclosure document with the SEC and make it available to potential investors.<sup>46</sup> There are two aspects of this disclosure document that call for SEC rulemaking.

First, the Act itself includes eight specific and detailed items that must be disclosed in the document, including the names of directors and officers, a business plan, and the method of determining the price.<sup>47</sup> This long list is followed by a potential ninth item: “[S]uch

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45. The CROWDFUND Act directs the SEC to issue rules within 270 days of its passage. Jumpstart Our Business Startups Act §§ 302(c), (d), 303(b), 304(a)(2). That date was December 31, 2012, which has come and gone, but the incoming Chairman has indicated that she intends to act soon. See Maria Lokshin, *D-F, JOBS Act, Enforcement Top White's Priorities for SEC Chairmanship*, 16 BNA M&A L. REP. 417 (Mar. 18, 2013) (quoting then-nominee for SEC chairman Mary Jo White: “There’s no higher priority that I have than moving the SEC along . . . under . . . the JOBS Act to get those regulations out as quickly as possible. . . . I think you can do them well and smartly and still get them out quickly.”).

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

47. See *supra* note 24 and accompanying text.

other information as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.”<sup>48</sup> The SEC should resist any temptation it may have to add to the disclosures already required of issuers by the Act. The eight items are more than enough, especially considering that many potential investors are unlikely to read the document in the first place.<sup>49</sup>

Second, one of the disclosures required in the Act is “a description of the financial condition of the issuer,” but the depth and care with which this must be given varies by size of offering, and the SEC has some authority here. For offerings of between \$100,000 and \$500,000, financial statements reviewed by an independent public accountant are required, but these may be conducted pursuant to “standards and procedures established by the Commission.”<sup>50</sup> The SEC should create simplified procedures for this financial review, so as to keep accountants’ fees low.

Relatedly, offerings of more than \$500,000 require disclosure of “audited financial statements” under the Act, though the SEC is empowered to change that figure.<sup>51</sup> The SEC should consider exercising that authority to raise it to some higher amount, depending on the real-life costs of obtaining such audited financial statements.

## 2. Promoters

Issuers are barred by the Act from directly promoting their own crowdfunded security. But the Act contemplates that issuers may hire outside promoters to do it for them, so long as the compensation is disclosed in a manner to be determined by the SEC.<sup>52</sup> This process should be simple and inexpensive for issuers to comply with. For example, the SEC could issue a rule providing that a clear statement of the promoters’ compensation amount (or a formula for determining the same) in the disclosure document will satisfy this obligation.

## 3. Annual Report

The CROWDFUND Act’s regulation of issuers does not end with the sale of the securities, and could potentially continue forever. One portion of the Act provides that issuers shall, “not less than annually, file with the Commission and provide to investors reports of

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

49. *See supra* note 8 and accompanying text.

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

51. *Id.* § 77d-1(b)(1)(D)(iii).

52. *Id.* § 77d-1(b)(3).

the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule.”<sup>53</sup>

This section gives the SEC wide discretion regarding this annual report requirement. The Commission could abolish the requirement entirely, for instance, or could only require one or two annual reports. Abolition might be an appropriate choice for the SEC to make, since a mandatory annual report could be burdensome for many crowdfunding issuers.

Recall, however, that crowdfunded securities may generally not be resold by their original purchasers for one year.<sup>54</sup> And even after that, it is unlikely that a liquid market for such securities will develop, given the very low volume of issuance. The illiquid nature of crowdfunded securities means that investors might find themselves in a position of vulnerability analogous to a shareholder in a closely held corporation.<sup>55</sup> Crowdfunding corporations will differ from close corporations in that the latter usually have only a handful of shareholders, while the former might end up with hundreds or thousands of shareholders. But the lack of a liquid secondary market creates the same potential for oppression in the crowdfunding context that is found in the close corporation.

Indeed, the Act enhances the possibility of such oppression in some ways by allowing investors to resell their crowdfunded securities within a year to the issuer, but not to other ordinary investors.<sup>56</sup> This heightens the concern that the crowdfunding investors could be “frozen out” from the companies they invest in.<sup>57</sup> Thanks to the absence of a secondary market for crowdfunded securities, the issuer (or its controlling group) may be tempted to offer an unfairly low price to cash out the other holders, knowing that they have essentially nowhere else to turn.<sup>58</sup>

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53. *Id.* § 77d-1(b)(4).

54. *Id.* § 77d-1(e).

55. *See, e.g., Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 661–64 (Mass. 1976).

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

57. “The essence of a freezeout is the displacement of public investors by those who own a controlling block of stock of a corporation, whether individuals or a parent company, for cash or senior securities. The public investors are thus required to give up their equity in the enterprise, while the controllers retain theirs.” Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978).

58. This is precisely what happened in the classic freezeout case of *Wilkes*. *See Wilkes*, 353 N.E.2d at 664 (“[T]he action of the majority stockholders here was a designed ‘freeze out’

An annual report does not totally insulate crowdfunding investors from being frozen out, but it could help arm them with information that could be used in a direct or derivative shareholder action against the controlling party. Therefore, the SEC should keep the annual report requirement, but only for a few years, and try to make it as painless as possible. To that end, it might be a good idea for the SEC to require very simple annual reports for three years after crowdfunding.<sup>59</sup>

#### 4. Blunderbuss Clause

At the very end of the CROWDFUND Act's section relating to issuers, after all the rules are laid out, Congress included a blunderbuss clause that requires issuers to "comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest."<sup>60</sup> While it may be appropriate for Congress to grant the SEC such broad and roving authority, the SEC should decline this offer to tack on additional rules to those already present in the statute.

The CROWDFUND Act is not a bare-bones statute, but a detailed piece of legislation that appears capable of functioning reasonably well as drafted. At the very least, the SEC should stay its hand and wait and see how crowdfunding works in practice before directing its blunderbuss authority to remedying any problems that arise. For now, the SEC should not exercise its power under this blunderbuss clause.

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The blunderbuss clause aside, the SEC's authority to create regulatory obligations for crowdfunding issuers is relatively modest. By contrast, the SEC's authority over crowdfunding intermediaries is intense and pervasive, as the next Section will explain.

#### *B. Rules for Intermediaries*

The CROWDFUND Act places significant responsibility upon intermediaries (funding portals and broker-dealers) to maintain the

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[intended] to pressure Wilkes into selling his shares to the corporation at a price below their value.").

59. In addition, common sense dictates that the reporting requirement should cease if and when none of the crowdfunded securities remain outstanding.

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

integrity of the securities crowdfunding market.<sup>61</sup> This makes good sense because intermediaries are repeat players that can efficiently handle SEC regulation and spread the costs to issuers and other market participants. In fact, these intermediaries have already organized professional organizations to share the cost of SEC regulation, even before securities crowdfunding has gotten off the ground.<sup>62</sup>

So, while the SEC should use a very light touch when regulating issuers, as discussed in the last Section, it may be appropriate for the Commission to place somewhat greater burdens on intermediaries. Still, costs should be kept to a minimum, or securities crowdfunding cannot succeed. The remainder of this Section addresses each component of the SEC's authority to promulgate rules and regulations for crowdfunding intermediaries.

### 1. Registration and Disclosure

The CROWDFUND Act requires intermediaries to register with the SEC either as a broker-dealer or as the newly created category of funding portal.<sup>63</sup> In addition to registering, intermediaries must also “provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate.”<sup>64</sup>

Many relevant disclosures will likely already be included as part of the registration process, so whatever document intermediaries must file with the SEC should be made public. This way, the intermediaries could file a single document that would satisfy both the registration and disclosure requirements.

To the extent there are additional disclosures that the SEC wishes to elicit, it makes sense for the SEC to add a few questions to its registration form or instructions to capture those additional facts. And, to the extent that there is sensitive business information that should be kept confidential, the SEC could redact that component.

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61. “[T]o make sure Americans don’t get taken advantage of, the websites where folks will go to fund all these start-ups and small businesses will be subject to rigorous oversight” by the SEC. Obama, *supra* note 2.

62. See, e.g., CrowdFund Intermediary Regulatory Advocates, [www.cfira.org](http://www.cfira.org); Financial Intermediaries, Managers and Brokers Regulatory Association, [www.fimbra.org](http://www.fimbra.org).

63. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(1). They also must register with any applicable self-regulatory organization. *Id.* § 77d-1(a)(2).

64. *Id.* § 77d-1(a)(3).

## 2. Investor Education

The Act places a duty on intermediaries to educate crowdfunding investors about the risks of investing. This obligation is split into three components.

First, intermediaries “shall . . . ensure” that each investor “reviews investor-education information, in accordance with standards established by the Commission.”<sup>65</sup> In promulgating these standards, the SEC should give wide latitude to intermediaries so that they may experiment with different methods of investor education.

Second, intermediaries “shall . . . ensure” that each investor “positively affirms” that she understands that she could lose her entire investment.<sup>66</sup> Similarly, the SEC should allow room for intermediaries to try different methods of obtaining this affirmation.

Third, intermediaries “shall . . . ensure” that each investor “answers questions demonstrating” that she understands the risks of speculative business investments and of illiquid securities, as well as “such other matters as the Commission determines appropriate by rule.”<sup>67</sup> It will be more than enough to educate investors about the risks of investing in speculative businesses and illiquid securities. The SEC should not add any additional matters here, at least for now.

Finally, as to all three of these obligations, the SEC should consider clarifying that an intermediary that acts reasonably and in good faith will satisfy the “shall . . . ensure” language, even if the system adopted works imperfectly in practice. This will allow for good faith experimentation in different methods of educating crowdfunding investors and testing their understanding.

## 3. Fraud Prevention

Intermediaries are obliged under the CROWDFUND Act to “take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director,” and twenty-percent shareholder of every issuer whose securities they offer.<sup>68</sup>

This is an expansive power for the SEC, as it could conceivably authorize just about any antifraud rule or regulation. But additional rules here could very easily drive the price of crowdfunding

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65. *Id.* § 77d-1(a)(4)(A).

66. *Id.* § 77d-1(a)(4)(B).

67. *Id.* § 77d-1(a)(4)(C)(iii).

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

prohibitively high. The Act already requires a background check and a “securities enforcement regulatory history” check on all the important people involved in every issuer that wants to try its hand at crowdfunding—not just the successful issuers. The required background checks will cost a few dollars each, which may not seem like a lot, but once this is multiplied by every officer, director, and major shareholder of every issuer, the total dollar value could be significant.

The SEC should not add to this cost by tacking on additional antifraud measures here. The Commission must not try to stamp out every fraudulent offering before it is made, for that task is impossible and the attempt would drive the cost of crowdfunding so high as to render the Act a dead letter. Rather, the SEC should rely on ex post enforcement, as well as the annual investment cap, to protect investors from harm.

Finally, to the extent that there are other cost-effective means of reducing the risk of fraud in securities crowdfunding, market forces will encourage intermediaries to adopt them. For instance, a reputation rating system like eBay’s “star” scores may work well in the context of securities crowdfunding.<sup>69</sup>

#### 4. Circulation of Issuer’s Disclosure Document and Financial Statement

Intermediaries are tasked with circulating to the SEC and potential investors the disclosure document and financial statement prepared by each issuer.<sup>70</sup> These documents are to be made available “21 days prior to the first day on which securities are sold to any investor (or such other period as the Commission may establish).”<sup>71</sup> Pursuant to this authority, the SEC could lengthen or shorten that timeframe, or key it to a different event, such as the first day the securities are offered to any investor. But the rule stated in the Act seems reasonable, so the SEC should probably just leave this one alone, at least for the time being.

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69. See *What Does the Star Next to a Feedback Score Mean?*, EBAY, <http://pages.ebay.com/help/feedback/questions/star.html> (last visited Apr. 5, 2013); see generally, e.g., ETRUST: FORMING RELATIONSHIPS IN THE ONLINE WORLD (Karen S. Cook et al. eds.) (2009); THE REPUTATION SOCIETY: HOW ONLINE OPINIONS ARE RESHAPING THE OFFLINE WORLD (Hassan Masum & Mark Tovey eds.) (2011).

70. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(6).

71. *Id.*



## 5. Reaching the Target

Crowdfunding issuers are required to set a specific dollar value as the target for their offerings, and intermediaries may only release the proceeds to an issuer if and when the aggregate capital raised meets or exceeds that target amount. The SEC is charged in the statute with drafting rules to put this procedure into effect.<sup>72</sup> These rules can and should be very simple and straightforward.

## 6. Cancellation of Commitment

As the last subsection described, investors may cancel their investments and get their money back if the offering fails to meet the target amount. Beyond that statutory ground for cancellation, the CROWDFUND Act appears to grant authority to the SEC to create additional grounds upon which investors may rescind: “[I]ntermediaries . . . shall . . . allow all investors to cancel their commitments to invest, as the Commission shall, by rule, determine appropriate.”<sup>73</sup>

The statute is somewhat ambiguous here, since this component of SEC authority is included as part of the target rule just considered.<sup>74</sup> The statute could thus be read as empowering the SEC to draft rules relating to commitment cancellation, but only for offerings that fail to meet their targets.

Whichever way the SEC reads the statute, it should exercise restraint in rulemaking on this point. It is important that investor commitments be clear and firm, and retractable only if the offering fails to meet the target, or for other sharply limited grounds, for example when the disclosure document related to an offering contains a material error or falsehood. Otherwise, the uncertainty over enforceability might needlessly raise the expected cost of crowdfunding securities.

## 7. Policing the Annual Investment Cap

The Act’s annual investment cap of \$5,000 is a bedrock statutory protection for crowdfunding investors, as discussed above in Part I.B, so enforcing this limit will be very important to the overall success of the Act. And this vital task is assigned in the first instance to intermediaries, who are required under the Act to “make such

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72. *Id.* § 77d-1(a)(7).

73. *Id.*

74. *See supra* Part II.B.5.

efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased [crowdfunded] securities . . . that, in the aggregate, from all issuers, exceed the investment limits set forth” in the Act.<sup>75</sup>

The theme of this Essay is that the SEC should use a light touch in drafting rules for securities crowdfunding—but this rule is an exception. The annual cap is so important to the entire statutory scheme that the SEC should properly place a relatively heavy burden on intermediaries to enforce it.

It may not be enough, for instance, for intermediaries to simply ask investors whether they have reached their annual limit and leave it at that, as crowdfunding investors might not remember or keep records of their past investments. Nor can intermediaries rely solely on their own internal records, as the cap is an aggregate one for all crowdfunding securities purchased on any platform and from any issuer.

How exactly to regulate intermediaries’ policing of the annual cap is a difficult and complex matter that deserves careful attention by the SEC. Modern information technology may make it possible to enforce the cap at very low cost, even across different crowdfunding platforms. But even if the cost of effectively enforcing this cap turns out to be a bit high, it is probably worth it, because the whole statutory scheme depends on it.

## 8. Privacy Protection

The CROWDFUND Act provides that intermediaries must “take such steps to protect the privacy of information collected from investors as the Commission shall, by rule, determine appropriate.”<sup>76</sup> This rule should be as minimally burdensome as possible, and the SEC should consider consulting with the Federal Trade Commission or others with relevant expertise.

## 9. Limitations on Funding Portals

The CROWDFUND Act creates the new concept of a “funding portal” that can act as an intermediary between crowdfunding issuers and investors. Beyond that core function, however, the Act limits the activities of funding portals.<sup>77</sup> They may not hold investor funds or securities, offer investment advice, solicit or compensate others to

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75. Jumpstart Our Business Startups Act § 302(b), 15 U.S.C.A. § 77d-1(a)(8).

76. *Id.* § 77d-1(a)(9).

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

solicit purchases of the securities they offer, nor “engage in such other activities as the Commission, by rule, determines appropriate.”<sup>78</sup> The SEC should wait and see what activities beyond intermediation that funding portals pursue, if any, and then regulate as necessary.

#### 10. Excluded Issuers

The Act excludes certain types of issuers from selling securities via crowdfunding: reporting (i.e., public) companies, investment companies, and any other issuer or type of issuer that “the Commission, by rule or regulation, determines appropriate.”<sup>79</sup> The CROWDFUND Act is designed to expand opportunity for issuers, so the SEC should not add to this list of excluded parties, at least absent compelling circumstances.

#### 11. Blunderbuss Clause

As is the case with issuers, the CROWDFUND Act includes a catch-all clause for SEC regulation of intermediaries, who are obliged to “meet such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.”<sup>80</sup> Again, in the interest of advancing the core statutory purpose of creating a low-cost funding mechanism, the SEC should decline to exercise its power under this clause, at least until it actually sees problems in the intermediary marketplace that require attention.<sup>81</sup>

#### *C. Rules for Investors*

The SEC was given only one rulemaking opportunity that relates directly to crowdfunding investors. The CROWDFUND Act prohibits an investor from transferring crowd-funded securities for one year after the date of purchase, unless they are transferred to the issuer, an accredited investor, or a member of the investor’s family, or as part of a registered offering.<sup>82</sup>

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78. *Id.* § 78c(a)(80)(E).

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

80. *Id.* § 77d-1(a)(12).

81. There is one additional area of potential SEC rulemaking regarding issuers and intermediaries: The Act directs the SEC to establish rules for disqualification. Jumpstart Our Business Startups Act § 302(d). However, the Act specifically instructs the SEC to make rules that are “substantially similar” to 17 C.F.R. § 230.262, so the SEC appears to have little discretion in the matter. *Id.* § 302(d)(2)(A).

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

Beyond these limitations, the Act provides that secondary sales of crowd-funded securities “shall be subject to such other limitations as the Commission, by rule, establish.”<sup>83</sup> However, the limitations already in the Act effectively deny the possibility of a liquid secondary market for crowd-funded securities, so there appears to be little further that the SEC should do in this regard. As crowd-funding develops, the SEC can observe the secondary market, such as it exists, and address problems if and when they arise.

#### CONCLUSION

This Essay’s core message to the SEC, and incoming Chairman White, is this: keep the rules and regulations governing securities crowd-funding as light and simple as possible. If the SEC gives crowd-funding some breathing room, it stands a good chance of bringing new opportunities and economic growth to America. And, if problems develop over time, the Commission can amend its initial rules as needed.

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83. *Id.* § 77d-1(e)(2).