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## From Revolutionary to Palace Guard: The Role and Requirements of Intermediaries Under Proposed Regulation Crowdfunding

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# FROM REVOLUTIONARY TO PALACE GUARD: THE ROLE AND REQUIREMENTS OF INTERMEDIARIES UNDER PROPOSED REGULATION CROWDFUNDING

Andrew D. Stephenson,\* Brian R. Knight,† & Matthew Bahleda‡

*Intermediaries in securities crowdfunding face significant requirements as a result of the statutory mandates of Title III of the JOBS Act. The SEC, in its proposed rules, provided structure to these requirements. The proposed rules would create strict requirements for intermediaries regarding their relationships with investors and how they undertake crowdfunding transactions under Section 4(a)(6) of the Securities Act. The proposed rules would also create and establish the guidelines for funding portals, a new type of limited purpose securities broker. While some commentators decry the SEC for placing undue burdens and legal liabilities on intermediaries in securities crowdfunding, the SEC had limited discretion in the proposed rules in regards to those issues. It is unclear what type of market will develop as a result of these rules as market participants work through the challenges and opportunities of securities crowdfunding.*

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## I. INTRODUCTION

Crowdfunding, the process of raising money from a large number of people who make small individual investments over the Internet, has

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achieved massive growth in popularity and acceptance as an alternative businesses may use to raise capital. In 2012 worldwide crowdfunding volume reached \$2.7 billion across donation, rewards, and equity-based crowdfunding.<sup>1</sup> In North America alone, the volume of funds pledged to crowdfunding increased by 105 percent from 2011 to 2012.<sup>2</sup> Global crowdfunding is projected to reach a volume of \$5.1 billion in 2013.<sup>3</sup> While growing, the amount of capital businesses receive from crowdfunding is dwarfed by capital raised by businesses using unregistered securities offerings. For comparison, the amount of investment capital contributed to early stage companies by angel investors in 2011 was approximately \$22.5 billion.<sup>4</sup>

In the United States, growth in the use of equity crowdfunding is constrained by the Securities Act of 1933 and state Blue Sky laws.<sup>5</sup> In general, any security sold in the United States must be registered with the Securities and Exchange Commission (“SEC”), or exempt from registration.<sup>6</sup> The same requirements apply at the state level.<sup>7</sup> Legislators in Congress and state governments have sought to tap into the resources available from the millions of retail investors who would be interested in supporting local and early-stage, high growth companies by exempting crowdfunding from Securities Act and state registration requirements. At the federal level, Congress included an exemption for crowdfunding by amending the Securities Act in Title III of the Jumpstart Our Business

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1. MASSOLUTION, 2013CF: THE CROWDFUNDING INDUSTRY REPORT 8 (2013).

2. *Id.* at 9.

3. *Id.* at 8. Kickstarter, one of the largest donation based crowdfunding sites saw growth from 2.4 million backers pledging \$320 million in 2012 to approximately 3 million backers pledging \$480 million. See Nick Summers, *3 million people pledged \$480 million to Kickstarter campaigns in 2013*, NEXT WEB (Jan. 8, 2014, 4:56 PM), <http://thenextweb.com/insider/2014/01/08/3-million-people-pledged-480-million-total-kickstarter-campaigns-2013/>.

4. ANGEL CAPITAL ASSOCIATION, ACA CONGRESSIONAL BRIEF, available at <http://www.angelcapitalassociation.org/data/Documents/Public%20Policy/State/ACACongressionalBrief.pdf> (last visited Jan. 28, 2014). Angel investors are limited to “accredited investors” as defined by the SEC. For a natural person to be an accredited investor, that person must have a net worth of over \$1,000,000, excluding the value of the primary residence, or have an income exceeding \$200,000 (or joint income with a spouse exceeding \$300,000). 17 C.F.R. § 230.501(a) (2013).

5. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012). Regulation of securities offerings and the licensing of broker-dealers and their agents by a state are governed by what is known as “blue sky” law, harking back to speculative schemes in the early part of the 20th Century that had no more substance than so many feet of “blue sky.” See *NASAA History*, N. AM. SEC. ADM’RS ASS’N, <http://www.nasaa.org/about-us/nasaa-history/> (last visited Jan 28, 2013).

6. Securities Act § 5, 15 U.S.C. §§ 77e. The consequences of selling a security without the securities being registered with the Securities and Exchange Commission nor qualifying for an exemption from registration are severe, and range from liability for rescission under Section 12(a)(1) of the Securities Act to possible criminal liability. See THOMAS LEE HAZEN, *FEDERAL SECURITIES LAW* 41 (3d ed. 2011).

7. See, e.g., WASH. REV. CODE § 21.20.320 (2012).

Startups Act (“JOBS Act”) of 2012.<sup>8</sup> States, such as Georgia, Kansas, Michigan, and Wisconsin have enacted state level crowdfunding regulatory exemptions that take advantage of the intrastate offering exemption from federal regulation and provide an exemption from state registration requirements.<sup>9</sup>

On October 23, 2013, the SEC met and unanimously approved its proposed rules to implement securities crowdfunding as authorized by Title III of the JOBS Act.<sup>10</sup> After passage of the JOBS Act and before the proposed rules, advocates of securities crowdfunding saw the law as an inexpensive means for small companies to raise funds from numerous investors through lightly regulated funding portals, a new type of securities intermediary.<sup>11</sup> However, the existing statutory scheme into which the SEC issued its proposed rules had already established a high bar for compliance by securities intermediaries, as well as for the initial and ongoing disclosure by issuers. Nevertheless, when compared to registered securities offerings, crowdfunding does present a new avenue to raise capital at a relatively low cost.<sup>12</sup>

This comment serves as a follow-up to *A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act* published in this *Journal* in Fall 2012, following the enactment of the JOBS Act.<sup>13</sup> This comment focuses on a few provisions of the proposed rules and their impact on intermediaries, including registered broker-dealers and funding portals undertaking a crowdfunding transaction under Section 4(a)(6) of the Securities Act as amended by the JOBS Act of 2012. Part II will cover the proposed requirements for all intermediaries conducting transactions under Section 4(a)(6). Part III will highlight the proposed rules that require practices that are new or different for established broker-dealers.

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8. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301–05, 126 Stat. 306, 315–23 (2012) [hereinafter JOBS Act].

9. See Invest Georgia Exemption, GA. COMP. R. & REGS. 590-4-2-.08 (2012); Invest Kansas Exemption, KAN. ADMIN. REGS. § 81-5-21 (2013); 2013 Mich. Pub. Acts 264 (2013), available at <http://www.legislature.mi.gov/documents/2013-2014/publicact/pdf/2013-PA-0264.pdf>; 2013 Wis. Sess. Laws 52 (2013), available at <https://docs.legis.wisconsin.gov/2013/related/acts/52>. Intrastate offerings are exempt from federal registration under Section 3(a)(11) of the Securities Act of 1933. 15 U.S.C. § 77c(a)(11) (2012). The intrastate exemption requires that the issuer be a resident of and doing business within the state or territory in which all offers and sales are made, and that no part of the issue be offered or sold to non-residents. See 17 C.F.R. § 230.147 (2013).

10. Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200 et seq.).

11. See generally SHERWOOD NEISS ET AL., CROWDFUND INVESTING FOR DUMMIES (2013).

12. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1470 (2013).

13. Thaya Brook Knight, Huiwen Leo, & Adrian A. Ohmer, *A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act*, 2 MICH. J. OF PRIVATE EQUITY & VENTURE CAP. L. 135 (2012).

Part IV will then identify critical areas in which the activities of funding portals are limited relative to broker-dealers. Part V will summarize the legal liabilities faced by intermediaries operating in the Section 4(a)(6) space. Part VI will look ahead at what the SEC is likely to change from the proposed rule and put forward yet unanswered questions about the future of crowdfunding under Section 4(a)(6) of the Securities Act. Crowdfunding was expected by some to be transformative and revolutionary. However, the reality is that crowdfunding is still operating under the terms of established federal securities laws and the intermediaries are still financial services institutions, with all of the obligations and burdens that attach to that status.

## II. OBLIGATIONS OF SECURITIES INTERMEDIARIES DURING CROWDFUNDING OFFERINGS UNDER SECTION 4(A)(6)

As defined by the Securities Exchange Act of 1934 (“Exchange Act”), a securities broker is any person or entity that is engaged in the business of effecting transaction in securities for the account of others.<sup>14</sup> Any person who acts as a broker of securities transactions must be registered with the SEC and is subject to SEC rules and oversight.<sup>15</sup> Over time, the SEC has clarified the activities it deems to be broker activities that require the person or entity to register with the SEC.<sup>16</sup> These activities include receiving commissions or other transaction-based compensation for finding investors for issuers—the activities engaged in by brokers and funding portals as intermediaries for Section 4(a)(6) transactions. Under the statute and proposed rules, intermediaries would be subject to a number of conditions, some of the most significant of which are discussed below.

### A. *Intermediaries Are Subject to Registration Requirements*

All intermediaries conducting transactions under Section 4(a)(6) must register with the SEC as a broker under Section 15(b) of the Exchange Act, or as a “funding portal.”<sup>17</sup> The proposed rules create a simple registration process for funding portals that requires filing a form with the SEC and registering with any applicable national securities association registered under Section 15A of the Exchange Act.<sup>18</sup> Currently, the Financial Industry Regulatory Authority (FINRA) is the only national securities association in existence that is registered under Section 15A of the Exchange

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14. Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4)(A) (2012).

15. Exchange Act § 15(a), *id.* § 78o(a).

16. See *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/marketreg/bdguide.htm> (last updated Oct. 6, 2009).

17. Crowdfunding, 78 Fed. Reg. 66,428, 66,555 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200 et seq.); see also *infra* Part IV.A.

18. Crowdfunding, 78 Fed. Reg. at 66,559.

Act.<sup>19</sup> As a condition of registration, funding portals will be required to obtain, and maintain, a fidelity bond that has a minimum coverage of \$100,000.<sup>20</sup> Nonresident funding portals, i.e., funding portals located outside the United States, face additional registration requirements.<sup>21</sup>

*B. Intermediaries May Not Have a Financial Interest in an Issuer for Which They Provide Services*

Intermediaries may not have a financial interest in an issuer that is using its platform to issue securities.<sup>22</sup> A financial interest is defined as “a direct or indirect ownership of, or economic interest in, any class of the issuer’s securities.”<sup>23</sup> Those familiar with the text of the JOBS Act will recall that the directors, officers, or partners of an intermediary had already been prohibited, by statute, from having a financial interest in an issuer using the intermediary’s services.<sup>24</sup> This prohibition is expanded in the proposed rules to include the intermediary itself, by prohibiting the intermediary and its leadership from receiving a financial interest in the issuer as compensation for the services provided.<sup>25</sup> This prohibition prevents the intermediary from having a stake in the success of the offering, which may bias the intermediary’s view when carrying out its other obligations, such as taking steps to reduce the risk of fraud.<sup>26</sup> Nevertheless, an intermediary may purchase securities in the issuers that it provides services for, so long as the terms of the purchase agreement are equivalent to those of retail investors and the purchase agreement is not in lieu of other compensation.<sup>27</sup> The proposed rules would require an intermediary to clearly disclose to an investor the manner in which the intermediary is compensated for its services regarding that issuance.<sup>28</sup> If the intermediary obtains a financial interest in the issuer during or after the offering in a manner that could be considered compensation for services that is not disclosed by the intermediary, that intermediary could be subject to securities fraud liability for omitting information necessary to make the information provided not misleading.<sup>29</sup>

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19. *Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, U.S. SEC. & EXCH. COMM’N (May 7, 2012), <http://www.sec.gov/divisions/marketreg/tmjjobsact-crowdfundingintermediariesfaq.htm>.

20. Crowdfunding, 78 Fed. Reg. at 66,559.

21. *Id.*

22. *Id.* at 66,555-56.

23. *Id.* at 66,556.

24. JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315-16 (2012); Securities Act § 4A(a)(11), 15 U.S.C. 77d-1(a)(11) (2012).

25. Crowdfunding, 78 Fed. Reg. at 66,555-56.

26. *See infra* Part II.D.

27. *See* Crowdfunding, 78 Fed. Reg. at 66,555-56.

28. *Id.* at 66,557 (§ 227.302(d)).

29. *See, e.g.*, Exchange Act Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (2013) (“It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact or to omit to

*C. Intermediaries Must Provide Investors with Educational Materials*

The SEC has proposed that intermediaries be required to provide disclosures and educational materials to investors upon establishing an account with the intermediary.<sup>30</sup> These materials must be “in plain language and . . . otherwise designed to communicate effectively and accurately” the specified information.<sup>31</sup> The most current version of these materials must be available on the intermediary’s platform at all times.<sup>32</sup> Furthermore, any material revision to the information must be made available to all investors before the intermediary may accept any additional investment commitments or effect any further transactions in securities offered and sold in reliance on Section 4(a)(6) of the Act.<sup>33</sup>

Intermediaries must receive positive affirmation from each investor that the investor has reviewed and understood the materials.<sup>34</sup> The SEC declined to provide intermediaries with a template or model questionnaire to be used to obtain the requisite affirmation.<sup>35</sup> Instead, the proposed rules would allow each intermediary to design its own process that is suited to its particular business model, requiring only that the process be reasonably designed to demonstrate receipt and understanding of the information.<sup>36</sup> Whatever process the intermediary undertakes, the affirmation from the investor must be received each time an investment is made.<sup>37</sup> Therefore, an investor who makes several investments through the same intermediary would be required to provide affirmation of his or her understanding for each of the investments made.

1. What educational materials must an intermediary provide to investors?

The proposed rules identify the minimum contents that intermediaries are required to provide in the educational materials. Those contents include: the process for investing via the intermediary’s platform; the risks associated with crowdfunding in general and the need for an investor to consider whether investing in crowdfunding securities is appropriate for him or her; the restrictions on resale of a security purchased; and the type of information that an issuer is required to deliver annually, which must include a notice that the investor may not be provided such information in

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state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .”).

30. Crowdfunding, 78 Fed. Reg. at 66,556–57.

31. *Id.*

32. *Id.* at 66,557.

33. *Id.*

34. *Id.*

35. *See* Crowdfunding, 78 Fed. Reg. at 66,471.

36. *Id.*

37. *Id.* at 66,557.

the future.<sup>38</sup> Additionally, intermediaries must provide investors with information regarding the limitations on the amounts an investor may invest,<sup>39</sup> and the circumstances under which an investor may cancel an investment commitment and any limitations of that right.<sup>40</sup>

The proposed rules would also require intermediaries to provide information regarding the types of securities that may be offered on the intermediary's platform and the risks associated with each type of security.<sup>41</sup> Intermediaries should take care to provide adequate information for every security it sells, because an intermediary may be deemed to have breached its duty to provide all appropriate educational materials if an issuer sells a security product not previously explained in the materials provided to an investor.<sup>42</sup> Securities professionals can imagine scenarios in which the failure to provide educational materials on a particular type of security purchased by a disgruntled investor could lead to legal action under the securities fraud rules, or could result in the loss of the exemption from registration.<sup>43</sup> More likely, the intermediary would face sanction by the SEC for not complying with its obligations to conduct offerings under Section 4(a)(6).<sup>44</sup>

#### D. *Intermediaries Have an Affirmative Obligation to Take Measures to Reduce the Risk of Fraud*

In order to protect investors, intermediaries have a statutory obligation further elaborated in the proposed rules to take measures to reduce the risk of fraud for purchasers of crowdfunding securities.<sup>45</sup> Intermediaries must have a "reasonable basis" for believing that the issuer has met the disclosure and process requirements of Section 4A(b) of the Securities

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38. *Id.* at 66,556–57.

39. *Id.* at 66,557; *see also id.* at 66,551 (limiting investors with an annual income and net worth of \$100,000 or less to five percent of the higher of their annual income or net worth and investors with an income and net worth of greater than \$100,000 to ten percent).

40. *Id.* at 66,557.

41. *Id.*

42. If the issuer did not know about the failure of the intermediary to provide updated educational materials, the issuer may not lose the benefits of the crowdfunding exemption. *See id.* at 66,562. The intermediary may face sanctions by the SEC and/or FINRA.

43. For instance, if the intermediary does not explain the mechanics of a convertible note, a purchaser of a convertible note may bring a securities fraud claim under the premise that the omitted information was necessary to prevent other information provided from being misleading. This would be a spurious claim except for the fact that the proposed rules require such information to be provided, and the proposed rules are designed with the assumption that all the investors are unsophisticated and easily misled by insufficient disclosure.

44. The SEC has authority to pursue civil claims for any violation of any provision of the Securities Act of 1933 or the Securities Exchange Act of 1934. Securities Act of 1933 § 20, 15 U.S.C. § 77t (2012); Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u (2012).

45. *See* Crowdfunding, 78 Fed. Reg. at 66,556.



Act.<sup>46</sup> As proposed, an intermediary may satisfy this requirement by relying on nothing more than the issuer's representation that it is in compliance with its disclosure and process requirements under the Act, unless the intermediary has reason to question the reliability of the representations.<sup>47</sup>

The proposed rules adopt a similar approach to the requirement that intermediaries have a "reasonable basis" for believing that the issuer has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary's platform.<sup>48</sup> Again, despite the apparent intent to reduce the risk of fraud, the proposed rules would allow an intermediary to satisfy this requirement by relying merely on the representation by the issuer that it has established such a means of record keeping.<sup>49</sup>

Intermediaries that rely solely on issuer representations may be accepting a greater amount of risk than that for which they are prepared. If the issuer fails to meet the disclosure and process requirements of Section 4A(b) of the Securities Act, the offering would not qualify for the Section 4(a)(6) exemption from registration under the Securities Act. If the offering proceeds without qualifying for the exemption, the issuer will have violated the registration requirements of Section 5 of the Securities Act.<sup>50</sup> Any person who purchases a security of the issuer in the offering that does not meet the requirements of the exemption will have the right to rescission of the transaction, plus interest.<sup>51</sup> This remedy can be severe for an early-stage company because the resulting sudden loss of capital. Additional liability may attach to the intermediary for allowing an offering to go forward that is not in compliance with the conditions of the exemption from registration.<sup>52</sup> Given the severity of the consequences, it is perplexing that the proposed rules would allow the intermediary to merely accept the representations of issuers that they have complied with the requirements of the exemption from registration.<sup>53</sup>

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46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (2012).

51. Securities Act § 12(a), *id.* § 77l(a). In effect, this remedy grants investors an ongoing right to "put" the securities back to the issuer. If the investor is confident in the investment, the investor may not act. However, if the investor loses confidence, the investor may demand the return of the consideration plus interest.

52. Securities Exchange Act of 1934 § 15(a), 15 U.S.C. § 78o(a) (2012). For example, funding portals offering securities that do not qualify for crowdfunding under Section 4(a)(6) could expose the funding portal to penalties for acting as an unregistered securities broker. *Id.* Additionally, it is conceivable that plaintiffs may get creative in arguing that crowdfunding intermediaries are making the statement that the securities offered qualify for the Section 4(a)(6) exemption from registration, resulting in a misstatement of a material fact if that issuer does not qualify.

53. *See* Crowdfunding, 78 Fed. Reg. at 66,556.

In addition to the requirements that intermediaries have a reasonable basis for believing the issuer has met its requirements to offer securities under Section 4(a)(6), the proposed rules establish that an intermediary must deny an issuer's access to its platforms in two instances. First, an intermediary must deny access if it has a reasonable basis for believing that the issuer, the issuer's leadership, beneficial owners of twenty percent or more of the issuer's outstanding voting equity securities, or promoters of the offering (collectively, "covered persons"), is subject to the "Bad Actor" disqualification under proposed Rule 503.<sup>54</sup> To satisfy this requirement, the intermediary must conduct background and securities enforcement regulatory checks on the issuer and its covered persons.<sup>55</sup>

Second, an intermediary must deny access to an issuer or offering that it believes presents the potential for fraud or otherwise raises concerns regarding investor protection.<sup>56</sup> The SEC notes that when evaluating the

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54. *Id.* at 66,556.

55. *Id.* The SEC does not provide guidance on the content of the required background and securities enforcement regulatory checks besides the requirement to have a reasonable basis for believing that no disqualifying events have occurred. *See id.* Disqualifying events include: (1) Felony or misdemeanor conviction in connection with the purchase or sale of a security, involving the making of any false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities; (2) Order, judgment or decree of any court of competent jurisdiction that restrains or enjoins the covered person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of a security, involving the making of any false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities; (3) Final order of a state securities commission, state banking regulator, state insurance commission, federal banking regulator, the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that bars the covered person from association with any entity regulated by such commission, authority, agency, or officer; engaging in the business of securities, insurance or banking; engaging in savings association or credit union activities; or that constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct; (4) Order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Securities Exchange Act, or Section 203(e) or (f) of the Investment Advisers Act of 1940 that suspends or revokes the covered person's registration as a broker, dealer, municipal securities dealer or investment adviser; places limitations on the activities, functions or operations of the covered person; or bars the covered person from being associated with any entity or participating in the offering of any penny stock; (5) Order of the SEC that orders the covered person to cease and desist from committing or causing a violation of or future violation of any scienter-based anti-fraud provision of the federal securities laws; or Section 5 of the Securities Act; (6) Suspension or expulsion from membership in, or suspension or bar from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principals of trade; (7) Participation in any registration statement or Regulation A offering statements filed with the SEC that was the subject of a refusal order, stop order, or order suspending the Regulation A exemption; (8) United States Postal Service false representation order, or any temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations. *Id.* at 66,562–63.

56. *Id.* at 66,556.

belief that an issuer presents the potential for fraud, the intermediary would not be required to have a reasonable basis for its belief.<sup>57</sup> In this way, the SEC grants significant discretion to each intermediary to screen issuers and protect investors.<sup>58</sup> However, if the intermediary is unable to adequately assess the risk of fraud of the issuer—e.g., if results from background or securities regulatory history checks are not available to the intermediary—then the intermediary must deny the issuer access to the platform.<sup>59</sup> If the intermediary becomes aware of the potential for fraud only after granting an issuer access to its platforms, any associated offerings must be canceled and any funds that have been committed by investors must be returned.<sup>60</sup>

### III. LIMITATIONS ON TRADITIONAL BROKER-DEALER ACTIVITY WHEN BROKERS CONDUCT SECTION 4(A)(6) OFFERINGS

The proposed rules place several restrictions and obligations on traditional broker-dealer activities when they act as an intermediary in a securities offering conducted under Section 4(a)(6). The restrictions and obligations include prohibiting broker-dealers from engaging in activities they are permitted to do when acting as an intermediary in other securities offerings, positive requirements in regards to their relationship with investors, and strict regulations on broker-dealer conduct during a Section 4(a)(6) offering. In many cases, it appears the SEC has built upon the rules and guidelines established by FINRA.

#### A. *Prohibitions on Certain Broker-Dealer Activities*

The first prohibition on broker-dealer activity is a subtle one, perhaps easily missed. Because all Section 4(a)(6) offerings must be conducted via a “platform,”<sup>61</sup> and platforms are exclusively “Internet Web sites or other similar electronic medium,”<sup>62</sup> broker-dealers without a web presence are forbidden from intermediating a Section 4(a)(6) offering. While this ultimately may not matter given the ubiquity and relative ease of creating such a platform, nonetheless this does represent a unique limit on traditional broker-dealer activity, which typically can be carried out through any means of communication.

One of the more striking limitations is the prohibition on broker-dealers, as well as their officers, directors, or partners from having a financial interest in an issuer using the broker-dealer’s services, or receiving a financial interest as compensation for services provided.<sup>63</sup> This prohibition is

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57. Crowdfunding, 78 Fed. Reg. at 66,463.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 66,552.

62. *Id.*

63. Crowdfunding, 78 Fed. Reg. at 66,555–56.

significant in the context of early-stage companies that may not have the resources to compensate a broker-dealer. In such a situation, it is typical for a broker-dealer to receive warrants or carried interest in future profits of the securities issued. The statutory language of the JOBS Act did not include this prohibition. Instead, the statute only prohibited financial interests or financial interest as compensation by the officers, directors, partners and those similarly situated to the broker-dealer.<sup>64</sup> The SEC argues that the expansion of the prohibition is consistent with the purpose of the JOBS Act to prevent conflicts of interest that may arise when persons, or in this case entities, facilitating the crowdfunding raise have a financial stake in the outcome.<sup>65</sup> This position was opposed by some commentators who felt that, with proper safeguards, having the intermediary take a financial interest in the issuer may help align the intermediaries' interest with the rest of the investors.<sup>66</sup>

### B. Enhanced Regulation of Broker-Dealer Conduct

In addition to the unique prohibitions on otherwise allowed broker-dealer activity, the proposed Regulation Crowdfunding represents a considerable amount of SEC micromanagement of broker-dealer activity previously only governed by FINRA rules and guidance. These new, strict, and specific requirements touch on many aspects of the lifecycle of the Section 4(a)(6) raise, from customer sign-up to the completion of the investment.

#### 1. Issuer screening

Under traditional FINRA rules broker-dealers have a responsibility to exercise due diligence on potential issuers to prevent frauds.<sup>67</sup> In practice, this requirement is meant to protect the investor customers of the broker-dealer and falls under the suitability obligation.<sup>68</sup> Broker-dealers, when facilitating transactions of non-registered securities must conduct a reasonable investigation into: (1) the issuer and its management, (2) the business prospects of the issuer, (3) the assets held or to be acquired by the issuer, (4) the claims being made, and (5) the intended use of proceeds of the offering.<sup>69</sup> In the proposed rules, however, the SEC creates a positive obligation for broker-dealers to examine the issuer for the sake of ensuring the issuer itself is qualified to offer securities under Section 4(a)(6). Under the proposed rules, broker-dealers must have a reasonable basis to believe that the issuer has followed the requirements to comply with their

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64. JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315-16 (2012).

65. Crowdfunding, 78 Fed. Reg. at 66,461.

66. *See id.* at 66,460-61 & nn.340-41.

67. *See FINRA Manual*, FIN. INDUS. REG. AUTH. [hereinafter *FINRA Manual*], available at [http://finra.complinet.com/en/display/display\\_viewall.html?rbid=2403&element\\_id=607](http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=607) (last visited Feb. 1, 2014) (Rules 2010, 2020, 2111, and 2310).

68. *Id.* (Rule 2111).

69. *See id.*

obligations under Section 4(a)(6),<sup>70</sup> and established means to keep accurate records of the holder of the securities that would be offered for sale through the platform.<sup>71</sup> This required investigation into the issuer's business practices and capabilities is unique to Section 4(a)(6) offerings.

## 2. Knowing and educating the customer

In its proposed rules, the SEC is also seeking to regulate the relationship between broker-dealers and investors to a much greater degree than in other types of securities offerings. The proposed rules appear to envision broker-dealers encountering novice investors without prior experience with securities intermediaries.<sup>72</sup> Previously, established broker-dealers have faced FINRA requirements to know their customers and have a reasonable basis to believe that recommended securities are suitable for the customer.<sup>73</sup> Broker-dealers participating in Section 4(a)(6) offerings must go beyond merely knowing the customer and additionally must educate the customer. This new standard creates additional responsibilities and burdens that could become a point of contention between broker-dealers and unsatisfied clients.<sup>74</sup>

Under the proposed rules, broker-dealers are required to provide investors with current and accurate educational materials at the time investors create their account, the contents of which are spelled out in far greater detail<sup>75</sup> than is applicable for other types of offerings,<sup>76</sup> and they must notify their customers if there is a material change in the information provided.<sup>77</sup> Broker-dealers must also disclose to customers at the time they sign up the manner in which the broker-dealers are compensated for the sale of securities,<sup>78</sup> and promoters for issuers must disclose their promotional activities.<sup>79</sup> The proposed rules would require investors to represent that they have reviewed and understood all of the provided information prior to making any investment commitment, adding to the recordkeeping requirements for established broker-dealers.

Recordkeeping on customers in Section 4(a)(6) transactions goes beyond passive data collection and storage. While broker-dealers in other contexts have a requirement to know their customer<sup>80</sup> and act accord-

70. Crowdfunding, 78 Fed. Reg. at 66,556.

71. *Id.*

72. It is unclear how the proposed customer signup rules will apply to broker-dealers offering securities under Section 4(a)(6) to investors who have been customers of the broker-dealer prior to the effectiveness of the crowdfunding regulations.

73. See *FINRA Manual*, *supra* note 66 (Rule 21111).

74. See *supra* Part II.C.

75. Crowdfunding, 78 Fed. Reg. at 66,556.

76. See *FINRA Manual*, *supra* note 66 (Rule 2267).

77. Crowdfunding, 78 Fed. Reg. at 66,556.

78. *Id.* at 66,557.

79. *Id.*

80. See *FINRA Manual*, *supra* note 67 (Rules 2090, 2111).

ingly,<sup>81</sup> broker-dealers generally accept their customers as they find them. In the proposed rules, the SEC is expecting the broker-dealer to take active steps to both monitor investors' investment activity to ensure they have not exceeded their limit and take proactive steps to educate investors.<sup>82</sup> The proposed rules place the responsibility for ensuring that individual investors have not exceeded their yearly investing limits in Section 4(a)(6) securities on broker-dealers by requiring that they have a reasonable basis for believing that the investor is within his or her limit.<sup>83</sup> While the broker-dealer is allowed to rely on the investor's representations that they have not exceeded their limit, the broker-dealer must have a reasonable basis for that reliance.<sup>84</sup> For instance, if the investor has exceeded his or her annual limit just with the broker-dealer in question, relying on an investor's representation that the investor has not exceeded the limit will not be reasonable.

### 3. Facilitating the offering

After the broker-dealer has complied with the requirements for onboarding issuers and potential investors, it must be certain it performs the necessary actions to facilitate the raise, many of which are unique to Section 4(a)(6). The proposed rules include specific directives regarding information that must be provided to investors, communications between investors, and communications between investors and the broker-dealer.

Broker-dealers are responsible for providing both the SEC and potential investors in a given issue the information required to be provided by that issuer under proposed Rules 201 and 203(a).<sup>85</sup> This information must be provided to the public on the intermediary's platform for a minimum of 21 days before closing.<sup>86</sup> The SEC further proposes that the information be provided in a way that allows it to be downloaded and stored, and access to the information cannot be conditioned on having an account with the broker-dealer.<sup>87</sup> The requirement to provide a prescribed set of information to the general public and file it with the SEC is justified by the SEC as a way to ensure that the SEC, FINRA, state regulators, and other interested entities get access to information necessary without any undue impediment.<sup>88</sup> Additionally, the availability of the information, according to the SEC, should ensure that investors have adequate opportunity to evaluate the investment opportunity.<sup>89</sup> As a result, the broker-dealer in a

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81. *Id.* (Rule 2090).

82. Crowdfunding, 78 Fed. Reg. at 66,557.

83. *See id.*; JOBS Act, Pub. L. No. 112-106, § 302(a)(6)(B), 126 Stat. 306, 315 (2012).

84. Crowdfunding, 78 Fed. Reg. at 66,557.

85. *Id.*

86. *Id.*

87. *Id.*

88. *See id.* at 66,469.

89. *Id.*

Section 4(a)(6) offering will not have any control over the dissemination of offering materials and will be unable to effectively require confidentiality agreements by prospective investors if the offering materials contain sensitive information.<sup>90</sup>

The proposed rules also require the broker-dealers to create online platforms and communication channels for its account holders to communicate, both with the issuer and each other.<sup>91</sup> These communication channels must be visible to the public as well, but commenting is restricted to people who have created accounts with the broker-dealer.<sup>92</sup> This requirement that broker-dealers facilitate a public conversation is not found in the JOBS Act; rather the SEC proposed this requirement because it believes that it would provide a central and transparent way for interested parties to discuss the offering and a single place to get all information about an offering.<sup>93</sup>

Under the proposed rules broker-dealers who choose to participate in Section 4(a)(6) offerings will find themselves somewhat limited in their business practices and compelled to take a much more active role guiding potential investors through the investment crowdfunding process. They will be required to provide additional and more specific information to the public than previously required, and will need to create technological capability to facilitate discussion regarding an issuance that is viable by the general public. It remains to be seen whether broker-dealers will consider the loss of business flexibility and additional effort and expense to be worth participating in the crowdfunding space.

#### IV. OBLIGATIONS AND LIMITATIONS OF FUNDING PORTALS IN THE COURSE OF A SECURITIES OFFERING

As stated above, the Section 4(a)(6) exemption from registration under the Securities Act requires that all crowdfunding offerings be conducted through a broker or funding portal.<sup>94</sup> Funding portals, but for the exemption from registration set out in the JOBS Act, would be required to fully register with the SEC as brokers.<sup>95</sup> In exchange for receiving reduced registration requirements, funding portals are strictly limited in their activities.

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90. There is a great deal of information that issuers are not required to disclose under the proposed rules that would be important to the average investor—material contracts, intellectual property, etc.—but that issuers might view as confidential and not want to disclose publicly. If the issuer provides this sensitive information in the offering materials, intermediaries would not be able to restrict access to only those investors that have signed confidentiality agreements.

91. Crowdfunding, 78 Fed. Reg. at 66,557.

92. *Id.*

93. *Id.* at 66,471-72.

94. Securities Act of 1933 § 4A(a)(6)(c), 15 U.S.C. § 77d-1(a)(6)(c) (2012) (as amended by section 302(b) of the JOBS Act).

95. Crowdfunding, 78 Fed. Reg. at 66,483.

A. *Funding Portals are Limited Purpose Brokers That May Only Deal in Section 4(a)(6) Securities*

Congress directed the SEC to create a new type of regulated entity called a funding portal.<sup>96</sup> According to the JOBS Act, a funding portal is defined as any person acting as an intermediary in a transaction involving the sale of securities for the account of others, solely pursuant to the crowdfunding exemption of Section 4(a)(6) of the Securities Act.<sup>97</sup> The SEC notes that the required activities of funding portals bring funding portals within the definition of “broker” under the Exchange Act.<sup>98</sup> Such activities include effecting transactions in securities for the account of others by ensuring that investors comply with the conditions of Section 4(a)(6), making the securities available for purchase through the funding portal, and ensuring the proper transfer of funds and securities.<sup>99</sup> In the proposed rules, the SEC emphasized its position that funding portals are, in-fact, limited purpose brokers by substituting the word “broker” for the word “person” in the definition.<sup>100</sup>

1. Other activities of funding portals that would not result in the loss of funding portal status

While funding portals are limited purpose brokers, the limitations placed on them are similar to the limitations on securities “bulletin boards” that avoid SEC registration as brokers. In order to avoid triggering the registration requirements for brokers, a bulletin board may post the availability of securities for purchase so long as it does not:

- (1) provide advice about the merits of particular opportunities and ventures;
- (2) receive compensation from [listing companies] other than nominal, flat fees to cover administrative costs and that such fees will not be made contingent upon the outcome or completion of any securities transaction resulting from a listing on the [bulletin board];
- (3) participate in any negotiations between investors and listing companies;
- (4) directly assist investors or listing companies with the completion of any transaction, for example, through the provision of closing documentation or paid referrals to attorneys or other pro-

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96. JOBS Act, Pub. L. No. 112-106, § 304(a)(2), 126 Stat. 306, 322 (2012).

97. Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80) (2012).

98. Crowdfunding, 78 Fed. Reg. at 66,483.

99. *Id.* at 66,483–84. Proposed Rule 402(a) sets out specific prohibitions for funding portals. Funding portals may not:

Offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on its platform or portal; compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal; hold, manage, possess, or otherwise handle investor funds or securities; or engage in such other activities as the Commission, by rule, determines appropriate.

*Id.* at 66,560.

100. *Id.* at 66,556 (“Funding portal means a broker acting as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) . . . .”) (internal quotation marks omitted).



professionals; (5) handle funds or securities involved in completing transactions; or (6) hold themselves out as providing any securities-related service other than a listing or matching service.<sup>101</sup>

None of the activities allowed for bulletin boards are prohibited by the funding portal rules. As a result, a registered funding portal offering crowdfunding securities under Section 4(a)(6) could also operate a parallel bulletin board for securities offerings other than Section 4(a)(6) offerings, so long as the funding portal clearly delineates which activities are which and informs investors that the funding portal does not provide any service other than a listing service on the bulletin board.

Likewise, a registered funding portal may also exist as a donation and rewards-based crowdfunding platform.<sup>102</sup> The basic rationale is that donation and rewards crowdfunding does not involve the offer and sale of securities,<sup>103</sup> and as such does not require compliance with state and federal securities laws. None of the activities of donation and reward crowdfunding run afoul of the restrictions placed on registered funding portals.

#### *B. Funding Portals Limited to Objective Criteria to Determine Whether to Accept Issuers*

Funding portals are further limited by the statutory language of the JOBS Act in regard to the methods by which they choose to accept or deny issuers that want to list on the funding portal. The SEC informs funding portals in the proposed rules that they are not allowed to “curate” offerings based upon anything but objective criteria.<sup>104</sup> This limitation stems from the statutory prohibition on offering investment advice or recommendations.<sup>105</sup> The curation of companies offering securities to create

101. Angel Capital Electronic Network (“ACE Net”), SEC No-Action Letter, 1996 WL 636094, at \*1 (Oct. 25, 1996). *See also* IPOnet, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996); Progressive Technology, Inc., SEC No-Action Letter, 2000 WL 1508655 (Oct. 11, 2000). Because funding portals and bulletin boards are similarly prohibited from providing investment advice, the analysis for impermissible activities by non-registered bulletin boards may be informed by the SEC analysis of the proposed rules for funding portals. For example, any marketing that merely identifies the listed securities as “high-quality” could result in the loss of the exemption from registration as impermissible investment advice. *See infra* Part IV.B.

102. Indiegogo, a donation and rewards based crowdfunding platform, has indicated interest in entering the securities crowdfunding space. *See* JD Alois, *Indiegogo CEO Slava Rubin Talks Equity Crowdfunding*, CROWDFUND INSIDER (Dec. 4, 2013, 1:43 PM), <http://www.crowdfundinsider.com/2013/12/27708-indiegogo-ceo-slava-rubin-talks-equity-crowdfunding-video/>.

103. However, some pre-sales may fit the definition of a security in states that follow the “risk capital” definition. *See, e.g.*, WASH. REV. CODE § 21.20.005(17)(a) (2012) (“‘Security’ means any . . . investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture . . . .”).

104. Crowdfunding, 78 Fed. Reg. 66,428, 66,560 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 227).

105. Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80) (2012).

a funding portal of “high quality” or other sorts of passive endorsements is, in itself, prohibited investment advice.<sup>106</sup>

This requirement has interesting impacts on the criteria that funding portals may use to determine which companies issuing securities to list on its site. The SEC, cognizant of the significance of this limitation on the funding portal, has provided a safe harbor for funding portals, the ability to limit issuers on their sites by applying objective criteria.<sup>107</sup> Those criteria must be reasonably designed to result in a broad selection of issuers offering securities, and be applied consistently to all potential issuers so as not to recommend or implicitly endorse certain issuers or offerings.<sup>108</sup>

Funding portal promoters have been concerned about the requirement that they not curate offerings.<sup>109</sup> The concern stems from the belief that the proposed rules prohibit funding portals from restricting access to issuers that are not ready to raise capital or present risks unsuitable to investors. However, funding portals are able to deny access based upon these concerns. Proposed Rule 301(c) in fact requires intermediaries, including funding portals, to deny access to its platform if it believes the issuers offering raises concerns regarding investor protection.<sup>110</sup> While funding portals could deny access to its platform even without a reasonable basis for believing the issuer raises concerns regarding investor protection,<sup>111</sup> funding portals could qualify their beliefs by conducting a thorough due diligence process prior to the start of an offering. If that due diligence program is conducted on an objective, consistent basis, it is reasonable that such a due diligence program could serve as an assurance that the funding portal is offering high-quality companies that are ready to raise capital to its investors.<sup>112</sup>

### C. Determination that the Issuer has Complied with its Obligations

Issuers offering securities under Section 4(a)(6) face a number of conditions in order to qualify for the exemption from registration under Sec-

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106. See Crowdfunding, 78 Fed. Reg. at 66,486.

107. *Id.* at 66,560.

108. *Id.* at 66,486.

109. See *The JOBS Act at a Year and a Half: Assessing Progress and Unmet Opportunities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. 17 (2013) (prepared testimony of Sherwood Neiss, Crowdfund Capital Advisors, LLC).

110. Crowdfunding, 78 Fed. Reg. at 66,556 (the SEC has stated that funding portals do not need a reasonable basis for denying access on these grounds).

111. See *id.* at 66,463.

112. The SEC has previously indicated that satisfactorily completing objective, pre-offering due diligence as a condition on listing would likely not constitute investment advice. See Meeting with David Blass, Chief Counsel, Div. of Trading and Markets, Sec. & Exch. Comm'n, and other Commission staff, and Sara Hanks, Brian Knight, and Andrew Stephenson, CrowdCheck, Inc., in Washington, DC (Sept. 24, 2013) (notes on file with author).

tion 5 of the Securities Act.<sup>113</sup> These conditions, such as filing disclosures and offering materials with the SEC, not advertising the terms of the offering, and filing annual reports serve to reduce the risk of fraud present in a securities offering with limited disclosure requirements.<sup>114</sup> As the conditions are meant to limit fraud, it follows that the Section 4A(a)(5) requirement of the Securities Act, which compels intermediaries in a crowdfunding transaction to “take such measures as to reduce the risk of fraud,” requires that intermediaries confirm whether issuers have complied with their obligations. This compulsion on intermediaries stems from both the SEC and FINRA obligations to examine issuers.

### 1. SEC’s proposed “reasonable basis” requirement

Section 4A(a)(5) of the Securities Act requires that intermediaries must take such measures to reduce the risk of fraud in Section 4(a)(6) transactions.<sup>115</sup> The SEC understood this requirement as compelling intermediaries to be gatekeepers and only allow issuers to go forward if the intermediary has a “reasonable basis” for believing that the issuer seeking to offer securities has complied with the requirements of Section 4A(b) of the Securities Act.<sup>116</sup> Additionally, the proposed rules give certainty to funding portals that they may deny access to the portal if the issuer may present the potential for fraud or raises concerns about investor protection.<sup>117</sup> Keep in mind, securities fraud is a broader concept than traditional commercial fraud—omissions necessary to make existing statements not misleading may constitute securities fraud along with affirmative misrepresentations.<sup>118</sup> As such, a portal may reasonably deny access to the portal if it believes the issuer is not sufficiently disclosing information.

Interestingly, the proposed rules allow an intermediary to accept the representations of the issuer that it has satisfied its disclosure requirements and is eligible to issue securities under Section 4(a)(6).<sup>119</sup> While the SEC has likely included this method as a means for the intermediary to control costs, merely relying on the representation of the issuer is not a sufficient means for intermediaries to control the securities law liability that they may face in Section 4(a)(6) transactions due to the statutory assignment of liability on the intermediary for misleading statements and omissions. Section 4A(c)(3) expressly extends securities fraud liability to

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113. Securities Act of 1933 § 4A(b), 15 U.S.C. § 77d-1(b) (2012) (as amended by section 302(b) of the JOBS Act).

114. *Id.*

115. Securities Act § 4A(a)(5), *id.* § 77d-1(a)(5).

116. Crowdfunding, 78 Fed. Reg. at 66,556.

117. *Id.* at 66,489.

118. *See* Securities Act § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2)(A); *see also* Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2013).

119. Crowdfunding, 78 Fed. Reg. at 66,556. *See supra* Part II.D.

the intermediary for statements made by the issuer.<sup>120</sup> This section has strong interplay with the requirement that the intermediary have a reasonable basis for believing the issuer complies with Section 4A(b) of the Securities Act. If the issuer does not comply with Section 4A(b), then the issuer has failed to meet the conditions of Section 4(a)(6) for exemption from the registration requirements of Section 5 of the Securities Act.<sup>121</sup> However, liability does not end with the issuer violating Section 5 of the Securities Act. The issuer may have misstated material information in its offering materials in order to claim compliance with the exemption. In such a scenario, the intermediary will be liable to any purchasers of the securities for the misstatements of the issuer under the liability created by Section 4A(c)(3).

Due to their limited experience with compliance with state and federal securities laws, funding portals are more likely than brokers to unreasonably rely on the representations of issuers that they are in compliance with the requirements of Section 4A(b). As one commenter on the proposed rules noted, without minimum qualifications, licensing, or examinations, it is uncertain how much experience and judgment funding portals will have at their disposal to make appropriate calls on how best to take measures to reduce the risk of fraud.<sup>122</sup>

## 2. FINRA broker due diligence requirements apply to funding portals

Funding portals must adhere to another set of requirements from FINRA in regards to investigating issuers that approach their platforms. FINRA has proposed rules for funding portals that reflect the obligations FINRA broker members have when selling securities issued pursuant to an exemption for the private placement of securities. While the FINRA proposed rules are not nearly as extensive as those for broker-dealers, due to the limitations on solicitation and investment advice, funding portals will be subject to FINRA's rules relating to "commercial honor and just and equitable principles of trade"<sup>123</sup> and prohibitions on "manipulative and fraudulent devices."<sup>124</sup> In previous FINRA notices, the organization

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120. Securities Act § 4A(c)(3) ("the term 'issuer' includes . . . any person who offers or sells the security . . ."). Intermediaries are sellers of securities. *See Pinter v. Dahl*, 486 U.S. 622 (1988); *see also* Crowdfunding, 78 Fed. Reg. at 66,499.

121. The fundamental principle of the Securities Act is that any offer or sale of securities must be registered or exempt from registration. Section 4(a)(6) creates such an exemption from registration, but the requirements of Section 4A(b) must be satisfied to qualify for the Section 4(a)(6) exemption. If there is no Section 4(a)(6) exemption, it is likely that the issuer has violated Section 5 of the Securities Act.

122. Letter from Vic Reichman to Elizabeth M. Murphy, Sec. & Exch. Comm'n (Dec. 2, 2013), *available at* <http://www.sec.gov/comments/s7-09-13/s70913-75.htm> (regarding File Number S7-09-13).

123. FINRA, Proposed Funding Portal Rules § 200(a) (2013) [hereinafter FINRA Proposed Rules], *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p369763.pdf>

124. *Id.* § 200(b).

has stated that a failure of a member to make a reasonable investigation into a security and the issuer's representations about the security can constitute a violation of these rules, as well as the SEC's rules against misleading statements.<sup>125</sup>

*D. Funding Portals Have a Limited but Important Role When Managing Communication Channels*

Intermediaries in a Section 4(a)(6) offering must establish communication channels by which prospective investors may communicate with the issuer and other prospective investors to evaluate the offering as a crowd.<sup>126</sup> For funding portals, the types of activities they may undertake with regard to communication channels is constrained by the limitations on funding portal activity, namely the prohibitions on soliciting investors or providing investment advice. So as to avoid situations where a funding portal may cross the line on proper activity, the SEC has proposed that funding portals be prohibited from participating in the communication channels it hosts, except for establishing guidelines and removing abusive or potentially fraudulent communications.<sup>127</sup>

However, enforcing the guidelines and removing abusive or potentially fraudulent communications may still trigger the prohibitions on investment advice. The SEC seems to focus on potentially fraudulent postings by individuals associated with the issuer.<sup>128</sup> Potentially fraudulent postings by the issuer or associated persons may take the form of hyping the offering and would generally be easier to enforce against using the guidelines. Thornier situations could arise in the case of persons not associated with the issuer that are critical of the offering. Such persons may be providing accurate information in an incendiary manner that goes against the communication channel guidelines. For example, one can imagine a holder of intellectual property, with a short fuse, fuming that the issuer is currently violating the holder's intellectual property rights. If the funding portal removes such information, could it be liable for providing investment advice by removing honest criticism?

*E. Funding portals must utilize third-parties to close an offering*

Funding portals are restricted to accepting investment commitments from potential investors for securities offering on the funding portal's platform.<sup>129</sup> They may not hold, manage, possess, or handle investor funds

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125. See FINRA REGULATORY NOTICE 10-22, OBLIGATION OF BROKER-DEALERS TO CONDUCT REASONABLE INVESTIGATIONS IN REGULATION D OFFERINGS (Apr. 2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf>.

126. Crowdfunding, 78 Fed. Reg. at 66,557.

127. See *id.*

128. See *id.* at 66,560.

129. See *id.* at 66,561.

and securities.<sup>130</sup> This statutory requirement is broad, and prompted the SEC to provide guidance through its safe harbor provision of the proposed rules.<sup>131</sup> Simply, any funding portal must rely on third-party entities that can accept investor funds and hold them in escrow until released, as well as handling the clearance and settlement of the securities. This requirement creates additional transaction costs for funding portals.

## V. LEGAL LIABILITY OF INTERMEDIARIES IN SECTION 4(A)(6) TRANSACTIONS

### A. *Intermediaries Have Primary Liability for Material Misstatements by the Issuer*

The statutory language of the JOBS Act expressly sets out the liability imposed on issuers for making false or misleading statements and omissions. Section 4A(c) provides that an issuer, including its officers and directors, will be liable to the purchaser of its securities in a transaction under Section 4(a)(6) if the issuer makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.<sup>132</sup> The company and its officers and directors bear the burden of proof with this respect to this liability: they must show that they did not know and, in the exercise of reasonable care, could not have known of the misleading statement or omission.<sup>133</sup>

However, intermediaries should be aware that the statute defines “issuer” as “any person who offers or sells the security in such offering.”<sup>134</sup> As noted by the SEC, under the requirements of Section 4(a)(6) transactions, intermediaries offer and sell securities.<sup>135</sup> As such, under this definition all intermediaries in Section 4(a)(6) transactions are primarily liable for the material misstatements and omissions of the issuers that list on their platforms.

The SEC appears comfortable extending primary liability to intermediaries in Section 4(a)(6) transaction because of the operating requirements already in effect for brokers and proposed for funding portals in the proposed rules. The SEC believes intermediaries are in a position to exercise reasonable care to eliminate materially false or misleading information.<sup>136</sup> In a requirement similar to that of brokers, proposed Rule 403(a), the SEC would require funding portals to implement policies and procedures reasonably designed to achieve compliance with the federal

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130. Securities Exchange Act of 1934 § 3(a)(80)(D), 15 U.S.C. § 78c(a)(80)(D) (2012); Crowdfunding, 78 Fed. Reg. at 66,556.

131. See Crowdfunding, 78 Fed. Reg. at 66,561.

132. Securities Act of 1933 § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2)(A) (2012).

133. *Id.* § 4A(c)(2)(B).

134. *Id.* § 4A(c)(3).

135. Crowdfunding, 78 Fed. Reg. at 66,499.

136. *Id.* at 66,531.

securities laws.<sup>137</sup> Such policies and procedures could include due diligence beyond conducting background checks by verifying the statements made by an issuer prior to posting the issuer's offering materials to the intermediary's platform. While this type of due diligence would go beyond the affirmative requirements for intermediaries set out in proposed Rule 301(a),<sup>138</sup> the intermediary would be accepting a significant amount of business risk by not conducting such due diligence on each issuer.

It is important to note that Section 4A(c) adds liability to an area of securities law that is already subject to extensive liability at both the federal and state levels. Intermediaries face potential liability for violations of other anti-fraud rules and statutes of previously existing securities law. For instance, intermediaries would continue to face potential liability for manipulative or deceptive practices or misleading statements that they have ultimate control of under Exchange Act Rule 10b-5.<sup>139</sup> Also, as entities that "willfully participate[ ]" in an offering, intermediaries would be liable for the false or misleading statements by the issuer made to induce a securities transaction under Section 9(a)(4) of the Exchange Act.<sup>140</sup> Additionally, many state anti-fraud rules subject intermediaries to liability for aiding and abetting securities law violations of issuers.<sup>141</sup>

#### B. *FINRA Obligations Faced by Brokers and Funding Portals*

In addition to SEC liability for securities law violations, FINRA imposes liability on funding portals and broker-dealers that violate the FINRA rules of conduct. Under FINRA Rules 2010, 2020, and proposed funding portal Rule 200, brokers and funding portals are required to observe high standards of commercial honor and must avoid engaging in manipulative, deceptive, or other fraudulent devices.<sup>142</sup> Additionally, proposed funding portal Rule 200 prohibits a funding portal from including on its website information from an issuer that the portal knows or has reason to know contains any untrue or misleading statement.<sup>143</sup>

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137. *Id.* at 66,561.

138. *See supra* Part II.D.

139. Exchange Act Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (2013); *see also* Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011).

140. Securities Exchange Act of 1934 §§ 9(a)(4), 9(f), 15 U.S.C. §§ 78i(a)(4), (f); *see* Roger Wiegley, *New Liability Exposure for Intermediaries in Private Placements*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Aug. 21, 2011, 9:40 AM), <http://blogs.law.harvard.edu/corpgov/2011/08/21/new-liability-exposure-for-intermediaries-in-private-placements/>.

141. *See, e.g.*, Jennifer Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, 36 DEL. J. OF CORP. L. 465 (2011).

142. *FINRA Manual*, *supra* note 67 (Rules 2010, 2020); *FINRA Proposed Rules*, *supra* note 121, §§ 200(a)-(b).

143. *FINRA Proposed Rules*, *supra* note 123, § 200(c)(3).

## VI. GOING FORWARD

A. *Predictions on What the SEC Will Do*

In many respects, the proposed rules issued by the SEC are rather conservative and do not stray far from the original requirements of the statute, even where the SEC was given latitude to modify requirements. For instance, the proposed rules do not amend the dollar categories for required financial statements,<sup>144</sup> and individual investor funding limitations.<sup>145</sup> Even the disclosures requirement of Form C does not expand significantly upon the the statutory requirements.<sup>146</sup> Funding portals should not expect the SEC to reduce the compliance requirements of the proposed rules. As financial intermediaries, funding portals will be faced with the requirements that accompany that status, including recordkeeping,<sup>147</sup> protecting customer privacy,<sup>148</sup> and compliance with anti-money laundering rules.<sup>149</sup> In order to protect investors and to prevent unscrupulous actors from participating in Section 4(a)(6) offerings as funding portals, the SEC will likely maintain those requirements.

B. *Unanswered Questions and Considerations for Issuers and Intermediaries*

The proposed rules for Regulation Crowdfunding were eagerly anticipated by presumptive market participants, but even if adopted as is there would remain several areas of ambiguity that could impact the likelihood of Section 4(a)(6) offerings going forward.

## 1. Will anybody enter the space strictly as a funding portal?

One of the JOBS Acts most significant innovations is the creation of a new type of regulated entity—the funding portal.<sup>150</sup> However, it remains unknown whether the new entity will thrive in the new market, or whether the traditional broker-dealer will remain the dominant player. While funding portals may ultimately have a lower regulatory barrier to entry, and can charge success fees and transaction-based compensation like traditional broker-dealers,<sup>151</sup> they lack the ability to undertake many of the activities broker-dealers use to attract investors, such as the ability to

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144. Compare Securities Act of 1933 § 4A(b)(1)(D), 15 U.S.C. § 77d-1(b)(1)(D) (2012), with Crowdfunding, 78 Fed. Reg. 66,428, 66,553 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 227).

145. Compare Securities Act § 4(a)(6)(B), with Crowdfunding, 78 Fed. Reg. at 66,551.

146. Compare Securities Act § 4A(b)(1), with Crowdfunding, 78 Fed. Reg. at 66,552.

147. Crowdfunding, 78 Fed. Reg. at 66,561.

148. *Id.*

149. *Id.*; Financial Crimes Enforcement Network, 31 C.F.R. Chapter X (2013) (Part 1023 establishes the rules for brokers or dealers in securities that would apply to funding portals as well).

150. See JOBS Act, Pub. L. No. 112-106, § 304(a)(1), 126 Stat. 306, 321 (2012).

151. Crowdfunding, 78 Fed. Reg. at 66,458 (Brokers and Funding Portals).



advertise companies directly to investors by name. They are also unable to augment Section 4(a)(6) raises with other potentially larger and more lucrative types of offerings (e.g., offerings under Rule 506(c) of Regulation D<sup>152</sup>), denying them the ability to completely service companies seeking to do a Section 4(a)(6) offering as a “side-car” to a larger raise and amortize their compliance costs across raises. These limitations on the revenue streams for funding portals would seem to limit their profitability relative to broker-dealers, placing them at a disadvantage.

Another challenge facing all platforms seeking to intermediate Section 4(a)(6) raises, but likely to be felt most acutely by funding portals, is the lack of clarity regarding certain intermediary requirements. We assume funding portals will feel this most acutely because their principals are likely to be less experienced and therefore more likely to misjudge the somewhat nebulous “reasonable basis” standard intermediaries must meet for determining whether an issuer poses a threat of fraud or has sufficient capability to keep track of their shareholders. While broker-dealers are presumably both more experienced on these issues and have the potential for greater revenue from other means of offerings to use to address compliance issues, funding portals may find themselves having to meet the same regulatory burdens with fewer resources. Improved guidance on how a platform may meet its obligations could limit the advantage enjoyed by broker-dealers.

Given this environment, it is questionable whether for-profit businesses will enter the market as pure funding portals, instead preferring to become or partner with a broker-dealer, leaving the funding portal entity viable for only non-profits and other entities less concerned with financial return.

## 2. Will any company want to take on the disclosure and reporting requirements?

Another outstanding question is whether companies seeking investment will utilize Section 4(a)(6), given the significant disclosure and reporting requirements, which are both considerable and vague. For example, the proposed rules require that issuers provide to the public and SEC, via EDGAR, certain information related to the raise.<sup>153</sup> However, it is unclear whether the information required to be provided to the SEC includes all of the offering materials of the issuer provided to the platform or only the select list specified by the regulation. While the SEC will hopefully clarify what it expects issuers to provide, the current uncertainty may limit issuers’ willingness to risk either unnecessarily over-disclosing or failing to provide all required information.

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152. 17 C.F.R. § 230.506 (2013).

153. See Crowdfunding, 78 Fed. Reg. at 66,552–55.

Likewise, the ongoing reporting requirements proposed in the JOBS Act<sup>154</sup> and the proposed rules<sup>155</sup> present a question for the viability of securities crowdfunding. Will companies accept the ongoing, and potentially significant, costs to comply with disclosure requirements for what are ultimately fairly modest sums of money? In particular, the proposed requirement that a company that raises over \$500,000 undergo a yearly audit until the securities are retired or repurchased<sup>156</sup> could render Section 4(a)(6) offerings too inefficient for all but the most desperate of companies. However, the ongoing audit requirement is not required by the JOBS Act and may be modified in the final rule, so ultimately this may not be an issue.

### 3. Will any investors show up?

Of course, no matter how good Section 4(a)(6) may be for issuers on paper, if investors do not take an interest, the issue (in both senses of the word) is moot. For investors the primary concern is likely to be the quality of the companies seeking to raise money and whether investors feel they can avoid being fleeced and get the return they are looking for (be it financial or simply psychological). Of course, the best way investors can assess whether an issuer presents such an opportunity is through good quality disclosure. While market competition and intermediaries should improve disclosure similar to what investors have demanded in other unregistered securities offerings, the regulatory environment is also likely to play a role. Fulsome disclosure obligations and clarity as to the scope of those obligations should help investors set their expectations, know what information to look for, and detect red flags. It will also help issuers and intermediaries structure their disclosure and offering materials to be as effective as possible at attracting investors while complying with the law.

## VII. CONCLUSION

The proposed rules for securities crowdfunding elaborate upon the statutory requirements for intermediaries conducting Section 4(a)(6) offerings. Section 4(a)(6) presented a challenge to the SEC because the general intent was to create a new, less expensive means to raise capital under federal securities law. However, that new structure must still fit within existing law and meet the requirements that are imposed on any registered financial intermediary. While the proposed rules have their share of discontents, in many cases the areas of consternation were compelled by the statute, which limited the SEC's ability to change them. The overarching securities law of the United States places certain obligations on intermediaries, including those participating in crowdfunding. Accepting this burden is the condition of being allowed to join the game in the first place.

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154. JOBS Act § 302(b)(4).

155. Crowdfunding, 78 Fed. Reg. at 66,554.

156. *Id.* at 66,486.

