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Challenges to Crowdfunding Offering Disclosures: What Grade Will Your Offering Disclosure Get?

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Challenges to Crowdfunding Offering Disclosures: What Grade Will Your Offering Disclosure Get?

ABSTRACT

Crowdfunding is a term used in many different contexts. The conversation surrounding crowdfunding encompasses diverse considerations and interests. In its broadest sense, crowdfunding is a technological fundraising medium for businesses, projects, or charitable causes. Instead of dealing with a financial institution or specific angel investors or venture capital funds, crowdfunded start-ups try to raise money from a worldwide "crowd." Some crowdfunding campaigns solicit donations and pre-orders, such as Kickstarter or Gofundme. Others sell securities. This Comment will only address the rules that apply to crowdfunding campaigns which offer securities.

Securities laws have two prime directives. First, companies can only offer and sell securities in a registered offering or in an offering that satisfies the requirements of an exemption from registration. Second, these businesses must not misstate material facts or omit material facts if the omission would make its other disclosures misleading to investors.

Primarily, the JOBS Act and other crowdfunding laws focus on the first prime directive. They create exemptions from registration that allow businesses to crowdfund, utilize general solicitation and, in some cases, offer and sell securities to non-accredited investors. These new exemptions present exciting and important changes that democratize the capital raising process by allowing new subsets of businesses to communicate with a broader investor base than ever before.

This Comment will briefly discuss these updated exemptions with a particular focus on Title II of the JOBS Act and the related SEC Rule 506(c), as well as Title IV of the JOBS Act and what some call Regulation A+. Both Rule 506 (c) and Regulation A+ are revolutionary because they change who may talk to investors and the technologies that may be used to reach them. The primary focus of this Comment is to discuss these securities laws' requirements for disclosures to investors in light of the

brave new world crowdfunding offers. On their face, the updated exemptions change very little about what issuers must say to investors. The disclosure challenges posed by the updated exemptions affect new issuers who have little prior disclosure experience and may have very low compliance budgets. These challenges require such new issuers to comply with traditional securities disclosure rules when they are talking to a less sophisticated crowd of investors than ever before utilizing new technological platforms that are constantly evolving. This Comment discusses how and why an issuer taking advantage of these updated exemptions might inadvertently violate securities disclosure laws when the speaker changes, the audience changes, or the disclosure platform changes, and how to avoid potential traps these changes create when paired with newly available disclosure platforms.

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INTRODUCTION

“We have only started on our development of our country—we have not as yet, with all our talk of wonderful progress, done more than scratch the surface.”¹

Innovation is not new. Technological, business, and legal innovations were as much a part of the first decades of America in the twentieth century as of the first decades of twenty-first century America. Based on the lessons learned from past innovation, we know it is highly likely that innovation will cause a chain reaction of changes, and that legal change usually lags behind changes in both technology and business. Further, when laws finally change, it causes even more technology and businesses change that require even more legal change. If we keep this interaction of technological, business, and legal innovation in mind as we analyze the state of the JOBS Act and the changes in securities laws, we will understand that the JOBS Act and SEC rules implementing the JOBS Act are merely the first steps in the race of securities laws to keep up with technological and business changes.

The turn of the twenty-first century has brought with it the advent of new technology, which has led to exponential growth of start-ups and emerging businesses. These businesses inevitably need operating capital. One would think that with such quick development of technology, the regulations governing the raising of capital and selling of securities would develop equally as fast. One would be wrong.

Until recently, emerging and growing businesses raised capital in private offerings under the traditionally restrictive principles of Regulation D.² These legal principles were created during the early 1980’s and were

1. HENRY FORD WITH SAMUEL CROWTHER, *MY LIFE AND WORK* 1 (The Floating Press 2009) (1922).

2. November 2011 saw the idea of easing SEC regulations for small businesses gain traction in Congress. A number of bills aimed at the topic were discussed, ultimately leading to the passage of the JOBS Act of 2012 on Mar. 27, 2012. See *Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011*, S. 1970, 112th Cong. (2011); *Access to Capital for Job Creators Act*, H.R. 2940, 112th Cong. (2011); *Entrepreneur Access to Capital Act*, H.R. 2930, 112th Cong. (2011); *Small Company Capital Formation Act of 2011*, H.R. 1070, 112th Cong. (2011); *Democratizing Access to Capital Act of 2011*, S. 1791, 112th Cong. (2011).

updated only in minor ways during the 1990's. Many changes have occurred in both technology and business since the SEC introduced Regulation D's primary principles: (1) businesses cannot make a general solicitation in a private offering;³ and (2) offers and sales are prohibited in private offerings to people who are not wealthy or sophisticated.⁴ These two well-meaning principles caused two major problems. First, it was difficult to raise capital when businesses could not tell investors they were selling securities.⁵ Second, institutional investors, venture capital funds, and a relatively small group of wealthy individuals obtained a virtual monopoly on buying securities in private offerings—even most accredited investors were unaware of most private offerings because of the prohibition against general solicitation. This monopoly lowered valuations of businesses raising capital and excluded both non-accredited investors and most accredited investors from buying securities before they increased in value after public offerings.

Titles II, III,⁶ and IV of the Jumpstart Our Business Startups (JOBS) Act of 2012⁷ and state crowdfunding laws redress the general solicitation

3. See SEC Rule 501, 17 C.F.R. § 230.501(a)(5)–(6) (2015) (defining accredited investors who are “natural person[s]” as those who have an individual or joint net worth of over \$1 million, or have made over \$200,000 per year, or \$300,000 per year along with their spouse).

4. Employing data from the 2013 Survey of Consumer Finances (SCF), a triannual survey conducted by the Federal Reserve, Rachita Gullapalli, a financial economist with the SEC's Division of Economic and Risk Analysis, estimates that only 3.5% of American households qualify as “accredited investors.” Rachita Gullapalli, *Accredited Investor Pool: Forum on Small Business Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION (Nov. 20, 2014), <http://www.sec.gov/info/smallbus/sbforum112014-gullapalli.pdf> [<https://perma.cc/6B3J-Y4G2>].

5. SEC Rule 502 provides that “general solicitation” of offers to buy securities includes, but is not limited to: “(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.” SEC Rule 502, 17 C.F.R. § 230.502(c) (2015). This is contrasted with product advertising or “factual business information” described in SEC Rule 169. See SEC Rule 169, 17 C.F.R. § 230.169(b)(1)(i)–(ii) (2015) (providing that factual business information includes “[f]actual information about the issuer, its business or financial developments, or other aspects of its business; and . . . [a]dvertisements of, or other information about, the issuers products or services”).

6. As this Comment was being finalized, the SEC's rules regarding equity crowdfunding under Title III of the JOBS Act became effective on May 16, 2016. Discussion of these rules will be for another article, but many of the disclosure strategies and best practices proposed by this Comment can be imported into offerings utilizing the new crowdfunding rules. The SEC has issued investor guidance bulletins on the new rules. See *Investor Bulletin: Crowdfunding for Investors*, U.S. SEC. & EXCHANGE COMMISSION,

problem.⁸ Titles II and IV of the JOBS Act and state crowdfunding regulations also redress the accredited investor problem.⁹ As discussed above, this Comment focuses on Title II of the JOBS Act and related SEC Rule 506(c) and Title IV of the JOBS Act and related SEC Regulation A+. Rule 506(c) did not make any changes to SEC disclosure requirements while Regulation A+ made only modest changes to disclosure requirements. Disclosure strategy is like any other issue; it is a mixture of law and facts. If the facts change, different decisions will be made about how the law applies. Important facts that affect how disclosure rules apply require crowd-funded businesses to consider: (1) who is communicating; (2) with whom they are communicating; and (3) how they are communicating.

This new regulation allows emerging businesses to take advantage of two tiers: Tier I and Tier II. Tier I allows for issuers to raise up to \$20 million during any twelve-month period, and Tier II allows for up to \$50 million to be raised during the same such period.¹⁰ Both tiers allow offers to unaccredited investors,¹¹ and issuers may “test the waters.”¹² Rule 506(k)(1) and Regulation A+ have wide-reaching effects: they open the world of private securities offerings to the general public, they allow issuers to raise capital from a wide reaching and previously-untapped market of unaccredited investors, and they permit use of any media sources available to sell securities.

https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html [<https://perma.cc/7AD8-LKAM>] (last visited May 17, 2016).

7. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

8. *Id.*

9. *Id.*

10. *Compare* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806, 21,895 (Apr. 20, 2015) (to be codified at 17 C.F.R. § 230.251) (creating Tier 1 (\$20 million) and Tier 2 (\$50 million) Regulation A+ exemptions), *with* Small Business Initiatives 57 Fed. Reg. 36,442, 36,468 (Aug. 13, 1992) (former Regulation A) (providing only \$5 million exemption in a twelve-month period).

11. *See* SEC Rule 251, 17 C.F.R. § 230.251(d) (2015) (outlining offering conditions for “natural persons” and others).

12. “Testing the waters” is a disclosure similar to a “general solicitation” of offers to buy securities. It involves an issuer filing SEC Form 1-A, which seeks the qualification of the offering statement. The issuer can “test the waters” by communicating with investors before and after filing the form. This “testing the waters” period is aimed at gauging market interest and projected investor response by garnering non-binding expressions of interest. Once the form is approved, the issuer may make sales of securities to contacted investors. *See* SEC Rule 255, 17 C.F.R. § 230.255 (2015) (describing Regulation A+ “Solicitations of interest and other communications”).

The greater fraud boundaries triggered in communications to investors have not changed in the new regulations,¹³ but the media and practices of soliciting and disclosing are in constant flux. As discussed above, because both rules permit general solicitations and Regulation A+ permits businesses to sell to non-accredited investors, issuers will be using new communications media to reach a much broader audience¹⁴ that will on average be less wealthy and less sophisticated than has traditionally been the case in unregistered offerings. In addition, the relatively low cost of modern media will enable many new issuers to conduct offerings.¹⁵

This major shift in the types of issuers, the audience of potential investors and the means of communication will undoubtedly pose many disclosure challenges at their intersection. Businesses must undertake greater efforts to help investors understand their investment to both drive future investment, as well as avoid misleading investors. Therefore, this Comment will discuss how to make disclosures in a general solicitation to both accredited and unaccredited investors. Part I summarizes the principal changes the JOBS Act made to exemptions from registration under the Securities Act of 1933 and summarizes key provisions of Regulation A+ and Rule 506(c). Part II discusses general disclosure principles that apply to exempt offerings, including Rule 506 (c) and Regulation A+ offerings. Finally, Part III discusses practical ways for issuers to minimize their liability risk and liability if they have limited disclosure compliance budgets, but still seek to utilize new technologies in making solicitations of offers and in making disclosures.

13. See *id.* (stating that “testing the waters” or “solicitation of interest” communications are “deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws”).

14. Facebook had 1.55 billion users in the third quarter of 2015. *Facebook: Number of Monthly Active Users Worldwide 2008–2015*, STATISTA, <http://www.statista.com/statistics/264810/number-of-monthly-active-facebook-users-worldwide/> [https://perma.cc/S4NJ-A2WD] (last visited May 9, 2016). Twitter had 307 million monthly active users in the third quarter of 2015. *Twitter: Number of Monthly Active Users Worldwide 2010-2015*, STATISTA, <http://www.statista.com/statistics/282087/number-of-monthly-active-twitter-users/> [https://perma.cc/T4DM-6XJH]. To put this into perspective, there are an estimated 323.50 million people in the United States, and 7.30 billion people on earth as of May 9, 2016. *U.S. and World Population Clock*, U.S. CENSUS BUREAU, <http://www.census.gov/popclock/> [https://perma.cc/KDB6-F7X8] (last visited May 9, 2016). There are roughly 2.93 billion internet users on earth, and 279.83 million in the United States. *The World Factbook*, CENT. INTELLIGENCE AGENCY, <https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html> [https://perma.cc/NPL3-TWV6] (last visited May 9, 2016). Roughly one in three people on earth uses the internet; one in five uses Facebook monthly, and one in twenty-four uses Twitter monthly.

15. See generally *supra* note 13.

I. NEW OPTIONS FOR SEC REGISTRATION EXEMPTIONS UNDER THE JOBS ACT OF 2012

The Securities Act of 1933, as amended (1933 Act) required all sales of securities to be either registered pursuant to section 5 of the 1933 Act or qualify for an exemption from registration.¹⁶ Exemptions from registration are listed in sections 3¹⁷ and 4¹⁸ of the 1933 Act. Exemptions from registration fall into three general categories: (1) exempt securities listed in section 3(a) of the 1933 Act, (2) exempt transactions listed under section 3(b) of the 1933 Act, and (3) exempt transactions listed under section 4 of the 1933 Act.¹⁹

The JOBS Act of 2012 provided updated avenues for businesses seeking SEC registration exemptions.²⁰ It did so by amending parts of sections 3 and 4 of the 1933 Act to either create new exemptions from registration or modify existing exemptions from registration as follows: (1) Title II of the JOBS Act directed the SEC to create a new Rule 506 (c) under section 4 of the 1933 Act; (2) Title III of the JOBS Act amended section 4 of the 1933 Act to add new section 4(6), which creates Federal crowdfunding; and (3) Title IV of the JOBS Act amended section 3 (b) of the 1933 Act to direct the SEC to greatly expand old Regulation A, which is known as Regulation A+.²¹

The first of these changes came in the form of SEC Rule 506(c), which became effective September 23, 2013, allowing issuers to raise unlimited amounts of capital using general solicitations, so long as all sales were made only to verified accredited investors.²² Second, Title III mandated federal crowdfunding offerings of up to \$1 million on highly regulated crowdfunding portals, for which the SEC issued proposed rules in July 2014.²³ Third, Title IV mandated new Regulation A+, which became effective June 20, 2015, and revitalized former Regulation A by allowing

16. Securities Act of 1933, Pub. L. No. 73-22, § 5, 48 Stat. 74, 77 (current version at 15 U.S.C. § 77e (2012)).

17. *Id.* § 3, 48 Stat. at 75 (current version at 15 U.S.C. § 77c (2012)).

18. *Id.* § 4, 48 Stat. at 77 (current version at 15 U.S.C. § 77d (2012)).

19. *Id.*

20. *See* Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

21. *Id.*

22. SEC Rule 506, 17 C.F.R. § 230.506 (2015).

23. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (amending 15 U.S.C. § 77d (2012)). The SEC adopted final rules on October 30, 2015 that went into force on May 16, 2016. Again, Title III rules were just becoming effective at the time of the finalization of this Comment, thus they are outside its scope. *See supra* note 6.

for two tiers of offerings up to \$50 million, the ability to generally solicit offers to buy securities, and the sales of securities to unaccredited investors. There are similar laws in approximately two dozen states that exempt intrastate investment crowdfunding offerings to both accredited and unaccredited investors, allow for general solicitation, and provide a limit of \$1 million to \$2 million per twelve-month period.²⁴

A. Title II-Mandated Rule 506 Exemptions

Rule 506 of Regulation D²⁵ is a “safe harbor” for the private offering exemption of section 4(a)(2) of the 1933 Act.²⁶ Companies relying upon Rule 506 exemption can raise an unlimited amount of money.²⁷ There are two distinct exemptions encompassed in Rule 506, under subsections (b) and (c) of the Rule.

i. Rule 506(b) Offerings

Subsection (b) offerings are not permitted to use general solicitation or advertising to market securities.²⁸ The issuer may, however, sell securities to an unlimited number of accredited investors, and up to thirty-five other

24. Such intrastate exemptions, although not the focus of this Comment, have some, though minimal, effect on the commercial landscape, due to the need for the States to comply with the so-called 80-80-80 rule of SEC Rule 147, 17 C.F.R. § 230.147 which mandates: (1) the issuer derive at least 80% of its and its subsidiaries’ gross revenues from the state; (2) the issuer have at least 80% of its and its subsidiaries’ assets located within the state; and (3) the issuer intend to use and use at least 80% of the net proceeds from sales made pursuant to the rule in connection with the operating of a business or the purchase of real property within the state. SEC Rule 147, 17 C.F.R. § 230.147 (2015). Needless to say, this restricts the benefit of such exemptions, and they are rarely used by businesses having a more than nominal interstate presence. For a frequently updated survey and summary of such intrastate exemptions, see *Intrastate Crowdfunding Directory*, N. AM. SEC. ADMIN. ASS’N, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/intrastate-crowdfunding-directory/> [<https://perma.cc/DD3Y-D6PC>] (last visited May 9, 2016). There are also state-level Blue Sky Laws requiring compliance. For discussion of such laws, James J. Cronin III, Comment, *Access to Capital: Rethinking Local Crowdfunding*, 38 CAMPBELL L. REV. 365 (2016).

25. SEC Rule 506, 17 C.F.R. § 230.506 (2015).

26. Securities Act of 1933, Pub. L. No. 73-22, § 3, 48 Stat. 74, 75 (codified at 15 U.S.C. § 77c (2012)).

27. *Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/rule506.htm> [<https://perma.cc/C6QY-FVMQ>] (last updated Oct. 6, 2014); see also *State v. Casper*, 297 S.W.3d 676, 686 (Tenn. 2009).

28. *Rule 506 of Regulation D*, *supra* note 27.

purchasers.²⁹ These thirty-five non-accredited investors must meet a “sophistication” requirement in order to qualify as purchasers.³⁰

Disclosures to accredited investors under subsection (b) are scrutinized less stringently, and must only comply with the anti-fraud prohibitions of federal securities laws.³¹ However, for non-accredited, “sophisticated” investors, the disclosures may be more stringently scrutinized as the issuer must show the investor had sufficient knowledge and expertise in financial and business matters.³² Non-accredited investors must also receive all disclosures accredited investors receive.³³ Companies must also be available to answer questions by prospective purchasers and provide financial statements³⁴ to a Rule 505³⁵ standard.³⁶

To better understand advertising and general solicitations, look to Rule 502(c) which is incorporated into Rule 506(b) offerings, but is not incorporated into Rule 506(c) offerings. “[N]either the issuer nor any person acting on its behalf shall offer or sell securities by any form of

29. *Id.*

30. *Id.* “Sophistication” means that the non-accredited investor, either alone, or combined with the expertise of her purchaser representative, has such knowledge and experience in financial and business matters that she is capable of evaluating the merits and risks of the prospective investment. SEC Rule 506, 17 C.F.R. § 230.506(b)(2)(ii) (2015). Such a subjective and mutable standard, placed upon the issuer, is not necessarily the clearest, which has led many platforms to focus upon either offering solely to accredited investors who are more objectively verifiable, or to opt for a Rule 506(c) offering. *See Mark v. FSC Sec. Corp.*, 870 F.2d 331, 336–37 (6th Cir. 1989) (placing the burden of proof on the issuer to subjectively verify that each individual non-accredited investor is sufficiently sophisticated).

31. SEC Rule 506, 17 C.F.R. § 230.506 (2015).

32. *Id.*

33. *Id.*

34. *See SEC v. Empire Dev. Grp., LLC*, No. 07-CV-03896, 2008 U.S. Dist. LEXIS 43509, at *24–26 (S.D.N.Y. May 30, 2008) (finding that the 506(b) issuer who failed to provide adequate financial statements to unaccredited investors did not qualify for Rule 506(b) exemption and was thus in violation of the SEC requirement of registration or compliance with a registration exemption).

35. SEC Rule 505, 17 C.F.R. § 230.505 (2015).

36. *Id.* The following standard applies for providing financial statements under Rule 505 and Rule 506(b): (1) Financial statements must be certified by an independent public accountant; (2) if a company other than a limited partnership cannot obtain audited financial statements without unreasonable effort or expense, only the company’s balance sheet must be audited; and (3) limited partnerships unable to obtain required financial statements without unreasonable effort or expense may furnish audited financial statements under federal income tax laws. *Rule 505 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/rule505.htm> [<https://perma.cc/TMY8-EZLD>] (last updated Oct. 27, 2014).

general solicitation or general advertising”³⁷ Rule 502(c) gives examples of prohibited practices, which include advertisements, articles, notices, and other communications published in any newspaper, magazine, or similar media or broadcast over television or radio, and any seminar or meeting whose attendees have been invited by general solicitation or general advertising.³⁸

ii. Rule 506(c) Offerings

Subsection (c) offerings, in comparison, allow companies to take advantage of general solicitations.³⁹ Such solicitations are conditioned on the issuer ensuring: (1) investors in the offering are all accredited investors; and (2) the issuer has taken reasonable steps to verify its investors are accredited investors, which could include reviewing documentation, such as W-2s, tax returns, bank and brokerage account statements, credit reports, and similar documentation.⁴⁰ Thus, solicitations may be made to the general public, if the issuer takes the necessary precautions to ensure purchasers are accredited. Of course, the representations made in such solicitations must still comply with federal securities regulations, which are discussed further *infra*.

The updates to Rule 506(c) may be the biggest change in securities laws in several decades. The rule creates the first private placement in which a company can conduct a general solicitation and advertise without prior review and approval of disclosure documents at either the federal or

37. SEC Rule 502, 17 C.F.R. § 230.502(c) (2015).

38. *Id.* Since Rule 502(c) pre-dates the internet, it does not specifically mention websites and social media, but these newer media are also prohibited by Rule 502(c).

39. SEC Rule 506(c), 17 C.F.R. § 230.506(c) (2015).

40. *Id.* Platforms facilitating Rule 506(c) offerings oftentimes will only allow access to investors upon advance verification that they are accredited, in order to ease compliance with this requirement. For an example of such a platform’s website layout, disclaimer, and verification procedure, see MALARTU, <https://malartufunds.us/preview> [<https://perma.cc/LS5S-VX2L>] (last visited May 9, 2016). The Malartu website states:

DISCLAIMER:

Due to current securities regulation, investments listed on Malartu are only available to Accredited Investors. Investing in startups carries a high degree of risk. In general, financial and operating risks confronting both early and developmental-stage companies, as well as more mature expansion-stage companies are significant. Many emerging growth companies go out of business[] every year. It is difficult to know how companies will grow, if at all, or what changes may occur in the market. A loss of an investor’s entire investment is possible and no profit may be realized. Investors are responsible for conducting their own due diligence.

Id.

state levels.⁴¹ This is why Rule 506(c) created a new type of offering—the Public Private Placement. Though Rule 506(c) contains no direct statement permitting advertising or general solicitations, the SEC backed into allowing general solicitations by not including the same cross reference to Rule 502(c) that prohibits advertising and general solicitations that Rule 506(b) had and continues to have. This indirect way of giving permission to advertise and solicit generally might reflect the fact that the SEC only approved Rule 506(c) because Congress and the President required it in Title II of the JOBS Act of July 2012. Because the SEC was directed to approve Rule 506(c), it will probably strictly enforce accredited investor verification rules and anti-fraud provisions that relate to what is said in advertising and how it is said.

The SEC's release that issued Rule 506(c) makes it clear that crowdfunded companies must satisfy two separate tests if they want to rely on Rule 506(c) to advertise or conduct a general solicitation.⁴² The first test is the same as in Rule 506(b).⁴³ By incorporating Rule 501(a),⁴⁴ you meet the test for an accredited investor in one of two ways: (1) the investor actually meets the criteria specified in Rule 501(a), or (2) the issuer has a "reasonable belief" that the investor meets the criteria specified in Rule 501(a).⁴⁵ The issuing release stated that the "reasonable steps" verification requirement "is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors."⁴⁶

The SEC believed this separate requirement would "avoid diminishing the incentive for issuers to undertake the reasonable verification steps envisioned by the [JOBS Act]."⁴⁷ Businesses can lose the exemption even if all purchasers are accredited investors. They actually have to do the work to verify accredited investor status if they want to advertise. Requiring crowdfunded businesses to pass two separate tests opens the door for purchasers who actually are accredited investors to sue businesses for not taking reasonable steps to verify their status if they lose money by

41. SEC Rule 506, 17 C.F.R. § 230.506 (2015).

42. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771 (July 10, 2013).

43. See 17 C.F.R. § 230.506.

44. SEC Rule 501(a), 17 C.F.R. § 230.501(a) (2015).

45. 17 C.F.R. § 230.506.

46. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771 (July 10, 2013).

47. *Id.*

investing in that business. If these accredited investors sue businesses for failing to verify their status, disclosed information to the investors will not even be an issue if they advertised but failed to satisfy Rule 506(c)'s verification standards. Of course, if the person actually is not an accredited investor, their case is even stronger.

This may change existing law—at least for Rule 506 (c) offerings. Courts have frequently dismissed law suits in which investors claimed they were not accredited investors, because courts have ruled the investors should not benefit from misleading the seller by signing false statements, unless investors can show the seller knew the statements were false.

iii. Advantages of Rule 506(c) Compared to Rule 506(b)

Rule 506(b) offerings have been using technology platforms for almost two decades. So, what advantages does Rule 506(c) offer? Why is it worth the trouble to verify accredited investor status? There are several advantages Rule 506(c) offerings have over Rule 506(b) offerings that are conducted on technology platforms that limit access to offering information to prequalified accredited investors. First, companies can use social media and other advertising to attract investors to their offering. This means businesses can be more proactive in attracting investors. Companies do not have to passively wait for investors to find their offering on a platform. Second, crowdfunded businesses can use non-accredited investors to tell accredited investors about their offering. This allows businesses to try to create “buzz” about their offering and have it “go viral” within certain internet and social media communities that share common interests so that non-accredited investors can become part of their sales distribution network.

B. Title III Exemptions

Title III of the JOBS Act has yet to yield any approved SEC Regulations. Title III, or the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” (CROWDFUND Act),⁴⁸ is the most progressive title of the JOBS Act, and proposes adding a crowdfunding exemption under the 1933 Act.⁴⁹ This exemption allows for an offering which does not exceed \$1 million in a twelve-month period.⁵⁰ It also places a cap on the aggregate amount sold to any individual unaccredited investor by the issuer, which must not exceed:

48. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 301, 126 Stat. 306, 315 (2012).

49. *Id.* § 302, 126 Stat. at 315 (2012) (amending 15 U.S.C. § 77d (2012)).

50. *Id.* § 302(a), 126 Stat. at 315.

- (i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and
- (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000.⁵¹

Likewise, the transaction must be conducted through a broker or a funding portal complying with the requirements of the Securities Act.⁵² These portals are what have largely stalled the implementation of Title III.⁵³ However some portals, such as CraftFund, have already begun to provide information seeming to foreshadow future interstate offerings.⁵⁴

51. *Id.*

52. *Id.*

53. John Lion, *JOBS Act Title III and Crowdfunding: What We Know So Far*, ONEVEST BLOG (Mar. 19, 2015), <http://blog.onevest.com/blog/2015/3/19/jobs-act-title-iii-and-crowd-funding-what-we-know-so-far> [<https://perma.cc/L4LQ-22Z8>].

54. *All Companies on CraftFund*, CRAFTFUND, <https://craftfund.com/company/all> [<https://perma.cc/H3PU-NZB4>] (last visited May 9, 2016). CraftFund, as of Apr. 2, 2016, although not offering securities to buyers or from companies outside of Wisconsin, had companies (primarily within the craft brewing industry) listed from its home state of Wisconsin, but also from North Carolina, Colorado, Florida, New York, Michigan, Maryland, Utah, California, Arizona, Wyoming, Georgia, Pennsylvania, New Jersey, Tennessee, Minnesota, Massachusetts, Alabama, Texas, Illinois, Virginia, and Hawaii. *Id.* The site allows anyone to create a user profile and browse and follow the companies listed on their site. *How it Works: The Process*, CRAFTFUND, <http://about.craftfund.com> [<https://perma.cc/BJ9U-L295>] (last visited May 9, 2016). However, only Wisconsin residents can create a user profile allowing them to browse offerings among other things. *Id.* It also limits issuers to being within the Wisconsin food/beverage and real estate development industries, and issuers must apply, complete a background check, file notice, disclosure documents, and escrow agreements with the Wisconsin Department of Financial Institutions. *Id.* Once the issuer is accepted by CraftFund, he can list on the site, solicit investments, sell to Wisconsin residents, and receive his capital via escrow when he has accomplished his capital-raising goals. *But see All Companies on Crowdfund*, *supra* note 54 (“CraftFund is not an investment adviser and makes no recommendation as to investment in any securities. Nothing contained on this website constitutes an offer of securities to any person who is not a legal resident of the State of Wisconsin, and no sales of securities will be made to persons who are not legal residents of State of Wisconsin. Neither the Securities and Exchange Commission nor any state regulator has passed upon the merits of or given its approval to the securities, the terms of the offerings, or the accuracy or completeness of any offering materials.”). *See also F.A.Q.*, CRAFTFUND, <http://about.craftfund.com> [<https://perma.cc/2HQ3-5A4B>] (last visited May 9, 2016).

C. Title IV-Mandated Regulation A+ Exemptions

Title IV of the JOBS Act directed the SEC to issue a new version of Regulation A permitting higher offering limits and other provisions that make the new Regulation A more attractive to issuers. The new Regulation A has been nicknamed Regulation A+.

Regulation A+⁵⁵ is the most radical update of the JOBS Act yet implemented, with its final rules having gone into effect as of June 20, 2015.⁵⁶ What was implemented was not crowdfunding per se, in the same vein as Title III, and its regulatory mechanism is significantly different.⁵⁷ It more resembles a traditional securities offering, as it is the direct descendant of the former Regulation A.⁵⁸ However, Regulation A+, being “offspring,” is still a “next-generation” offering.⁵⁹

II. THE REGULATION A+ REVOLUTION

Regulation A+ allows businesses to achieve three primary objectives. First, they can raise capital. Second, shareholders and affiliates of the issuer can resell their shares in the offering. And finally, the issuer can develop a resale market for shareholders and new investors to gain liquidity after the offering. Liquidity—or the lack thereof—often affects the price investors are willing to pay in many offerings. Therefore, these three goals are intertwined. Liquidity and resale markets usually are important to a business’s ability to raise capital at reasonable valuations.

A. The Two Tiers of Regulation A+

The update to Regulation A allows for two tiers of Regulation A+ offerings: (1) Tier I offerings allow for the raising of up to \$20 million in a twelve-month period; (2) Tier II offerings allow for the raising of up to \$50

55. SEC Rules 251–263, 17 C.F.R. §§ 230.251–.263 (2015).

56. *Id.*

57. Anna Pinedo, *It’s Not Crowdfunding!*, MOFOJUMPSTARTER BLOG (July 13, 2015), <http://www.mofojumpstarter.com/2015/07/13/its-not-crowdfunding/> [<https://perma.cc/S5BQ-ZLE6>].

58. Thomas J. Kim, *Regulation A+ Takes Effect*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 20, 2015), <http://corpgov.law.harvard.edu/2015/06/20/regulation-a-takes-effect/> [<https://perma.cc/6MER-RFSC>].

59. *See id.* Regulation A+ has fewer disclosure compliance prescriptions than registered securities, permits short-form registration to immediately list equity securities on a national exchange, benefits from Blue Sky Law preemption, and results in an offering that takes advantage of the marketing benefits of a registered securities offering, but with the lower compliance cost that comes with a securities offering. *See id.*

million in a twelve-month period.⁶⁰ The two tiers are both subject to the same basic disclosure requirements of providing: issuer information; issuer eligibility; bad actor certification; summary information; jurisdictions; unregistered offerings; a cover page; a table of contents; risk factors; dilution; plan of distribution; use of proceeds; business; property; management's discussion and analysis (MD&A); directors, executive officers, and significant employees; security ownership; securities being offered; bad actor disclosure; EDGAR document incorporation; exhibits; and signatures.⁶¹ Both tiers utilize SEC Form 1-A.⁶²

B. Tier II Requirements

Tier II issuers are subjected to more stringent requirements than a Tier I offering, yet have a higher offering limit of \$50 million in securities sales within a twelve month period.⁶³ After the initial twelve month period, issuer affiliates may re-sell up to \$15 million in a twelve-month period.⁶⁴ A noted difference is in financial statement disclosure: Tier I may provide unaudited balance sheets and financial statements, whereas Tier II must provide audited balance sheets and financial statements.⁶⁵ The cost of these audits can be remarkably prohibitive for start-up businesses, which oftentimes are seeking early-stage investment for the same reason they cannot afford such audits: they need money.⁶⁶ Tier I issuers are also permitted to provide less information as to executive compensation and related party transactions.⁶⁷ Most pertinently for Regulation A+ offerings, the liability provisions of section 11 of the 1933 Act⁶⁸ for material

60. SEC Rule 251, 17 C.F.R. § 230.251 (2015).

61. Kim, *supra* note 58.

62. *Form 1-A*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/about/forms/form1-a.pdf> [<https://perma.cc/4A2T-32JU>] (last visited May 9, 2016).

63. SEC Rule 251, 17 C.F.R. § 230.251 (2015).

64. *Id.*

65. Kim, *supra* note 58.

66. In Securities Act Release No. 9741 that issued Regulation A+, the SEC estimates the cost for audited financial statements for Regulation A+ offerings are likely to average in excess of \$28,000. Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 80 Fed. Reg. 21,806 (Mar. 25, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, and 260). The SEC qualifies this estimate by saying that audits should be easier and less expensive for small businesses, because auditing a small business is less complicated than it is for bigger companies. *See id.*

67. Kim, *supra* note 58.

68. Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74, 82 (current version at 15 U.S.C. § 77k (2012)).

misstatements or omissions do not apply.⁶⁹ This standard for registered securities offerings imposes strict liability on the issuer, and liability for executive officers, directors, and the auditing accountant (subject to a due diligence defense).

However, section 3(b)(2)(D) of the 1933 Act⁷⁰ still imposes seller liability under section 12(a)(2) of the Securities Act⁷¹ for Regulation A+ sellers. This opens up Regulation A+ issuers to greater potential liability than Rule 506 issuers.

C. Tier I Requirements

Under Regulation A+, Tier I offerings are subjected to fewer requirements, as the offering limit is lower. For Tier I offerings, issuers are limited to offering no more than \$15 million in securities sales within a twelve-month period. After expiration of the initial twelve month period, issuer affiliates are limited to reselling no more than \$6 million over a twelve-month period. It is important to note that, unlike Tier II, Tier I does not preempt state registration laws for either offers or sales of securities.⁷² State anti-fraud rules, however, apply to both Tier I and Tier II offerings. Finally, one of the primary things issuers should consider when choosing whether to make a Tier I offering or a Tier II offering is how state securities registration laws will affect their Tier I offering with respect to expenses, timing, and substantive terms of the offering.

69. *Id.*

70. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012) (amending section 3(b) of the Securities Act of 1933 (codified as amended at 15 U.S.C. § 77c(b) (2012))).

71. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (amending section 12 of the Securities Act of 1933 (codified as amended at 15 U.S.C. § 77l (2012))).

72. The JOBS Act added section 18(b)(4)(D) to the Securities Act, exempting section 3(b)(2) securities from state Blue Sky Laws if the securities are “(i) offered or sold on a national securities exchange; or (ii) offered or sold to a qualified purchaser, as defined by the Commission” Jumpstart Our Business Startups (JOBS) Act, Pub. L. 112-106, § 401, 126 Stat. 306, 325 (codified as 15 U.S.C. § 77r(b)(4)(D)). The new rule defines “qualified purchaser” as “any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A.” Amendments, 80 Fed. Reg. at 21899 (to be codified at 17 C.F.R. § 230.256). Since Tier I offerings are not included in “qualified purchasers,” they are not preempted by Blue Sky Laws. *Id.*

III. DISCLOSURE MATERIALITY STANDARDS IN THE NEW COMPLIANCE LANDSCAPE

“What is ‘material?’” is the most compelling question a securities lawyer needs to answer with regards to tailoring disclosures to comply with the SEC and avoiding being relegated to the regulatory doghouse. This question is the difference between successfully generating capital investment and committing fraud.⁷³ The materiality standard generally for securities offerings has not changed under the JOBS Act and is still found in SEC Rule 405:

The term *material*, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.⁷⁴

This standard is focused on the information provided, and how a reasonable investor would prioritize that information in a given context. Implicit in the standard, explicit in practice, and clearly evidenced by case law, the question of “what is material?” takes different forms when being disclosed by an issuer in different contexts and is analyzed on an ad hoc basis.⁷⁵ “[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁷⁶ The same standard for material affirmative representations is applied to

73. The entire purpose of the 1933 Act, and other laws of the post-1929 Stock Market Crash era was to protect consumers and place stricter fraud standards on businesses seeking to sell securities. See Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74, 74 (preamble) (“An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof. . . .”); Securities Exchange Act of 1934, Pub. L. No. 73-291, § 2, 48 Stat. 881, 881–82 (current version at 15 U.S.C. § 78b (2012)) (“[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . including . . . to insure the maintenance of fair and honest markets in such transactions.”); see also STAFF OF H. COMM. ON INTERSTATE & FOREIGN COM., 95th Cong., 1st Sess., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 556–60 (Comm. Print No. 95-29, 1977) (discussing disclosure philosophy behind federal securities legislation).

74. SEC Rule 405, 17 C.F.R. § 230.405 (2015).

75. *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988) (discussing within a merger context that “[m]ateriality depends on the facts and thus is to be determined on a case-by-case basis”).

76. *Id.* at 231–32 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

omissions, even though omissions are perhaps more latent and unintentional.⁷⁷ Materiality is “a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts.”⁷⁸ This Comment now explores how this standard mutates when applied to three common contexts: (1) financial statements; (2) projections; and (3) due diligence.

A. Financial Statement Materiality

Financial statements are legally important, but very expensive. The costs of an accountant include the professional service hours spent auditing financial statements. If such information will be used in a securities offering, however, the accountant will also include an upcharge for assuming the additional professional liability. Thus, small businesses often adapt the way they operate in order to maximize cost savings while minimizing their liabilities by tying the quantity of information they disclose to the size and complexity of their business. This takes the form of many small to mid-sized businesses using cash financial statements for tax purposes rather than accrual-based Generally Accepted Accounting Principles (GAAP) compliant statements. Under the new regulations there are new requirements regarding financial statements.

Yet, materiality has not changed. It is still perhaps the best disclosure approach to adhere to the traditional adage, “If you have nothing nice to say, don’t say anything at all.”⁷⁹ It is still a material misrepresentation for a chief executive officer to significantly overstate a company’s earnings.⁸⁰ It is still reasonable for a jury to regard concealing information by stock options backdating as material.⁸¹ Each case is still analyzed on its own facts, and the Court has consistently rejected the application of bright-lined materiality analysis, opting for a fact-driven analysis reflecting the diversity of American businesses.⁸² The SEC dealt specifically with

77. TSC Indus., Inc., 426 U.S. at 449 (applying Rule 405 materiality standard to omission of fact).

78. *Id.* at 450.

79. See *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (holding in an action for securities fraud under Rule 10b that “[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak[.]” and further holding “that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information”).

80. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

81. *SEC v. Reyes*, 491 F. Supp. 2d 906, 916 (N.D. Cal. 2007).

82. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 249 (1998) (rejecting a bright-line rule for materiality); accord *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 40 (2011) (“As in *Basic*, *Matrixx*’s categorical rule would ‘artificially exclud[e]’ information that

materiality issues in financial statements in Staff Accounting Bulletin No. 99 (SAB 99)⁸³ issued August 12, 1999. Saying the SEC has addressed the issue does not mean the SEC itself even agrees with or is fond of how muddled the standard is.⁸⁴ Still, some courts are fond of the standard.⁸⁵

The same plaintiff-friendly statute of limitations is in place.⁸⁶ Plaintiffs in suits under securities laws generally have “two years after the discovery of the facts constituting the violation,”⁸⁷ or five years after the violation, whichever is earlier.⁸⁸ A defendant can be made liable at any time within a five-year period for a misrepresentation, if an individual plaintiff did not discover the facts constituting fraud until much later. However, the date of the violation, as used in title 28, section 1658(b) of the United States Code, has been held to mean the date of the fraud or misconduct itself, which means the section “‘serves as an unyielding and absolute barrier’ to a cause of action, regardless of whether that cause has accrued.”⁸⁹

Additionally, in a securities fraud claim, in order to be material a representation or omission must be “in connection with the purchase or sale

‘would otherwise be considered significant to the trading decision of a reasonable investor.’” (quoting *Basic Inc.*, 485 U.S. at 236)).

83. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 19, 1999) (“The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.”).

84. See Paul S. Atkins, SEC Comm’r, Address at the Twentieth Annual Tulane Corporate Law Institute (Apr. 3, 2008) (transcript available at <https://www.sec.gov/news/speech/2008/spch040308psa.htm> [<https://perma.cc/AN4H-JEVN>]) (“Anyone who has tried to apply SAB 99 is left with little certainty.”).

85. See *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163 (2d Cir. 2000) (“SAB No. 99 is thoroughly reasoned and consistent with existing law . . .”).

86. See 28 U.S.C. § 1658(b) (2012). Section 1658(b) provides:

[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws . . . may be brought not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.

Id.

87. *Id.* This has been held to mean that the statute of limitation begins to run: (1) when the plaintiff did in fact discover; or (2) when a hypothetical objectively reasonably diligent plaintiff would have discovered the “facts constituting the violation,” whichever comes first, and that the “facts constituting the violation” include a scienter requirement of intent to deceive, manipulate, or defraud. *Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010).

88. See 28 U.S.C. § 1658(b).

89. *McCann v. Hy-Vee, Inc.*, 663 F.3d 926, 930 (7th Cir. 2011) (quoting *Klein v. DePuy, Inc.*, 506 F.3d 553, 557 (7th Cir. 2007)).

of any security.”⁹⁰ This means that in order to have standing to sue for money damages under Rule 10b-5,⁹¹ the plaintiff must be the actual purchaser or seller of the securities in question.⁹² It is not sufficiently justiciable for the following groups of individuals (who may have been directly affected by a representation or omission) to bring claims under Rule 10b-5: (1) potential purchasers of securities who allege they were fraudulently induced not to buy; (2) actual shareholders who allege they were fraudulently induced not to sell; and (3) shareholders who sustained a loss in the value of their investment as the result of fraudulent activity.⁹³ The standard for injunctive relief, however, is easier for the plaintiff to satisfy, although involves more narrow factual circumstances to allege a sufficient injury-in-fact.⁹⁴ The justiciability standards help to limit peripheral liability for disclosures, and favors issuers who pre-screen sales and sell to accredited investors or who employ some “sophistication” requirement to their investors, because they are only liable to their investors, and only liable to their investors regarding facts or omissions which caused the investors to make buying or selling decisions.⁹⁵ In the absence of both requirements, there is no suit. However, there is a “fraud on the market” exception to the “in connection with” requirement, which raises a presumption that the market price of a security was influenced by a representation, and affected sale or purchase of securities.⁹⁶ It is unclear

90. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2015).

91. *Id.*

92. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737–39 (1975).

93. *Id.*

94. Multiple courts exercise a relaxed standard in this regard. *See United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981); *Davis v. Davis*, 526 F.2d 1286, 1289 (5th Cir. 1976).

95. The “in connection with” requirement has been held to be satisfied when misconduct “touches” or “coincides” with a particular securities transaction, and such a determination is made using a factor analysis:

(1) whether a securities sale was necessary to the completion of the fraudulent scheme . . . ; (2) whether the parties’ relationship was such that it would necessarily involve trading in securities . . . ; (3) whether the defendant intended to induce a securities transaction . . . ; and (4) whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.

SEC v. Pirate Inv’r LLC, 580 F.3d 233, 244 (4th Cir. 2009) (citations and internal quotation marks omitted). Such factors are not dispositive or mandatory requirements, but have been used to guide analysis. *See id.*

96. In order for the presumption to apply plaintiff must prove the following: “(1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.” *Halliburton Co.*

whether such an exception would or could be invoked in an initial offering of securities, however, seeing as there is not an ongoing “efficient market” for such securities.⁹⁷ Taken together, knowledge of these standards makes “general solicitation” disclosures less scary, because issuers can employ the same factor analyses as their home courts to tailor their individual disclosures to investors. They even have an advantage the court does not: they have intimate knowledge of the intricacies and idiosyncrasies of their own company, industry, and investors. Combining intimate knowledge of their business with knowledge of the controlling securities fraud standard⁹⁸ potential plaintiffs must meet is useful for businesses to consider in tailoring their disclosures. Individual issuers should also keep in mind the “with particularity” pleading standard for plaintiffs.⁹⁹

v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2408 (2014) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.7 (1988) and *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011)).

97. “Efficient market” factors include: (1) whether the stock trades at a high weekly volume; (2) whether the stock is followed and reported on by securities analysts; (3) whether the stock has market makers and arbitrageurs; (4) whether the company is eligible to file SEC registration Form S-3—used by companies whose stock is actively traded and widely followed—as opposed to Form S-1 or S-2; (5) whether there are “empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price.” *Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999) (quoting *Cammer v. Bloom*, 711 F. Supp. 1264, 1287 (D.N.J. 1989)).

98. A private plaintiff must establish: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.” *Stoneridge Inv. Partners v. Sci-Atlanta, Inc.*, 552 U.S. 148, 157 (2008). Lower courts have required the plaintiff to provide evidence of all six elements, ruling that a claim will fail if it is missing *one* element. See *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996) (compressing the six *Stoneridge* elements into four).

99. The Private Securities Litigation Reform Act of 1995 (PSLRA) established heightened pleading standards in securities cases where the plaintiff alleges false or misleading statements or omissions of material fact. The PSLRA provides:

In any private action arising under this chapter in which plaintiff alleges that the defendant—

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state *with particularity* all facts on which that belief is formed.

The purpose of financial statements is to provide some sort of investment trajectory—the SEC knows this, which is why brokers frequently disclaim “past performance is no guarantee of future performance” or some variation thereof. Small businesses with few assets and little history of past performance do not have the same danger of providing relied-upon representations as large businesses with a long operating history, and such statements may not be all too material to a reasonable investor’s decision, because the more important factors would include what intangible assets the company has that adds to its valuation. Likewise, a company possessing a less than impressive balance sheet may indeed have valuable interests such as intellectual property, valuable and beneficial relationships with potential customers, or a good idea yet poor marketing due to lack of capital. Choosing not to provide investors with GAAP compliant financial statements on the basis they are immaterial always involves some level of risk. In many situations, the risk level is too high. But in some situations, such as a beginner business with little assets or cash flow, risk levels are lower and the cost to the issuer is so prohibitive it may make sense to evaluate the materiality of financial statements and tailor disclosures to investors to make financial statements not material.

i. Regulation D Offerings

Rule 502(b)(2)(i) of Regulation D recognizes disclosure rules are not a one-size-fits-all matter when it provides a materiality qualifier to the specific financial statements requirements applying to issuers who sell to non-accredited investors in Rule 505 and Rule 506(b) offerings: “[A]t a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser the following information, to the extent material to an understanding of the issuer, its business and the securities being offered: [the financial statement information provided in paragraph (B) and the other information provided in paragraph (A)].”¹⁰⁰

Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, § 101, § 21D, 109 Stat. 737, 747 (amending Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. § 78u-4(b)(1) (2012))) (emphasis added); *see also* Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1106 (9th Cir. 2003) (“[A] plaintiff must set forth *more* than the neutral facts necessary to identify the transaction. The plaintiff must set forth what is false or misleading about a statement, and why it is false.”) (citing *Decker v. GlenFed, Inc.* (*In re GlenFed, Inc.*), 42 F.3d 1541, 1548 (9th Cir. 1994)); *Norfolk Cty. Ret. Sys. v. Ustian*, No. 07-CV-07014, 2009 U.S. Dist. LEXIS 65731 at *24–25 (N.D. Ill. 2009) (applying PSLRA standard to “excruciatingly detailed” complaint and grouping allegations into four general categories: (1) red flags; (2) misstatements; (3) the magnitude and pervasiveness of the accounting errors; and (4) motive and opportunity).

100. SEC Rule 502, 17 C.F.R. § 230.502(b)(2)(i) (2015).

By tying the financial statement disclosure standard to the financial knowledge a business possesses about itself, Regulation D allows for greater flexibility in making such disclosures in alternative more informal media. If a company chooses to use non-GAAP compliant means to disclose their financial information, a good approach is to follow the format of a Management's Discussion and Analysis (MD&A) section of a Prospectus and the periodic reports (Form 10-K and 10-Q) which public companies file with the SEC.¹⁰¹

In Regulation D offerings, issuers that decide their financial statements are not material to understanding the issuer, its business, or the offering take the risk courts will disagree with the issuer's determination. Placement agents, attorneys, and other professional advisers may also disagree with the issuer's determination. Most securities offering documents contain many immaterial facts, which are often included out of fear someone may later decide they are material. Dumping a lot of immaterial information into a Private Placement Memorandum usually is less costly than doing a fine analysis to weed out immaterial information. Thus, both risk protection and lower traction costs are usually aligned. However, this risk and cost alignment often breaks apart when it comes to financial statements. Given the expense and delay involved in producing financial statements, some issuers would incur substantially lower transaction costs if they did not have to produce GAAP compliant financial statements.

ii. Regulation A+ Offerings

Regulation A+ and Title III Federal Crowdfunding rules and registered offerings do not specifically give issuers the same flexibility regarding materiality Regulation D offers. In these types of offerings, the

101. The SEC describes the purpose of MD&A as follows:

The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A requirements are intended to satisfy three principal objectives: [(1)] To provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management; [(2)] To enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and [(3)] To provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75056, 75056 (Dec. 29, 2003) (first alteration in original) (footnotes omitted).

issuer could lose its exemption if it does not comply with the conditions stated in the exemption.¹⁰² For public offerings filed with the SEC requiring SEC staff approval, the staff has been reluctant to waive financial statement requirement, even in situations where the issuer has acquired a “significant” business for which the financial records cannot be audited.¹⁰³ This issue sometimes arises when the issuer buys part of a business and the seller did not maintain financial records, which makes it impossible to distinguish the financial performance of both parts of the business, or to determine when financial records are missing.

The SEC generally takes the position that if the acquired business is “significant” (as defined in Rule 3-05 of Regulation S-X), the issuer must delay registration until the issuer can provide audited financial statements including the acquired business.¹⁰⁴ If two years of financial statements are required, this could mean operating the business for two years after the acquisition before one can produce the required financial statements.¹⁰⁵ Given this substantial burden on issuers acquiring other businesses, issuers should not assume the SEC is likely to grant financial statement waivers in Regulation A+ offerings based on arguments financial statements are not material.

B. Projections Materiality

A common disclosure minefield is providing forward looking opinions and presenting them as though they were fact. This used to be the norm in the era before federal regulation of securities.¹⁰⁶ Oftentimes, projections

102. See generally SEC Rules 251–263, 17 C.F.R. §§ 230.251–263 (2015) (Regulation A+ requirements); Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (Title III Crowdfunding requirements). For a further discussion of Title III crowdfunding requirements, see *supra* note 6.

103. Form 1-A requires the Regulation A+ issuer to provide the following information with regards to financial statements: cash and cash equivalents; investment securities; accounts and notes receivable; property, plant, and equipment; total assets; accounts payable and accrued liabilities; long term debt; total liabilities; total stockholders’ equity; total liabilities and equity; total revenues; costs and expenses applicable to revenues; depreciation and amortization; net income; earnings per share—basic; and earnings per share—diluted. *Form 1-A*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/forms/form1-a.pdf> [<https://perma.cc/4A2T-32JU>] (last visited May 9, 2016).

104. SEC Rule 210, 17 C.F.R. § 210.3-05 (2015).

105. *Id.*

106. Years before the passage of the Securities Act of 1933, the U.S. Supreme Court commented:

The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, “speculative schemes which have no more basis than so many feet of ‘blue sky’”; or, as stated by counsel in another case, “to stop

are useful to provide investors with an idea of how a company views itself. But there are many potential issues in providing projections. When a projection is made, it is made utilizing the existing universe of the facts; yet in the future, the facts may change, and the projections may need to be updated to reflect changes in the facts. Inevitably, these projections must rest themselves on assumptions about past performance and/or future trends.

Five factors can be used to help an issuer assess its liability exposure with regards to projections: (1) risk and “forward looking statements”; (2) process and standards; (3) good faith; (4) reasonable assumptions; and (5) disclosure of assumptions.

i. Risk and “Forward Looking Statements”

Another statutory implement which issuers would be wise to utilize is the “safe harbor” provision of the Private Securities Litigation Reform Act of 1995 (“PSLRA”).¹⁰⁷ This provides an exemption for material projections which are identified as forward looking statements¹⁰⁸ and accompanied by meaningful cautionary statements.¹⁰⁹ The safe harbor also exempts immaterial “forward-looking statements,”¹¹⁰ but the fact dependent and mutable standard for materiality provides less clear guidance to rely upon, as noted *supra*.

A smart practice for issuers would be to issue disclaimers in all circumstances making absolutely clear to potential investors the amount of risk they are entering into, the contingencies possible if the company’s assumptions and projections differ from actual future performance, and that a contingency exists (however likely or unlikely) that the investor could lose their whole investment.

the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations.” Even if the descriptions be regarded as rhetorical, the existence of evil is indicated, and a belief of its detriment; and we shall not pause to do more than state that the prevention of deception is within the competency of government and that the appreciation of the consequences of it is not open for our review.

Hall v. Geiger-Jones Co., 242 U.S. 539, 550–51 (1917) (citations omitted).

107. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, § 102, § 21E, 109 Stat. 737, 753 (1995) (amending the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78u-5(c)(1) (2012))).

108. A “forward-looking statement” is defined as “a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items” 15 U.S.C. § 78u-5(i)(1) (2012).

109. *Id.* § 78u-5(c)(1)(A)(i).

110. *Id.* § 78u-5(c)(1)(A)(ii).

ii. *Process and Standards*

In creating its projections, the issuer will likely rely on professional standards such as those provided by the American Institute of Certified Public Accountants (AICPA),¹¹¹ the SEC,¹¹² or others. Informing investors which standards were used in making disclosures makes it easier for the investor or potential investor to decide whether they should rely upon the projections, and provides cover for the issuer in the case of a regulatory audit. If professional standards are not used in projections, the issuer should tell investors and disclose the alternative processes and standards used to produce the projections.

iii. *Good Faith*

Adhering to the duty to provide good faith projections not only helps to provide a good argument in the case of a fraud lawsuit, it also helps to drive investment and create investor confidence in the issuer.¹¹³ If a company has a history of good faith dealing, the investors may develop a better relationship with the company, as nobody could be accused of “hiding the ball.”¹¹⁴

iv. *Reasonable Assumptions*

The reasonableness of projections took on a new importance in light of the Supreme Court’s recent decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*.¹¹⁵ The case dealt with the stock issuer’s belief that its contracts with pharmaceutical manufacturers were “legally and economically valid” and its representation to that effect to investors.¹¹⁶ In assessing this opinion statement, the Court partially softened the standard for untrue statements of material facts,

111. See generally *AT Section 301: Financial Forecasts and Projections*, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AT-00301.pdf> [<http://perma.cc/2MSD-KPHC>] (last visited May 9, 2016).

112. See, DIV. OF CORP. FIN., U.S. SEC. & EXCH COMM’N, FINANCIAL REPORTING MANUAL 197–98 (2015), <https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic3> [<https://perma.cc/YRD3-PQRR>].

113. See U.C.C. § 1-304 (AM. LAW INST. & NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014) (“Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.”).

114. “Good faith” is defined in the Uniform Commercial Code as: “honesty in fact and the observance of reasonable commercial standards of fair dealing.” *Id.* § 1-201(20).

115. *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

116. *Id.* at 1323.

holding that an opinion can only be an untrue statement of material fact if it was not subjectively and sincerely held at the time it was relayed to investors.¹¹⁷ The Court also held that opinions can still be materially false and misleading if the underlying material facts about the opinion-making inquiry or the underlying knowledge are not provided, and that the omitted facts would cause a reasonable investor to come to a conflicting opinion.¹¹⁸ In short, under the *Omnicare* standard, an issuer is more likely to be found guilty of omitting material facts that tend to undermine the reasonableness of its issued projection opinion than being found guilty of providing a facially materially false and misleading projection.¹¹⁹ This is because an issuer has the defense of subjectively believing the truth of its opinion at the time, and to avoid this sort of liability, the issuer must only provide opinions to investors that the issuer itself believes to be true.¹²⁰ *Omnicare* reemphasizes the need for issuers to provide the full factual context underlying its assumptions, to avoid giving false and misleading opinions.

v. Disclosure of Assumptions

Applying the *Omnicare* decision, the issuer can avoid liability for the omission of material facts underlying projections by carrying on its projection-generating process with transparency. Such transparency need not be in real time, but should be contemporaneous with the release of a projection.¹²¹ The credence behind this line of thought is that if an issuer provides the entire universe of material facts to its investors, even if it forms an unreasonable opinion, the disclosure of the facts serves to caution the investors. This then mitigates the unreasonableness of the issuer projection, so that the investors can come to their own opinions, as well as their own opinions about the issuer's opinions. "[T]o avoid exposure for omissions . . . an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief. Such ways of conveying opinions so that they do not mislead will keep valuable information flowing[,] . . . the only kind of information investors need."¹²²

For new businesses seeking to take advantage of the new JOBS Act registration exemptions, providing projections could be its strongest ally. Issuers have a duty to do everything in their power to test the projection assumptions, so that in a suit for fraud, the company can rest upon a history

117. *Id.* at 1327.

118. *Id.* at 1329.

119. *See id.*

120. *Id.* at 1326.

121. *Id.* at 1329–30.

122. *Id.* at 1332.

of reasonableness with regards to making its projections. Only the most updated and accurate information should be provided, which of course adds to the compliance cost. Such projection should also comply with the overall duty of good faith.¹²³ But for businesses with little operating history or cash on hand, objectively evidenced optimism in projections is what drives investment. For any size and complexity of issuer, the issuer should provide its projections, assumptions, and disclaimers, along with the standards and processes that it used to produce its projections.

C. Due Diligence Materiality

Due diligence is the baseline factual investigation that parties do to ensure that their transactions are based in reality.¹²⁴ The above analysis for fraud standards and materiality also assists conductors of due diligence. The type and scope of due diligence performed prior to a transaction is often shaped by the exposure to potential liability. There are generally three sources of liability in securities law: (1) section 11 of the 1933 Act¹²⁵ for misstatements and misleading omissions in a registration statement; (2) section 12(a) of the 1933 Act¹²⁶ for misstatements and misleading omissions in public offerings (including exempt public offerings),¹²⁷ whether or not in a registration statement; (3) section 10¹²⁸ and Rule 10b-5¹²⁹ liability for misstatements and misleading omissions in private offerings. Section 10 and Rule 10b-5 liabilities are most pertinent to the private securities offerings altered under the JOBS Act, however the proper

123. Providing specifically tailored cautionary language as to each projection is the best practice in satisfying of the duty of good faith. See Noam Noked, *Giving Good Guidance: What Every Public Company Should Know*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 8, 2012), <http://corpgov.law.harvard.edu/2012/11/08/giving-good-guidance-what-every-public-company-should-know/> [<https://perma.cc/KF47-VGGX>].

124. A more traditional legal source has defined the term as “[a] prospective buyer’s or broker’s investigation and analysis of a target company, a piece of property, or a newly issued security[.] A failure to exercise due diligence may sometimes result in liability, as when a broker recommends a security without first investigating it adequately.” *Due Diligence*, BLACK’S LAW DICTIONARY (10th ed. 2014).

125. Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74, 82 (codified as amended at 15 U.S.C. § 77k (2012)).

126. Section 12(a) was added by amendment to the Securities Act of 1933 in 1995. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (amending 15 U.S.C. § 771 (2012)).

127. This includes offerings utilizing Regulation A+, Title III, and state-law intrastate crowdfunding exemptions, but *not* Rule 506 offerings.

128. 15 U.S.C. § 77j (2012).

129. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2015). This is the only source of liability for Rule 506 offerings, which will be discussed further, *infra*.

scope and extent of due diligence, like materiality, is a mixed question of fact and law, and is case specific. However, like materiality, there are principles and strategies that parties can employ in conducting due diligence of transactions.

In cases under Rule 10b-5, there is more limited liability for corporations for failure to conduct due diligence. The Supreme Court addressed this issue in *Central Bank, N.A. v. First Interstate Bank, N.A.*¹³⁰ It held that there was no secondary liability under Rule 10b-5 for those who had aided and abetted a violator of the Rule.¹³¹ The Private Securities Litigation Reform Act of 1995 was passed and later gave the SEC the power to enjoin lawyers and others who knowingly aid and abet a primary violation, but this statute did not create a private right of action by investors against lawyers and other professionals, thereby leaving the *Central Bank* decision largely in effect.¹³²

IV. THE TROUBLED INTERSECTION OF DISCLOSURE AND THE NEW MEDIA

With the current state of crowdfunding regulations, one would be right to be thoroughly confused, frightened, and befuddled. So are many of the small businesses that were initially the intended beneficiaries of the JOBS Act. The questions many small business owners worry themselves with are ones concerned with the bottom line: liability exposure. There are several considerations these small businesses must take into account.

Social media is an important tool that issuers can take advantage of if they are willing to bear the risks. Social media is the great unknown in the new compliance landscape. There is little guidance for private issuers under registration exemptions in this regard, but such issuers would be wise to conform their practices to those of registered issuers whenever possible.¹³³ The trend in the securities field is against selective disclosure of information in favor of more public disclosures.¹³⁴ The SEC has issued

130. *Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).

131. *Id.* at 191.

132. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); *see also* *Stoneridge Inv. Partners v. Sci-Atlanta, Inc.*, 552 U.S. 148, 162 (2008) (“Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties.”).

133. *See generally* *Securities Act Rules: Questions and Answers of General Applicability*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/divisions/corpfm/guidance/securitiesactrules-interps.htm> [<http://perma.cc/2M3Z-36GP>] (last updated Aug. 6, 2015).

134. The SEC discussed this trend when releasing new Final Rules in 2000:

[W]e have become increasingly concerned about the selective disclosure of material information by issuers. As reflected in recent publicized reports, many

guidance about the use of social media with regards to public companies.¹³⁵ These guidelines are an extension from its guidance governing disclosure of information via company webpages.¹³⁶ Its overall attitude toward the use of social media is an optimistic one, but still one that emphasizes issuers notifying investors of disclosure practices.¹³⁷

In applying the same natural extension of the analysis that the SEC uses to craft its decision making, what conclusions can be drawn for issuers under the JOBS Act? Looking at prior points the SEC emphasized in its disclosure guidance in the realm of internet media, the SEC puts an emphasis on the distinguishing between “push” and “pull” technology.¹³⁸ These two “static” technologies are distinguished from the more “dynamic,” “interactive” technologies.¹³⁹ Utilizing such technologies allows an issuer to control the access and release of information. This distinction, as released in 2008 guidance, is a bit dated, but still has great

issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public.

Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51716 (Aug. 24, 2000).

135. See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Exchange Act Release No. 69,279 (Apr. 2, 2013), <https://www.sec.gov/litigation/investreport/34-69279.pdf> [<https://perma.cc/H2EJ-WBPR>] [hereinafter Investigative Report] (determining that use of a Netflix executive’s Facebook page to disclose that Netflix had streamed 1 billion hours of content in the month of June was not actionable under Regulation FD (17 C.F.R. §§ 243.100–103) and section 13(a) of the Securities Exchange Act of 1934).

136. Commission Guidance on the Use of Company Web Sites, 73 Fed. Reg. 45862 (Aug. 7, 2008).

137. The Investigative Report states:

We appreciate the value and prevalence of social media channels in contemporary market communications, and the Commission supports companies seeking new ways to communicate and engage with shareholders and the market . . . [I]ssuers must take steps sufficient to alert investors and the market to the channels it will use for the dissemination of material, nonpublic information.

Investigative Report, *supra* note 135, at 8.

138. See Commission Guidance on the Use of Company Web Sites, Exchange Act Release No. 58,288, Investment Company Act Release No. 28,351, 73 Fed. Reg. 45862, 45867 n.51 (Aug. 7, 2008) (“Push technology, or server push, describes a type of Internet-based communication where the request for the transmission of information originates with the publisher or central server. It is contrasted with pull technology, where the request for the transmission of information originates with the receiver or client.”).

139. *Id.* at 45864 & n.20 (“‘Interactive’ investor-related tools and functionality, such as ‘blogs’ and electronic shareholder forums, promote direct communications with companies, their officers and other representatives.”).

utility when viewing disclosures on social media through the SEC regulatory lens.¹⁴⁰ For an issuer making disclosures on social media, key questions include: (1) what information is being “pushed” to investors and potential investors? (2) what information and data do investors and potential investors request when utilizing “pull” technologies? (3) what balance of “push” to “pull” is maintained in the “interactive” disclosures, and is it a healthy balance between the two?

The above questions are a framework that builds upon traditional SEC wisdom on framing disclosures via technology. The most successful issuer-users of social media will be those who intimately know their investors, market, and industry, and who can tailor a balance of push and pull media to facilitate a mutually beneficial conversation.¹⁴¹ The goals for the issuer are to ultimately close a successful deal by marketing its securities, while minimizing its fraud liabilities, and building a healthy relationship with its investors. Goals for investors include receiving accurate, up-to-date, instant, and interactive information from the issuer, so that they can make reasonable and successful investment decisions. Both issuers and investors utilize “push” and “pull” technologies throughout the trading process.

Also useful is the “safe harbor” for forward looking information that is provided in section 27A of the 1933 Act, discussed *supra*, which is satisfied when a statement is forward looking and accompanied by meaningful cautionary statements. When crafting disclosures in social media, it is best to always disclaim any statement that is forward looking as such, and to provide cautionary statements that are fact specific to place such statements within the “safe harbor.” Such disclaimers may be more challenging in some media fora that have character limits, such as Twitter,

140. For instance, many social media fora now blur the SEC’s distinction between “push” and “pull” technologies. On Twitter, for example, users can tweet “at” a given account, which the SEC would categorize as a “pull” technology. Tweeters can also tweet utilizing “hashtags,” which allow a user to place their message within a similar stream of tweets centered around the same content or “hashtag,” which functions similarly to a “push” technology, and could allow issuers to send information to a specific audience. See *Getting Started with Twitter*, TWITTER.COM, <https://support.twitter.com/articles/215585> [http://perma.cc/9VKA 4L7C] (last visited May 9, 2016).

141. Finding this balance requires the issuer making the investors aware of its presence on and use of various fora. The Investigative Report states:

The central focus of [the SEC’s] inquiry [into whether a public company’s website use is permissible] is whether the company has made investors, the market, and the media aware of the channels of distribution it expects to use, so these parties know where to look for disclosures of material information about the company or what they need to do to be in a position to receive this information.

Investigative Report, *supra* note 135, at 3.

but not impossible. Many users of Twitter often provide internet links to more detailed pages such as blogs, news reports, or YouTube videos. Interested readers of a tweeter's "tweet" can then click the link and get the full story. In the disclosure arena, such links could be invaluable for issuers to provide the maximum amount of linked information and disclaimer bang for their 140-character-buck. Yet, unfortunately, such practices are still risky, as the courts have yet to rule on such a disclosure strategy.¹⁴²

Yet another unanswered question is whether the SEC guidance relating to entanglement or adoption of third party statements made on company websites will translate well into the social media context. A recent guide on social media disclosures cautions issuers away from referencing and linking on social media to outside pages that do not necessarily reflect the views of the issuer: "activity such as 'friending' a securities research analyst on Facebook or tweeting an analyst's handle on Twitter—as well as retweeting an analyst's tweet about the company—could potentially be construed as adoption of the analyst's past and future statements about a company or its securities."¹⁴³

Thus, it would be wise for issuers who insist upon having a social media presence to be extremely wary or issue a policy prohibiting any sort of endorsement or rebroadcasting of third party statements. If such actions are taken, smart practices to remediate risk would be disclaiming that the view is that of a third party and does not necessarily reflect the view of the issuer, and providing the context of the facts surrounding the third party statement. Additionally, issuers could provide some sort of editorial viewpoint on the third party statement that makes clear that the issuer is not adopting it, or disclaim that the issuer does not mean to endorse the full history of an analyst or source of information, but means to endorse only that information that is linked, shared, or rebroadcasted.¹⁴⁴ In any media,

142. JAY G. BARIS & DAVID M. LYNN, MORRISON & FOERSTER, *THE GUIDE TO SOCIAL MEDIA AND THE SECURITIES LAWS* 5 (2015), <http://media.mofo.com/docs/pdf/150615-Guide-Social-Media-Securities/9B4C44871B0C9784CFCAFE9D49521F5F/150615-Social-Media-Securities-Guide.pdf> [<http://perma.cc/S6EY-GMYX>] ("It remains uncertain whether a court would determine that either [(1) linking to a web page, SEC report or press release or (2) providing multiple-tweet disclosures] provides a means by which the forward-looking statements are identified and are accompanied by meaningful cautionary statements.").

143. *Id.*

144. Such practices are based on SEC guidance on issuer responsibility for hyperlinked information, which provides several "adoption" analysis factors: (1) context of the hyperlink; (2) risk of confusion; and (3) presentation of the hyperlinked information. *See* Use of Electronic Media, Securities Act Release No. 7856, Exchange Act Release No. 42,728, Investment Company Act Release No. 24,426, 65 Fed. Reg. 25843, 25848 (May 4, 2000). These factors are equally useful in the first party disclosure and third party

the same substance, formality, and detail of information should reflect that provided in a Prospectus, so that users or readers in one forum will not be provided with incomplete or inconsistent information when compared with all others.

Within the 506(c) context, issuers can take advantage of the lifting of the general solicitation ban.¹⁴⁵ Rule 506(c) issuers can take advantage of general solicitation, which could have viral capital-raising effect on social media if it complies with the conditions for advertising: (1) the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors; (2) all purchasers of securities must be accredited investors, either because they fall within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors at the time of the sale of securities; and (3) the issuer satisfies the conditions of Rule 501¹⁴⁶ and Rules 502(a)¹⁴⁷ and 502(d).¹⁴⁸ However, in order to make a general solicitation, the issuer must take “reasonable steps to verify” that every purchaser is an accredited investor, and just because all investors are in fact, accredited investors, does not guarantee compliance.¹⁴⁹ “Someone can be an ‘Accredited Investor,’ but if the issuer does not take reasonable steps to verify the investor’s status, the issuer does not qualify for the Rule 506(c) exemption.”¹⁵⁰ Thus, in order to get the benefits of general solicitation, the issuer must undertake costly efforts to verify each investor. This verification effort can be efficiently streamlined through the use of a third party intermediary such as a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant to review the investor’s documents and verify that the investor is in fact an

disclosure contexts when hyperlinks are used to expand an individual social media disclosure.

145. In contrast, issuers relying on 506(b) are still barred from making general solicitations and must limit their solicitations to those potential investors within their close network, and such investors must be accredited or sophisticated.

146. SEC Rule 501, 17 C.F.R. § 230.501 (2015).

147. SEC Rule 502, 17 C.F.R. § 230.502(a) (2015).

148. *Id.* § 230.502(d); E. Knox Proctor V & James F. Verdonik, *Rule 506(c) Private Offerings General Solicitation and Advertising Provisions*, WARD & SMITH (Sept. 19, 2014), <http://www.wardandsmith.com/articles/rule-506c-private-offerings-general-solicitation-and-advertising-provisions> [<http://perma.cc/4M6F-EH63>].

149. *Id.*

150. *Id.*

accredited investor.¹⁵¹ Recently, intermediary platforms have arisen to verify individual investor's accredited status.¹⁵²

Another useful model for an issuer to monitor and control its disclosures in the social media space is made by comparison to the SEC Office of Compliance Inspections and Examinations (OCIE) National Examination Risk Alert¹⁵³ which outlines the SEC Staff's compliance concerns with regards to the investment adviser industry, but its strategies easily translate to issuers. In this risk alert, the SEC staff provides a nonexclusive list of several compliance risk factors to assess social media effectiveness: (1) usage guidelines;¹⁵⁴ (2) content standards;¹⁵⁵ (3) monitoring;¹⁵⁶ (4) frequency of monitoring;¹⁵⁷ (5) approval of content;¹⁵⁸ (6) firm resources;¹⁵⁹ (7) criteria for approving participation;¹⁶⁰

151. *Id.*

152. Platforms such as Venovate allow issuers to take advantage of Rule 506(c) offerings. *See Raising Capital for Alternative Opportunities*, VENOVAE, <http://welcome.venovate.com/raising-capital-for-alternatives> [<http://perma.cc/AM33-S2W8>] (last visited May 9, 2016). Venovate also provides a platform for Regulation A+ offerings. *See Access to Regulation A+*, VENOVAE, <http://welcome.venovate.com/why-venovate/> [<https://perma.cc/9TCS-SN5U>] (last visited May 9, 2016).

153. *Investment Adviser Use of Social Media*, NAT'L EXAMINATION RISK ALERT (Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, Washington, D.C.), Jan. 4, 2012, at 1, <https://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf> [<http://perma.cc/GZT9-BD5L>]. This report particularly addresses the use of social media with regards to Rule 206(4)-1 under the Investment Advisers Act of 1940. *Id.*

154. "Usage guidelines" refer to general standards regarding use or prohibition of certain social media fora based upon risk analysis, and the SEC suggests providing a list of approved sites for disclosures to be made or providing a list of certain functionalities on sites that are permitted or prohibited. *See id.* at 3.

155. "Content standards" refer to content-focused controls with regards to disclosure compliance, and suggests grouping disclosures by content and prohibiting or permitting disclosures within these groups. *See id.*

156. "Monitoring" refers to the methods by which a firm provides oversight on various social media platforms, and cautions that some platforms may provide limited access to third parties which may complicate oversight policies. *See id.*

157. "Frequency of monitoring" refers to the policies of how routine oversight of social media disclosures are, and suggests that firms could take an approach that is either based upon a routine schedule of monitoring (e.g., daily, weekly, biweekly), or could take a more probability/contingency based method that focusses on monitoring responses to the occurrence or nonoccurrence of contingencies that are likely to trigger social media disclosures and monitoring their compliance in real time, but warns that post hoc monitoring may not be appropriate in many circumstances. *See id.*

158. "Approval of content" refers to placing pre-approval controls on disclosures, such as having a system that functions similar to a prior restraint on speech in the First Amendment context. *See id.* at 4.

159. "Firm resources" refers to the analysis a company must conduct prior to entering the social media space to ensure that it has adequate resources to sufficiently monitor all

(8) training;¹⁶¹ (9) certification;¹⁶² (10) functionality;¹⁶³ (11) personal/professional sites;¹⁶⁴ (12) information security;¹⁶⁵ and (13) enterprise wide sites.¹⁶⁶ The list, while not exhaustive, can be used by issuers to assess its disclosure risks and craft industry and firm-appropriate policies to manage these risks.

CONCLUSION

The outset of this Comment posited that changes in technology and business practices have made basic securities law principles obsolete since the SEC formulated Regulation D's primary principles that: (1) businesses cannot make general solicitations in private offerings, and (2) securities rules should limit the ability of people to invest if they do not have sufficient assets to lose money without the loss adversely impacting them and their families.

disclosures on social media, and various cost-saving policies such as spot-sampling of disclosures, or using lexicon-based search methodologies to ensure compliance of its disclosures. *See id.*

160. "Criteria for Approving Participation" refers to analysis of the individual social media platform to assess compatibility between the platform's various functionalities and the company's compliance risk policies. *See id.* Applicable functionality assessments include "the reputation of the site, the site's privacy policy, the ability to remove third-party posts, controls on anonymous posting and the advertising practices of any social media site that the firm or its IARs or solicitors use to conduct business." *See id.*

161. "Training" refers to providing training amongst employees and disclosure staff to promote and educate about compliance policies and how to avoid risk. *See id.*

162. "Certification" refers to adding a requirement that disclosure staff satisfy certain certification procedures that include training or education on compliance strategies and policies. *See id.*

163. "Functionality" refers to monitoring the social media platform for updates in functionalities and programming to ensure ongoing compliance with the company's disclosure risk policies. *See id.* Such a team would assess whether the platform allows for the ability to control and accurately assess its risk. *See id.*

164. "Personal/Professional Sites" refers to employees utilizing their own personal social media pages to disclose professional information that could be imported as a disclosure of the company. *See id.* at 5. Companies can create policies to control the types of company communications that are permitted on sites that are not operated, supervised or sponsored by the company. *See id.*

165. "Information Security" refers to policies related to company or employee presence on sites that pose elevated information security risks. *See id.* The goals for companies include protecting its information and information systems from unauthorized access, use, disclosure, disruption, modification, perusal, inspection, recording, or destruction. *See id.* The use of firewalls and secure passwords is contemplated by this factor. *See id.*

166. "Enterprise Wide Sites" refers to the management of all sites associated with a company to ensure internal compliance across sites. *See id.*

These rules promote secret communications among a small group of elite issuers, institutional investors, and wealthy individual investors in a culture where most information and communications are now openly shared and everyone has the ability to participate in the conversation if they have a mobile device or a modem.

In response to this disconnection between Regulation D principles on the one hand and technology and modern business practices on the other hand, the JOBS Act and many state legislatures have restructured securities laws to promote more open communications to a broader audience (called the crowd). It has accomplished this by revising old exemptions from registration and by creating new exemptions in the form of Rule 506(c) issued under Title II of the JOBS Act, section 4 (a)(6) created by Title III of the JOBS Act, Regulation A+ issued under Title IV of the JOBS Act, and state crowdfunding laws that are designed to be used in conjunction with SEC Rules 147 and 504, which the SEC has proposed amending to make state crowdfunding laws usable by more businesses.

All of these crowdfunding exemptions from registration permit issuers to use inexpensive technology to substantially reduce the cost of communicating with large numbers of potential investors. The exponential growth of internet and social media use during the past two decades demonstrate two basic facts that securities laws must deal with—as the cost of communicating decreases and user interfaces make technology easier to use, more people will communicate with one another and people will change what they say and how they say it to adapt to the type of technology they use to communicate.

The focus on the new freedom to communicate reminds us that the heart of the 1933 Act was never about how people communicated with one another. Communication tools always change. Therefore, rules about the tools people use to communicate must always change or become irrelevant. The core of the Securities Act regulates the substance of what is being communicated.

Section 12(a)(2) of the 1933 Act and section 10 of the Securities Exchange Act of 1934 create liability (subject to certain defenses), if an issuer makes any “untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.”¹⁶⁷ Sometimes whether a statement is untrue or misleading and sometimes is an issue. In other cases, the issue may be whether a statement or omission related to a fact. In most cases, however, the primary issues are whether facts are material.

167. Securities Act of 1933, Pub. L. No. 73-22, § 12, 48 Stat. 74, 84.

That is why the key to designing any disclosure strategy is to ask and answer: “What is ‘material’ about this business and this offering?” Materiality issues generally break down into two basic categories. How is this business similar to other successful businesses and similar to other unsuccessful businesses? How is this business different from other successful businesses and different from other unsuccessful businesses? Answering these questions helps to both develop the issuer’s sales pitch about why people should invest and the issuer’s disclosure strategy about what securities laws require issuers to disclose to investors.

None of the new crowdfunding exemptions from registration weaken these basic disclosure principles and some of the crowdfunding exemptions supplement these disclosure principles by adding more specific disclosure requirements about financial statements. Recognizing that intentional securities fraud is perpetrated by a relatively small group of criminals who repeatedly and intentionally violate securities laws, the new crowdfunding exemptions specifically exclude issuers that are affiliated with what are commonly called “bad actors.”

Most securities disclosure violations are unintentional and are made by business people who simply make mistakes. Therefore, keeping out the “bad actors” is only the first step to ensuring disclosure compliance. The challenge of making the new crowdfunding exemptions work will be to reduce the number of disclosure mistakes issuers make.

Disclosure strategy is like many other legal issues: a mixture of law and facts. If the facts change, issuers need a different strategy for how to comply with the legal requirements. Important facts that affect how disclosure rules apply require businesses that use the different crowdfunding exemptions to raise capital to consider: (1) who is communicating (what are the specific things that are important to this particular business); (2) with whom they are communicating (what level of understanding do targeted investors have); and (3) how they are communicating (how do you blend securities law disclosure requirements with communications styles that are effective for the type of communications tools being used). Low risk can mean low cost and low liability exposure, but also low reward. High risk can mean high cost and high liability exposure, but also high reward. Ultimately, an issuer must have a sense of self-actualization that allows it to find the right mixture of risk versus reward in its formation and utilization of disclosure strategies and policies.

Addressing these issues requires more complicated analysis for crowdfunding offerings than for traditional private placements, because securities law compliance can be expensive, many of the new issuers that will be conducting crowdfunding offerings will have low compliance

budgets and many potential investors will lack experience evaluating investments in private businesses. The bar that issuers must clear for their disclosures is not lower because the issuer is inexperienced or cannot afford good disclosure advice. Consequently, issuers must find ways to make disclosures more cost effective. For some, this could mean sticking to more conventional, traditional, cheaper, and safer options.

Inevitably, issuers will try to rely on standard disclosure forms to lower disclosure costs and liabilities. That can be a useful start, but it is difficult to create forms that both sell the offering and satisfy disclosure requirements, because investors usually want to know what is different about the particular business. Why will this particular business succeed when other businesses in the same industry fail? Disclosure forms are much better at describing similarities than differences. If issuers only describe how much they and other businesses are alike, issuers will undercut their sales message.

Effectively dealing with these complications in crowdfunding offerings will require issuers to streamline their sales messages and disclosures to focus on the most important things investors need to know about their businesses. This will require issuers to be disciplined in their sales messages. Issuers must resist the temptation to try to be all things to all investors. Less really can be more.

The scope of the issuer's duty not to misstate material facts and to avoid omitting material facts that make prior statements of material facts misleading to investors is defined by the claims issuers make about their businesses. Fewer claims generally translates into fewer material facts that investors must evaluate, fewer opportunities to misstate material facts and fewer omissions that can cause statements to be misleading. Understanding this basic fact is the key to issuers being able to communicate their sales messages in ways that focus investors on why they should invest, satisfy securities law disclosure requirements and permit issuers to stay within budget.

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