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## Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries

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**WISDOM OF THE INTERMEDIARY CROWD: WHAT THE  
PROPOSED RULES MEAN FOR AMBITIOUS CROWDFUNDING  
INTERMEDIARIES**

TABLE OF CONTENTS

INTRODUCTION ..... 1146

I. BACKGROUND OF CROWDFUNDING AND THE CROWDFUND ACT ..... 1151

II. TITLE III OF THE JOBS ACT OF 2012: THE CROWDFUND ACT ..... 1153

III. WHAT THE CROWDFUND ACT REQUIRES OF INTERMEDIARIES ..... 1153

IV. THE SEC’S PROPOSED RULES FOR INTERMEDIARIES UNDER THE  
CROWDFUND ACT..... 1154

    A. *A Brief Look at Intermediary Liability to Frame the Discussion* ..... 1155

    B. *Requirements with Respect to Reducing Fraud*..... 1157

    C. *Requirements with Respect to an Investor’s Account Opening* ..... 1162

        1. Account Opening..... 1162

        2. Educational Materials..... 1163

        3. Promoters of Offerings..... 1166

        4. Importance of the Communication Channel..... 1169

        5. Desire for Demographic Data..... 1173

    D. *Requirements with Respect to Transactions* ..... 1174

        1. Issuer Information ..... 1174

        2. Investor Qualification..... 1176

        3. Investor’s Acknowledgement of Risk ..... 1177

        4. Maintenance and Transmission of Funds ..... 1178

    E. *The Challenges Surrounding Material Changes* ..... 1180

    F. *Payments to Third Parties* ..... 1181

    G. *Making Liquidity as Accessible as Possible for Investors*..... 1183

CONCLUSION..... 1186

## INTRODUCTION

Crowdfunding, the raising of large quantities of small funds through the internet crowd,<sup>1</sup> has been gaining momentum worldwide.<sup>2</sup> The issue for securities crowdfunding in the United States is whether the Jumpstart Our Business Startups (JOBS) Act of 2012<sup>3</sup> will be able to balance low cost of compliance for small businesses and entrepreneurs against the need for investor protection in such a way as to allow ordinary, non-accredited investors (also known as retail investors) to provide small businesses and entrepreneurs the access to capital for which they are starving. Title III of the JOBS Act—referred to as the CROWDFUND Act—contains the crowdfunding exemption to registration of securities that would allow the non-accredited crowd to invest.<sup>4</sup>

President Obama hailed crowdfunding as a “game changer” that would allow “ordinary Americans to go online and invest in entrepreneurs they believe in.”<sup>5</sup> Former SEC Chairman Mary Schapiro sees the JOBS Act and crowdfunding as ushering in a new era, and she describes this legislation as a “fundamental change in the securities markets.”<sup>6</sup> Crowdfunding has revolutionary potential, and, if implemented correctly, it could “be a boon to small businesses and growing businesses that sometimes are shut out of those

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1. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10 (2012). This is distinguishable from perhaps the more traditional form of raising funds through a bank, an angel investor, or through a public offering of securities. *Id.* at 101–03. This is not to say the concept of crowdfunding is new; it has “been the backbone of the American political system since politicians started kissing babies.” *Id.* at 11 & n.17 (quoting JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF BUSINESS 253 (2008)). This Comment uses the term “crowdfunding” in its most contemporary sense, namely, seeking small funds through the internet crowd. Crowdfunding is the product of crowdsourcing and microfinance. *Id.* at 27. Crowdsourcing usually consists of “breaking a project into tiny component tasks and farming those tasks out to the general public by posting the requests on a website.” Rachel Emma Silverman, *Big Firms Try Crowdsourcing*, WALL ST. J., Jan. 17, 2012, <http://online.wsj.com/article/SB10001424052970204409004577157493201863200.html>. Microfinance is the offering of small-ticket loans to help start or expand businesses. Ashutosh Joshi, *SKS Microfinance Shares Jump on Loan Deal*, WALL ST. J., Dec. 7, 2012, <http://online.wsj.com/article/SB10001424127887324640104578164602767925688.html>; see also Joseph Adinolfi, *Mini Loans Feed Bigger Ambitions*, WALL ST. J., Sept. 8–9, 2012, at B1.

2. Yen, *State of International Crowdfunding*, LAUNCHT (Feb. 6, 2013), <http://www.launcht.com/blog/2013/02/06/state-of-international-crowdfunding/>.

3. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 315 (2012) [hereinafter JOBS Act].

4. *Id.* “CROWDFUND” stands for: Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure. *Id.* § 301.

5. Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WALL ST. J., Jan. 18, 2013, at C1.

6. Angus Loten, *Stalled Crowdfunding Rules Leave Business Plans on Ice*, WALL ST. J., Dec.13, 2012, at B1.

very fancy boardrooms where decisions are made behind closed doors and in very secretive meetings.”<sup>7</sup>

The CROWDFUND Act requires that the Securities and Exchange Commission (SEC) promulgate regulations to flesh out many of the details of the Act’s statutory framework, and on October 23, 2013, the SEC unanimously approved its proposed rules.<sup>8</sup> Though securities crowdfunding under the CROWDFUND Act requires the SEC to adopt final rules in order to be operational, this Comment focuses on the SEC’s proposed rules because the policies and challenges identified in the proposed rules will persist regardless of the content of the final rules. More specifically, this Comment focuses on what an ambitious securities crowdfunding intermediary should extract from the proposed rules; by analyzing the proposed rules, a proactive intermediary can arm itself with a decisive competitive advantage over other intermediaries. Ultimately, an intermediary that can distinguish itself from the pack will win over more investors and issuers than its competitors.

The CROWDFUND Act requires that securities be crowdfunded via an intermediary,<sup>9</sup> which is an online platform. The SEC proposed to define an intermediary as “a broker registered under Section 15(b) of the Exchange Act (15 U.S.C. 78o(b)) or a funding portal registered under § 227.400 and includes, where relevant, an associated person of the registered broker or registered

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7. 158 CONG. REC. S1778 (daily ed. Mar. 19, 2012) (statement of Sen. Mary Landrieu).

8. Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239–40, 249). The Financial Industry Regulatory Authority (FINRA), a non-governmental self-regulatory organization of the securities industry, is also expected to issue certain limited rules, but these are not the focus of this Comment. *Regulatory Notice 12-34: Jumpstart Our Business Startups Act: FINRA Requests Comment on Proposed Regulation of Crowdfunding Activities*, FINRA 2 (July 2012), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p131268.pdf> (“The regulatory scheme established by Congress expressly contemplates a role for an organization such as FINRA by mandating that each registered funding portal be a member of an applicable SRO. However, Congress limited a national securities association’s examination and enforcement authority over such registered funding portals to its rules ‘written specifically for registered funding portals.’”) (footnote omitted). It should be noted that, though the SEC unanimously approved its proposed rules, broader approval of the proposed rules has been far from unanimous. For example, recently the Investor Advisory Committee, whose opinion the SEC values, unanimously voted to recommend stricter crowdfunding rules because it did not believe that the SEC had reached the appropriate balance in the proposed rules. Ted Knutson, *SEC Advisory Committee Wants Tighter Crowdfunding Rules*, FINANCIAL ADVISOR (Apr. 10, 2014), <http://www.fa-mag.com/news/sec-advisory-committee-wants-tighter-crowd-funding-rules-17580.html>; Inv. Advisory Comm., *Recommendation of the Investor Advisory Committee: Crowdfunding Regulations*, SEC (Apr. 10, 2014), available at [www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf](http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf).

9. “Securities Act Section 4(a)(6)(C) requires a [securities] crowdfunding transaction to be conducted through a broker or funding portal that complies with the requirements of Securities Act Section 4A(a).” Crowdfunding, 78 Fed. Reg. at 66,458.

funding portal.”<sup>10</sup> A funding portal is a new creation of the CROWDFUND Act, and it is encumbered with significantly more restrictions than a broker-dealer.<sup>11</sup> In discussing what an ambitious intermediary should extract from the SEC’s proposed rules, this Comment discusses many things that only a broker-dealer intermediary could do. A funding portal intermediary will still benefit from this discussion, especially because funding portals are already partnering with broker-dealer intermediaries.<sup>12</sup> Accordingly, this Comment contemplates the ideal securities crowdfunding intermediary, which has all the legal flexibility of a broker-dealer and all the technological savvy of a funding portal, and so the distinction between broker-dealer and funding portal is disregarded for purposes of this Comment.

Throughout the proposed rules, the SEC touted the flexibility that it was allowing intermediaries. Intermediaries need to recognize the opportunity that this flexibility presents. This flexibility respects intermediaries’ expertise, and it is an opportunity for intermediaries to develop an efficient and tailored

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10. *Id.* at 66,556 (§ 227.300(c)(3)).

11. *See* JOBS Act, Pub. L. No. 112-106, § 304(b), 126 Stat. 306, 322 (2012); *see also* Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L.J. 177, 205 (2013) (“The combined attributes assigned to funding portals in the CROWDFUND Act, when viewed in their actual and anticipated regulatory context, may very well be so burdensome and costly that they discourage the development and registration of funding portals.”).

12. Crowdfunding, 78 Fed. Reg. at 66,516 (“[O]ur conversations with industry participants indicate that market competition to offer broker-dealer services as part of intermediaries’ service capabilities might either drive more broker-dealer growth in the longer term or provide registered funding portals with the incentive to form long-term partnerships with registered broker-dealers. For example, crowdfunding platforms could have incentives to partner with broker-dealers because of broker-dealers’ experience in providing recommendations or investment advice, as well as broker-dealers’ access to investors. There is anecdotal evidence that these partnerships are already forming under existing regulations, and one report predicted that in the first quarter of 2013, two to three dozen crowdfunding portals would partner with broker-dealers to start conducting private offerings under Regulation D in anticipation of securities-based crowdfunding.”) (footnotes omitted); *see also id.* at 66,526 (“[W]e believe that some brokers might acquire or form partnerships with funding portals to obtain access to a new and diverse investor base.”); *see also* Andrew D. Stephenson, Brian R. Knight & Matthew Bahleda, *From Revolutionary to Palace Guard: The Role and Requirements of Intermediaries Under Proposed Regulation Crowdfunding*, 3 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. (forthcoming 2014) (“[I]t is questionable whether for-profit businesses will enter the market as pure funding portals, instead preferring to become or partner with a broker-dealer, leaving the funding portal entity viable for only non-profits and other entities less concerned with financial return.”); Letter from Kim Wales, Exec. Bd. Member, Steve Ferrando, Bd. Member, & Chris Tyrell, Chairman, Crowdfund Intermediary Regulatory Advocates, to Elizabeth M. Murphy, Sec’y, U.S. Securities & Exchange Commission (Jan. 26, 2014), *available at* <http://www.sec.gov/comments/s7-09-13/s70913-261.pdf> (“Before the Final Title III Rules are adopted and crowdfunding is implemented, it is readily apparent that Funding Portals and Broker Dealers will be coordinating efforts to the extent permissible by law.”).

method to carry out securities crowdfunding under the CROWDFUND Act.<sup>13</sup> This flexibility is the space where great intermediaries will stand out from decent intermediaries and therefore attract more investors and issuers. In addition to sleek and user-friendly platforms, intermediaries will attract these groups by streamlining the compliance process under the CROWDFUND Act for investors and issuers.

If intermediaries simply treat this flexibility as a null obligation, they should not be surprised to have issuers or investors drag them into lawsuits over either issuers' or investors' own compliance failures. Additionally, intermediaries could potentially see this flexibility regulated away in response to such lawsuits. Ambitious intermediaries will not view the grants of "flexibility" from the SEC as null obligations, but rather as challenges to show how they can devise more effective systems than the SEC could have hoped to create by regulation.<sup>14</sup>

While this Comment discusses items that an ambitious intermediary ought to extract from the SEC's proposed rules, lackadaisical intermediaries should be wary of dismissing this Comment as inapplicable. For example, as the SEC discusses intermediaries sourcing certain obligations out to third parties, the SEC is clear that the intermediaries "remain responsible for compliance with the requirements."<sup>15</sup> An intermediary cannot simply outsource to a third party and close its eyes—it "should investigate and understand the procedures used

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13. An intermediary would be mistakenly narrow-minded to believe that theirs is simply a passive platform role. See ROCKETHUB, IMPLEMENTATION OF CROWDFUNDING: BUILDING ON TITLE III OF THE JOBS ACT: RESPONSE TO PROPOSED RULES (RELEASE NO. 33-9470) 12 (Feb. 2014) [hereinafter ROCKETHUB WHITEPAPER 3.0], available at <http://www.sec.gov/comments/s7-09-13/s70913-206.pdf> ("An intermediary may initially seem to serve solely as the platform on which an issuer's offering appears. In actuality, the intermediary creates the user experience and the user interface for both issuers and investors. The intermediary also creates the system through which issuers and investors interact with one another and third-party service providers. For example, whether or not a Portal uses a third-party payment service or its own technology, the issuer will perceive them as one and the same.").

14. See, e.g., Letter from Nicholas Tommarello, Chief Exec. Officer, Wefunder, to the U.S. Securities & Exchange Commission (Jan. 30, 2014) [hereinafter Wefunder Letter 2], available at <http://www.sec.gov/comments/s7-09-13/s70913-179.pdf> ("Product designers whose profession and expertise is information design can come up with superior solutions that will achieve better results than what is currently envisioned in the proposed rules."). Professor Stuart Cohn expresses a similar sentiment when speaking about legislators intending to legislate an ideal crowdfunding framework. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1445 (2012) ("Yet, for all their good intentions, legislators are not experts in the nuances of securities laws and existing federal and state laws. The results reflected this lack of expertise, with House bills containing too few protective measures, the Senate bills containing too many.").

15. Crowdfunding, 78 Fed. Reg. at 66,464.

by the third party to determine the reasonableness of the reliance on a third party.”<sup>16</sup>

There will be competition between intermediary platforms,<sup>17</sup> and there will be some that are driven from the market.<sup>18</sup> This is fine, so long as there are trustworthy and robust intermediaries that protect investors,<sup>19</sup> help entrepreneurs with compliance,<sup>20</sup> and ultimately get those entrepreneurs access to capital through securities crowdfunding.<sup>21</sup> In fact, ambitious intermediaries

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16. *Id.* at 66,464 n.373.

17. The SEC anticipates this competition: “Moreover, the business models of the successful crowdfunding intermediaries are likely to change over time as they grow in size or market share or if they are forced to differentiate from other market participants in order to maintain a place in the market.” *Id.* at 66,527.

18. *See, e.g.*, Mark Fidelman, *13 Experts and 13 Trends That Will Dominate Crowdfunding in 2014*, HUFFINGTON POST, Jan. 29, 2014, [http://www.huffingtonpost.com/mark-fidelman/13-experts-crowdfunding\\_b\\_4677749.html](http://www.huffingtonpost.com/mark-fidelman/13-experts-crowdfunding_b_4677749.html) (quoting Steve O’Hear, Technology journalist for TechCrunch) (“I think there are too many platforms and we are likely to see some go away and/or consolidation, although it’s still early days. Any platform has to attract both investors looking to invest and companies looking to raise. The more you have of one, the more you can attract the other. Additionally, the larger the network the more useful the network becomes. A classic network-effects play. In the long term it makes sense therefore that only a finite number of platforms can be supported by the market.”); *see also* Wefunder Letter 2, *supra* note 14 (anticipating a dominant crowdfunding platform after a couple of years).

19. The importance of investor protection is what slowed down the JOBS Act in the Senate. *See* 158 CONG. REC. S1777 (daily ed. Mar. 19, 2012) (statement of Sen. Mary Landrieu). The House had passed their version H.R. 3606 in huge bipartisan numbers (390 to 23); however, numerous senators brought the issue of inadequate investor protections to the Senate floor. *See* 158 CONG. REC. S1963–77 (daily ed. Mar. 22, 2012) (statement of Sen. Richard Durbin) (entering into the record the statement of Luis A. Aguilar, SEC Comm’r, *Investor Protection Is Needed for True Capital Formation*); 158 CONG. REC. S1700 (daily ed. Mar. 15, 2012) (statement of Sen. Richard Durbin) (making clear that he wants to “engender economic growth but not at the expense of the integrity of America’s financial markets or at the expense of the innocent investors”).

20. *See, e.g.*, *Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, IPLEDGE (Jan. 28, 2014), <http://ipledg.com/blog/?p=513>. After discussing the Australian Small Scale Offerings Board (ASSOB), which has had eight years of experience in equity crowdfunding outside the United States, the article reflectively notes: “Perhaps the biggest matters uncovered include not initially having oversight of the issuers share registry, originally thinking it could be all done online, and *expecting issuers could manage large parts of the process themselves.*” *Id.* (emphasis added).

21. Catering to entrepreneurs was an essential part of the intent of Congress in passing the JOBS Act. *See, e.g.*, 158 CONG. REC. S1705 (daily ed. Mar. 15, 2012) (statement of Sen. Jon Kyl) (“The JOBS Act will demonstrate to entrepreneurs and job creators that we value what they do, that we want to make it easier for them to innovate, to gain access to capital to grow and to lift others up as they become more successful.”).

should seek to shoulder the weight of compliance because the system works best when they bear the highest compliance cost.<sup>22</sup>

This Comment proceeds in four parts. Part I provides a brief background of crowdfunding and the passage of the CROWDFUND Act. Part II provides a condensed overview of the CROWDFUND Act. Part III discusses the statutory requirements on intermediaries. Lastly, Part IV discusses the SEC's proposed rules for intermediaries under the CROWDFUND Act, especially in light of the thesis introduced above.

## I. BACKGROUND OF CROWDFUNDING AND THE CROWDFUND ACT

While there are several different types of crowdfunding,<sup>23</sup> this Comment is concerned with securities crowdfunding. Securities crowdfunding encompasses either equity or debt crowdfunding and, unlike non-securities crowdfunding, is not inherently limited as non-securities crowdfunding.<sup>24</sup> In fact, Danae Ringelmann, co-founder of the successful crowdfunding website Indiegogo,

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22. See Andrew A. Schwartz, *Keep it Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 43, 60 (2013) (“[T]he SEC should use a light touch in drafting rules for securities crowdfunding—but . . . place a relatively heavy burden on intermediaries” so as to enforce the annual cap, which is “so important to the entire statutory scheme.”); see also *While US Equity Crowdfunding Waits, UK Equity Crowdfunding Spikes*, CROWDFORCE (Nov. 1, 2012), <https://crowdforce.co/while-us-equity-crowdfunding-waits-uk-equity-crowdfunding-spikes>. The success of equity crowdfunding in the United Kingdom, which is already legal, is due in large part to the relatively high cost of compliance placed on crowdfunding intermediaries. *Id.* The U.K. securities system is much like the U.S. securities system in that both are built around investor protection by requiring detailed disclosures. *Id.* In equity crowdfunding in the U.K., the responsibility for disclosure falls to the crowdfunding intermediaries. *Id.* In other words, “as long as Crowdcube or Seedrs or GrowVc or any of the other U.K. crowdfunding platforms are willing to vouch for their projects, then those projects can be legally crowdfunded through equity giveaways.” *Id.* For a more comprehensive discussion of equity crowdfunding abroad in the U.K., Italy, France, and elsewhere worldwide, see Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You’re Expecting*, 46 CORNELL INT’L L.J. 427, 437–49 (2013). *But see* 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown) (“[A]ll rules, regulations and registration requirements should be developed with minimal burden and cost to the intermediaries . . . [because] these costs will ultimately be passed through to issuers.”). The Senator has a point, but this Comment argues that the intermediaries that succeed will be the ones who can best internalize compliance costs and present a streamlined, low-compliance-cost process to entrepreneurs.

23. Professor Steven Bradford specifies five different categories based on what investors are promised for their contributions: (1) the donation model, (2) the reward model, (3) the pre-purchase model, (4) the lending model, and (5) the equity model. Bradford, *supra* note 1, at 14–15. Professor Bradford’s analysis concludes that donation, reward, and pre-purchase models do not involve securities, but lending with a promise of interest and equity model crowdfunding are likely securities for the purposes of the Securities Act of 1933. *Id.* at 31.

24. C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 197 (2012) (noting that non-securities crowdfunding “can only attract a limited number of investors.”).



said that equity crowdfunding was the original idea.<sup>25</sup> Only after realizing securities regulation barred the equity approach did Indiegogo offer “perks” to funders of different campaigns.<sup>26</sup>

Issuing securities triggers the need to comply with both federal and state securities laws.<sup>27</sup> To comply with federal law, securities offerings must be registered with the SEC under section 5 of the Securities Act of 1933, although there are certain exemptions.<sup>28</sup> Prior to the CROWDFUND Act there was no federal exemption that catered well to securities crowdfunding.<sup>29</sup> State securities laws, or “Blue Sky” laws, would also apply to crowdfunding securities,<sup>30</sup> but the CROWDFUND Act treats crowdfunding securities as “covered securities,” making state securities laws largely preempted and irrelevant.<sup>31</sup> Therefore, this analysis will only focus on the issues pertaining to federal securities laws.

Given the inadequate structure of section 5 of the 1933 Act and the strong push behind crowdfunding in Congress, President Obama signed the JOBS Act into law on April 5, 2012, and thereby created an exemption for securities crowdfunding under Title III of the Act, namely the CROWDFUND Act.<sup>32</sup>

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25. Stephen Shankland, *Indiegogo Moves Crowdfunding Business Beyond USA*, CNET (Dec. 5, 2012, 8:03 AM), [http://news.cnet.com/8301-11386\\_3-57557268-76/indiegogo-moves-crowdfunding-business-beyond-usa/](http://news.cnet.com/8301-11386_3-57557268-76/indiegogo-moves-crowdfunding-business-beyond-usa/). More recently, Indiegogo’s other co-founder, Slava Rubin, has intimated that, after the SEC finalizes crowdfunding rules, Indiegogo “will look to experiment and . . . evolve as needed.” Alex Konrad, *Crowdfunder Indiegogo Raises Its Own Big-Time Funding*, FORBES (Jan. 28, 2014, 5:00 AM), <http://www.forbes.com/sites/alexkonrad/2014/01/28/indiegogo-raises-big-time-funding/>.

26. Shankland, *supra* note 25.

27. See Bradford, *supra* note 1, at 30.

28. Securities Act of 1933, 15 U.S.C. § 77e(c) (2012).

29. See Nikki D. Pope, *Crowdfunding Microstartups: It’s Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973 (2011); see also Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 370 (2012) (concluding that the U.S. system of financial regulation has become outdated to deal with the complexity and fluidity of financial interests, which can be seen by, among other things, focusing on what is classified as securities in the crowdfunding era).

30. D. Scott Freed, *Crowdfunding as a Platform for Raising Small Business Capital*, MD. B.J., July–Aug. 2012, at 12, 14.

31. STUART R. COHN, *Part III. Planning for Exemption from Federal Regulation—Chapter 9A. Section 4(6)—The Crowdfunding Exemption*, in 1 SECURITIES COUNSELING FOR SMALL & EMERGING COMPANIES § 9A:8 (2012). Section 4(a)(6) was made a part of the list of covered securities in section 18(a)(4) of the 1933 Securities Act. *Id.* at n.1 (citing 15 U.S.C. § 77r(a)(4)). State antifraud requirements are still applicable as are state filing fees in the state of the issuer’s principal place of business and any state in which the purchasers represent 50% or more of the total purchases. *Id.*

32. JOBS Act, Pub. L. No. 112-106, § 301, 126 Stat. 306, 315 (2012).

## II. TITLE III OF THE JOBS ACT OF 2012: THE CROWDFUND ACT

The CROWDFUND Act is laid out in a new section of the Securities Act of 1933, section 4(a)(6).<sup>33</sup> As long as a given investor does not exceed an individual investment cap based on the investor's net worth and annual income, section 4(a)(6) exempts an issuer's offering of one million dollars or less.<sup>34</sup> The CROWDFUND Act requires that securities be offered through an intermediary that complies with the new section 4A(a) of the Securities Act; the issuer will have to comply with the new section 4A(b).<sup>35</sup> The issuer requirements are largely disclosure related,<sup>36</sup> and the intermediary requirements will be discussed below.

## III. WHAT THE CROWDFUND ACT REQUIRES OF INTERMEDIARIES

Section 4A(a) of the Securities Act of 1933 is amended by section 302(b) of the CROWDFUND Act, which prescribes the requirements for intermediaries.<sup>37</sup> A crowdfunding intermediary for purposes of the new section 4(a)(6) must be either a broker or a funding portal.<sup>38</sup> Such intermediaries must register with any applicable self-regulatory organization (SRO), as defined in section 3(a)(26) of the Securities Exchange Act of 1934.<sup>39</sup> The intermediaries are required to provide disclosures related to risks and other investor education materials that the SEC determines are necessary.<sup>40</sup> The intermediary must ensure that each investor reviews the investor education materials, affirms their understanding of the same, acknowledges the possibility they might lose their entire investment, and answers questions showing an understanding of startup investment risk generally and the risk of illiquidity.<sup>41</sup>

Furthermore, intermediaries must guard against fraud by doing, *inter alia*, background checks on an issuer's officers.<sup>42</sup> The intermediary must leave a funding period open for a minimum of twenty-one days, and it cannot allow proceeds to reach an issuer unless the target has been met or surpassed.<sup>43</sup> The intermediary is also tasked to ensure that no investor exceeds investment limits

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33. *Id.* § 302(a), 126 Stat. at 315 (codified at 15 U.S.C. § 77d(a)(6)).

34. *Id.*

35. *Id.* § 302(a)–(b), 126 Stat. at 316–17 (codified at 15 U.S.C. §§ 77d-1(a)–(b)).

36. *See id.* § 302(b), 126 Stat. at 317–18 (codified at 15 U.S.C. § 77d-1(b)(1)).

37. JOBS Act, § 302(b), 126 Stat. at 315 (codified at 15 U.S.C. § 77d-1(a)).

38. *Id.* § 302(b), 126 Stat. at 316 (codified at 15 U.S.C. §§ 77d-1(a)(1)). As mentioned above, this Comment is not concerned with the distinction between a broker and a funding portal intermediary, but rather it focuses on crowdfunding intermediaries generally. *See supra* INTRODUCTION.

39. JOBS Act, § 302(b), 126 Stat. at 316 (codified at 15 U.S.C. § 77d-1(a)(2)).

40. *Id.* (codified at 15 U.S.C. § 77d-1(a)(3)).

41. *Id.* (codified at 15 U.S.C. § 77d-1(a)(4)).

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

43. *Id.* (codified at 15 U.S.C. §§ 77d-1(a)(6)–(7)).

in a twelve-month period and to take precautions to protect the privacy of an investor's information.<sup>44</sup> Also, the intermediary cannot compensate promoters who provide them with potential investor information.<sup>45</sup> Nor can directors, officers, or partners of an intermediary have a financial interest in an issuer using its services.<sup>46</sup> Lastly, there is a catch-all phrase allowing the SEC to promulgate whatever other guidance is necessary "for the protection of investors and in the public interest."<sup>47</sup> Through this catch-all phrase and other language throughout these intermediary requirements, Congress mandated that the SEC promulgate regulations to flesh out the statutory framework. These regulations are the basis for the SEC's proposed rules discussed below.

#### IV. THE SEC'S PROPOSED RULES FOR INTERMEDIARIES UNDER THE CROWDFUND ACT

This Part discusses what an ambitious securities crowdfunding intermediary should extract from the SEC's proposed rules. Regardless of the content of the final rules, the policies and challenges identified in the proposed rules will persist. By analyzing the SEC's discussion in the proposed rules, specifically where the SEC proposes minimal additions to the statutory framework and provides intermediaries with significant flexibility, an intermediary can discover how best to address the underlying challenges of securities crowdfunding under the CROWDFUND Act. Identifying and addressing these challenges is where great intermediaries will distinguish themselves from the rest, and it is that distinction that will attract investors and issuers to great intermediaries.

This Part proceeds in seven sections. Section A looks at an intermediary's liability under the proposed rules. Section B analyzes an intermediary's obligations to reduce fraud. Section C discusses an intermediary's responsibility with respect to opening investor accounts, while Section D addresses requirements with respect to securities crowdfunding transactions. Section E looks at challenges relating to material changes in an offering's terms, and Section F addresses certain payments to third parties. Lastly, Section G looks at how to make liquidity as accessible as possible for crowdfunding investors. This Part does not exhaustively review all the proposed requirements for intermediaries; rather it focuses on requirements where the SEC proposed minimal changes to the statutory framework because such requirements provide the flexibility for exceptional intermediaries to stand out from the crowd.

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44. JOBS Act, § 302(b), 126 Stat. at 316 (codified at 15 U.S.C. §§ 77d-1(a)(8)–(9)).

45. *Id.* § 302(b), 126 Stat. at 317 (codified at 15 U.S.C. § 77d-1(a)(10)).

46. *Id.* (codified at 15 U.S.C. § 77d-1(a)(11)).

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

A. *A Brief Look at Intermediary Liability to Frame the Discussion*

As mentioned above, treating “flexibility” as a null obligation is a liability for intermediaries. Section 4A(c) proposes to make an issuer liable to someone who purchases its securities under the CROWDFUND Act, if the issuer:

[M]akes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements . . . not misleading, provided that the purchaser did not know of the untruth or omission, and the issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.<sup>48</sup>

Because “Section 4A(c)(3) defines, for purposes of the liability provisions of Section 4A, an issuer as including ‘any person who offers or sells the security in such offering,’”<sup>49</sup> the SEC thinks it is “likely that intermediaries . . . would be considered issuers for purposes of this liability provision.”<sup>50</sup> Accordingly, the SEC is clear that intermediaries need to have policies in place to ensure issuer compliance.<sup>51</sup>

Now, intermediaries might downplay this potential liability because the SEC also proposed “a safe harbor for certain insignificant deviations from a term, condition or requirement of Regulation Crowdfunding.”<sup>52</sup> The SEC proposes, however, a safe harbor for issuers “because, under the statute, an issuer could lose the exemption because of the failure of the intermediary to comply with the requirements of Section 4A(a),” and the SEC “believe[s] that an issuer should not lose the offering exemption due to such failure by the intermediary, which likely would be out of the issuer’s control, if the issuer did not know of such failure . . . .”<sup>53</sup> Issuers who find themselves sued for wrongful offerings will lean very hard on this language of the SEC so that they do not forfeit the exemption.<sup>54</sup> Such issuers will say that it was the intermediary’s compliance failure entirely and that as a simple issuer they had

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48. Crowdfunding, 78 Fed. Reg. 66,428, 66,498–99 (proposed Nov. 5, 2013).

49. *Id.* at 66,499.

50. *Id.*

51. *See id.* (“We believe that steps intermediaries could take in exercising reasonable care in light of this liability provision would include establishing policies and procedures that are reasonably designed to achieve compliance with the requirements of Regulation Crowdfunding, and that include the intermediary conducting a review of the issuer’s offering documents, before posting them to the platform, to evaluate whether they contain materially false or misleading information.”) (footnote omitted).

52. *Id.* at 66,496 (referencing proposed Rule 502 of Regulation Crowdfunding (§ 227.502)).

53. Crowdfunding, 78 Fed. Reg. at 66,496.

54. It should be noted that the safe harbor is not an automatic pass: “[T]he proposed rules would provide that notwithstanding this safe harbor, any failure to comply with Regulation Crowdfunding would nonetheless be actionable by the Commission.” *Id.* (referencing proposed Rule 502(b) of Regulation Crowdfunding (§ 227.502(b))).

no idea. In precisely such a situation as this, an intermediary will be glad that it did not treat the flexibility in the proposed rules as a null obligation; an intermediary will be able to point to the best practices it took so as to surpass the minimum statutory and regulatory requirements.

Additionally, intermediaries might downplay the potential liability because the SEC also included “an exception from disqualification for offerings in which the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person.”<sup>55</sup> Again, when an issuer is sued for wrongful action, the issuer will claim it took reasonable care. Arguably, “reasonable care” for an unsophisticated issuer will be a lower standard relative to intermediary standards. And again, an issuer will lay blame on its intermediary, claiming, for example, that the intermediary did not advise them otherwise.

This disqualification example also illustrates the balancing act for intermediaries. Exercising reasonable care that no disqualifications existed requires an issuer to make a “factual inquiry.”<sup>56</sup> One aspect of this factual inquiry is determining “appropriate cut-off dates.”<sup>57</sup> Here intermediaries need to be careful to not be too involved. If an intermediary requires an issuer to use a specific period for purposes of “appropriate cut-off dates,” then perhaps the intermediary is more apt to be included in a lawsuit because it gave the recommendation. There is a fine line between helping issuers comply and not recommending or requiring things that the issuer can point to as something they relied on to their detriment.

Intermediaries need also be aware of the possible liability that could arise from investor reliance.<sup>58</sup> “[T]he proposed rules would require disclosure in the offering materials of matters that would have triggered disqualification had

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55. *Id.* at 66,505 (referencing proposed Rule 503(b)(4) of Regulation Crowdfunding (§ 227.503(b)(4))).

56. *Id.*

57. *Id.* (“The timeframe for inquiry also should be reasonable in relation to the circumstances of the offering and the participants. The objective would be for the issuer to gather information that is complete and accurate as of the time of the relevant transactions without imposing an unreasonable burden on the issuer or the other offering participants. With that in mind, we would expect issuers to determine the appropriate cut-off dates to apply when they make a factual inquiry, based upon the particular facts and circumstances of the offering and the participants involved, to determine whether any covered persons are subject to disqualification before seeking to rely on the exemption.”).

58. In the context of investor-intermediary relations, the SEC recognizes that there will be reliance on intermediaries: “We believe that if intermediaries take the measures we propose to require, investors would be more willing to participate in securities-based crowdfunding offerings.” Crowdfunding, 78 Fed. Reg. at 66,531. In other words, the SEC is acknowledging that investors will rely on intermediaries and their implied representation that issuers on their platform are not fraudulent or likely to commit fraud.

they occurred after the effective date of proposed Regulation Crowdfunding.”<sup>59</sup> The SEC thinks this disclosure “is particularly important because . . . investors may have the impression that all bad actors would now be disqualified from participating in offerings under Section 4(a)(6),” and so the SEC “expect[s] that issuers would give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events would be appropriately presented in the total mix of information available to investors.”<sup>60</sup> Failure to disclose such information would not be insignificant.<sup>61</sup> Therefore, an intermediary needs to treat the opportunity of regulatory flexibility as a challenge, not a null obligation, so that an intermediary will be best prepared to fend off potential lawsuits from not only the issuers but also the investors it works with.

#### *B. Requirements with Respect to Reducing Fraud*

Under Securities Act Section 4A(a)(5), an intermediary must take measures established by the SEC to decrease the risk of fraud “including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person.”<sup>62</sup> To implement this provision, the SEC proposed requiring that an intermediary “have a reasonable basis for believing that the issuer is in compliance with relevant regulations and has established means to keep accurate records of holders of the securities it offers,” and “that the intermediary deny access if it believes the issuer or its offering would present a potential for fraud.”<sup>63</sup> These proposed intermediary obligations will be discussed in order.

“[T]he proposed rules would require an intermediary to have a reasonable basis for believing that an issuer . . . complies with the requirements in Securities Act Section 4A(b) and the related requirements in Regulation Crowdfunding.”<sup>64</sup> The SEC proposes to require the intermediary to check the issuer’s compliance because “it would help to reduce the risk of fraud.”<sup>65</sup> The SEC gives intermediaries significant flexibility here because it “permit[s] intermediaries to reasonably rely on representations of the issuer, absent

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59. *Id.* at 66,506 (referencing proposed Rule 201(u) of Regulation Crowdfunding (§ 227.201(u))).

60. *Id.*

61. *Id.*

62. Securities and Exchange Act of 1933, ch. 38, § 4A(a)(5), 48 Stat. 74.

63. Crowdfunding, 78 Fed. Reg. at 66,461 (referencing proposed Rule 301 of Regulation Crowdfunding (§ 227.301)).

64. *Id.* at 66,461–62 (referencing proposed Rule 301(a) of Regulation Crowdfunding (§ 227.301(a))).

65. *Id.* at 66,462.

knowledge or other information or indications that the representations are not true,” and the SEC did not propose any specific actions for intermediaries to take.<sup>66</sup>

Intermediaries need to realize the opportunity of flexibility that the SEC imparts here, and intermediaries should not take this flexibility for granted.<sup>67</sup> At a minimum, intermediaries should adopt the crowdfunding platform RocketHub’s<sup>68</sup> understanding of “reasonable basis,” which requires “adher[ing] to anti-discrimination laws when denying access to the intermediary’s platform,” because “discriminatory practices do not provide for a reasonable basis for disqualifying an issuer.”<sup>69</sup>

There is a second “reasonable basis” requirement that intermediaries have with respect to ensuring issuer compliance, namely “to have a reasonable basis for believing that an issuer has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary’s platform.”<sup>70</sup> This is no small task to ensure. The SEC was clear that “[t]he ability to keep track of the ownership of an issuer’s securities is necessary to protect investors and critical for maintaining the integrity of securities transactions made in reliance on Section 4(a)(6).”<sup>71</sup> Though the CROWDFUND Act did not require this of intermediaries, the SEC chose to have intermediaries help share the issuers’ burden because “intermediaries would be well-positioned to make this determination.”<sup>72</sup>

Again, the SEC is respectful of the ability of intermediaries to devise systems that work; the SEC again provides flexibility because it does “not propos[e] to require a particular form or method of recordkeeping of securities, nor . . . that an issuer use a transfer agent or any other third party.”<sup>73</sup> The SEC has faith that “accurate recordkeeping can be accomplished by diligent issuers

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66. *Id.*

67. See Stephenson, Knight & Bahleda, *supra* note 12, at 21 (“While [“verifying the statements made by an issuer prior to posting the issuer’s offering materials to the intermediary’s platform”] would go beyond the affirmative requirements for intermediaries set out in proposed Rule 301(a), the intermediary would be accepting a significant amount of business risk by not conducting such due diligence on each issuer.”) (footnote omitted).

68. RocketHub is on Forbes’ short list for social entrepreneur sites. Devin Thorpe, *Eight Crowdfunding Sites For Social Entrepreneurs*, FORBES (Sept. 10, 2012, 10:05 AM), <http://www.forbes.com/sites/devinthorpe/2012/09/10/eight-crowdfunding-sites-for-social-entrepreneurs/>. RocketHub is also known for screening projects that are illegal or in bad taste. *Putting Your Money Where Your Mouse Is*, ECONOMIST (Sept. 2, 2010), [http://www.economist.com/node/16909869?story\\_id=16909869&CFID=155277003&CFTOKEN=21314214](http://www.economist.com/node/16909869?story_id=16909869&CFID=155277003&CFTOKEN=21314214).

69. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 59.

70. Crowdfunding, 78 Fed. Reg. at 66,462 (referencing proposed Rule 301(b) of Regulation Crowdfunding (§ 227.301(b))).

71. *Id.*

72. *Id.*

73. *Id.*

or through a variety of third parties,” and the SEC even anticipates that a broker intermediary could provide such recordkeeping.<sup>74</sup> An ambitious intermediary would offer issuers assistance with their recordkeeping compliance as a means of attracting issuers and distinguishing itself from fellow intermediaries that would not offer such assistance. An intermediary is especially well suited to handle an issuer’s recordkeeping because it is uncertain exactly what communication connection investors and issuers will have outside of the intermediary. For instance, at several points throughout the proposed rules, the SEC expressed doubt that an issuer will even have the email addresses of investors.<sup>75</sup>

While intermediaries are permitted to “rely on an issuer’s representations concerning the [recordkeeping] means it has established, unless the intermediary has reason to question the reliability of the representations,” the SEC suggests a “range of functions” that would be important for keeping accurate records.<sup>76</sup> In addition to, or more likely instead of checking to see if an issuer has any of the “range of functions,” an intermediary might simply handle the recordkeeping itself.<sup>77</sup> This would allow an intermediary to have the

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74. *Id.*; see also *id.* at n.354.

75. Crowdfunding, 78 Fed. Reg. at 66,454 (“[W]e believe that many issuers may not have email addresses for investors.”); *id.* (Request for Comment No. 96) (“Would issuers have access to the investors’ email addresses?”); *id.* at 66,451 n.225 (“We believe that in order for the issuer to have email addresses for the investors, it would need to obtain those email addresses from the intermediary, since it would be the intermediary that would collect that information when a potential investor opens an account. In order for the issuer to have e-mail addresses after the shares issued pursuant to Section 4(a)(6) are traded, an issuer would need to collect that information from each new investor in connection with any sale of the issuer’s securities in a secondary market.”). In fact, one crowdfunding platform, Wefunder, makes clear that on its site “issuers will not have email addresses for investors,” though messages sent via Wefunder’s communication channel are also emailed to investors’ inboxes. Wefunder Letter 2, *supra* note 14.

76. Crowdfunding, 78 Fed. Reg. at 66,462.

Such functions could include, for example, the ability [of the issuer] to (1) monitor the issuance of the securities the issuer would offer and sell through the intermediary’s platform, (2) maintain a master security holder list reflecting the owners of those securities, (3) maintain a transfer journal or other such log recording any transfer of ownership, (4) effect the exchange or conversion of any applicable securities, (5) maintain a control book demonstrating the historical registration of those securities, and (6) countersign or legend physical certificates of those securities.

*Id.* Additionally, an ambitious intermediary could extract from one of the SEC’s requests for comment that checking with FINRA’s BrokerCheck and the Commission’s Investment Adviser Public Disclosure program when performing background checks would be ideal. *Id.* at 66,464 (Request for Comment No. 133).

77. See ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 59 (“The proposed rules should allow intermediaries to provide the necessary services to issuers, and investors for document, record keeping, and information sharing. This may be a for-fee service, and should be permitted.”). Though RocketHub thought that the proposed rules hampered this ability, RocketHub acknowledged that “[p]ortals are well positioned to offer ancillary services to issuers



best “reasonable basis” possible regarding an issuer’s compliance with recordkeeping requirements. Alternatively, an intermediary could vet third-party recordkeeping services<sup>78</sup> and then make recommendations to the issuer; perhaps an intermediary might even partner with such services or establish a relationship where the intermediary’s issuers could use recordkeeping services at a discount.

Another way that intermediaries are required to help deter fraud is by conducting background checks on certain issuer persons, and intermediaries must:

[D]eny access to its platform, if the intermediary has a reasonable basis for believing that an issuer, or any of its officers, directors (or any person occupying a similar status or performing a similar function) or 20 Percent Beneficial Owners, is subject to a disqualification under the proposed rules or if the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.<sup>79</sup>

While the SEC recognizes that an intermediary might outsource portions of these background checks,<sup>80</sup> the SEC preserves flexibility for intermediaries and is “not proposing to establish specific procedures for intermediaries to follow to reduce the risk of fraud beyond conducting the prescribed background and securities enforcement regulatory history checks.”<sup>81</sup> Again, the SEC shows its faith in intermediaries. In allowing intermediaries this flexibility “to design systems and processes to help reduce the risk of fraud in securities-based crowdfunding,” the SEC cites intermediaries’ “judgment” and “concern for the reputational integrity of [their] platform[s] and crowdfunding.”<sup>82</sup>

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in an efficient manner that will improve the market, increase investor information and reduce transaction costs . . . . Crowdfunding platforms organically provide ancillary services to the benefit of users (soon to be issuers and investors).” *Id.* at 58.

78. Or, the intermediary could recommend recordkeeping software. *See* Letter from Jonathan Miller & Freeman White, Bd. Members, Crowdfund Intermediary Regulatory Advocates, to Elizabeth M. Murphy, Sec’y, U.S. Securities & Exchange Commission (Feb. 3, 2014) [hereinafter Miller & White CFIRA Letter], available at <http://www.cfira.org/wp-content/uploads/2014/02/CFIRA-Ongoing-Reporting-Requirements.pdf> (“For decades, at least, there has been software that is available at a nominal charge to small companies to keep track of their securities transactions. The Division of Trading and Markets, which regulates the trading markets and transfer agents is well aware of, and does not object to non-12(g) companies keeping their own records, using software designed for that purpose, or using non-registered transfer agent third parties to perform those functions for them.”).

79. Crowdfunding, 78 Fed. Reg. at 66,463 (referencing proposed Rule 301(c) of Regulation Crowdfunding (§ 227.301(c))).

80. The SEC “anticipate[s] that an intermediary may use the services of a third party to gather the information to conduct the required background and regulatory checks on issuers and their control persons.” *Id.* at 66,464.

81. *Id.* at 66,463.

82. *Id.*

Intermediaries should go above and beyond to keep the trust of the SEC because that will strengthen the probability that the SEC will allow the intermediaries flexibility going forward.<sup>83</sup> An intermediary could follow part of a suggestion from RocketHub “to post the results of a background check alongside the issuance,” not disclosing personal information but designating “specific flag[s]” for categories such as “non-verified work history or academic background.”<sup>84</sup> Intermediaries also should follow a second recommendation from RocketHub—permitting issuers “to opt into more premium background services, which go above the minimum requirements set by the Commission, the results of which could be displayed.”<sup>85</sup> This allows issuers to control their costs or send an extra positive signal to the crowd. Truly ambitious intermediaries could also take a page from the crowdfunding platform Wefunder<sup>86</sup> and “grill[] the founders face to face.”<sup>87</sup>

Lastly, the proposed rule for denying an issuer the use of an intermediary’s platform if the intermediary simply *believes* there is a potential for fraud shows the strength of the SEC’s trust in the discretion of intermediaries. Even if the information an intermediary collects about an issuer does not trigger disqualification under the proposed rules, an intermediary’s *belief* that there is still a potential for fraud would require an intermediary to reject that issuer.<sup>88</sup>

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83. *See id.* at 66,463 n.363. The SEC acknowledged a letter of the Crowdfund Intermediary Regulatory Advocates (CFIRA), summarizing it in a footnote as follows:

[S]tating that because there is no mandated infrastructure that intermediaries are required to use, each intermediary should utilize an infrastructure that incorporates some type of fraud deterrence and fraud detection system, whether proprietary or licensed through a third party; that, in order to deter fraud, funding portals should have a video interface “whereby each issuer is required to give a short presentation on their business which is capable of being viewed live and saved for later viewing at any time by a potential investor;” and that in terms of detecting fraud, we should require intermediaries to build certain fraud detection systems into the functionality of their platforms.

*Id.* (referencing and quoting Letter from Candace S. Klein, Chair, & Vincent R. Molinari, Co-Chair, Crowdfund Intermediary Regulatory Advocates, to the U.S. Securities & Exchange Commission (May 30, 2012) [hereinafter Klein & Molinari CFIRA Letter], *available at* <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-80.pdf>).

84. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 62.

85. *Id.*

86. Wefunder played an integral part in lobbying for the JOBS Act. WEFUNDER, <https://wefunder.com/wefunder> (last visited Apr. 9, 2014). Wefunder explains their mission: “We help everyone invest in startups. It’s like Kickstarter, but with equity.” *Top 10 Equity Crowdfunding Websites For Startups*, CROWDCRUX, <http://www.crowdcruz.com/top-10-equity-crowdfunding-websites-for-startups/> (last visited Apr. 9, 2014).

87. Letter from Nicholas Tommarello, Chief Exec. Officer, Wefunder, to the U.S. Securities & Exchange Commission (Jan. 30, 2014) [hereinafter Wefunder Letter 1], *available at* <http://www.sec.gov/comments/s7-09-13/s70913-179.pdf>.

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

This belief is not even required to have a reasonable basis.<sup>89</sup> Additionally, the SEC also requires an intermediary to reject an issuer “if [the intermediary] believes that it is unable to adequately or effectively assess the risk of fraud of the issuer or its potential offering.”<sup>90</sup>

Equating flexibility in the context of reducing fraud with the SEC’s “trust” of intermediaries, however, is a rosy oversimplification. Intermediaries need to realize what these standards translate into when an intermediary is attached as a party to a lawsuit against a wrongful issuer. When the SEC or other enforcement body asks an intermediary why it did not deny a wrongful issuer, an intermediary will have to show that it did not even have a belief that there was potential for fraud. In such an instance, the ambitious intermediary that did not settle for the minimum requirements will be able to point to the extra steps it took as a robust basis for its belief and thereby be less likely to share in the wrongful issuer’s liability.

### C. *Requirements with Respect to an Investor’s Account Opening*

This section discusses five aspects of an investor’s account opening: (1) requirements at account opening, (2) educational materials requirements, (3) requirements relating to promoters of a specific offering, (4) the importance of the new communication channel that the SEC proposed, and (5) the SEC’s desire for additional data about securities crowdfunding under Title III.

#### 1. Account Opening

The proposed rules require that an investor create an account with an intermediary prior to investing, but the SEC declined to require an intermediary to gain any specific information from the investor.<sup>91</sup> The SEC “anticipate[s] that at a minimum the intermediary would obtain basic identifying and contact information, such as full name, physical address and email address.”<sup>92</sup> Here, again the SEC is respecting the ability and discretion of intermediaries by trusting them to collect the necessary information. Intermediaries need to realize how important investor contact information is; it is unclear whether or not issuers will even have investors’ contact information or that they will have a way of reaching their investors outside of the intermediary.<sup>93</sup> In fact, “though communications among investors could occur outside the intermediary’s platform, communications by an investor with a crowdfunding issuer or its representatives about the terms of the offering

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89. *Id.*

90. *Id.*

91. *Id.* at 66,465.

92. *Id.* RocketHub would add to this list date of birth and social security number. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 64.

93. *See supra* note 75 and accompanying text.

would be required to occur through [an intermediary's communication] channels."<sup>94</sup> A prudent intermediary should request multiple means of communication with investors; an intermediary cannot assume that if it is unable to reach a given investor it can simply ask the issuer to contact them—the issuer relies on the intermediary as its vital link to its investors, not vice versa.<sup>95</sup>

## 2. Educational Materials

The SEC is also “proposing to require intermediaries to provide educational material about the types of securities available for purchase on their platforms and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution”<sup>96</sup> and “to provide educational material regarding the limitation on the amounts investors may invest pursuant to Section 4(a)(6)(B) and the proposed rules.”<sup>97</sup>

While the SEC did not propose specific rules as to what this educational material should entail, this obligation is inherently linked to an intermediary's duty to have a reasonable basis that an investor is in compliance with investment limits.<sup>98</sup> Just as an issuer could be expected to drag an intermediary into an enforcement action against itself, an investor undergoing enforcement action will not hesitate to point a finger at the intermediary through which they invested.<sup>99</sup> Undoubtedly, as enforcement evaluates whether an intermediary really could have had a reasonable basis that a given investor was compliant, enforcement will look to see how an intermediary carried out this obligation to provide educational material regarding investment limits to investors. The SEC

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94. Crowdfunding, 78 Fed. Reg. at 66,472 (referencing proposed Rule 204 of Regulation Crowdfunding (§ 227.204)).

95. *See id.* at 66,466 (discussing investors assuming that “following an offering conducted through the intermediary's platform through which they purchased securities, the intermediary would be the primary contact for investors wishing to obtain information about, or wishing to communicate with, the issuer”).

96. *Id.* (referencing proposed Rule 302(b)(1)(ii) of Regulation Crowdfunding (§ 227.302(b)(1)(ii))).

97. *Id.* (referencing proposed Rule 100(a)(2) of Regulation Crowdfunding (§ 227.100(a)(2))).

98. *Id.* (referencing proposed Rule 303(b)(1) of Regulation Crowdfunding (§ 227.303(b)(1))).

99. *See, e.g.,* Stephenson, Knight & Bahleda, *supra* note 12, at 7 (“Securities professionals can imagine scenarios in which the failure to provide educational materials on a particular type of security purchased by a disgruntled investor could lead to legal action under the securities fraud rules, or could result in the loss of the exemption from registration. More likely, the intermediary would face sanction by the SEC for not complying with its obligations to conduct offerings under Section 4(a)(6).”) (footnote omitted).

is certainly not sending the message that “flexibility”<sup>100</sup> means minimum-effort compliance. The SEC expressly rejected the suggestion of a commenter that “a disclaimer in isolation would be sufficient information to satisfy the statutory educational requirement.”<sup>101</sup>

A prudent intermediary will see the investor educational requirements as a challenge to design something that would foreclose any possibility that the investor herself was unaware of the statutory limits. Because it “take[s] its] responsibility to educate seriously,” Wefunder sets a high bar for ambitious intermediaries to follow: Wefunder “intend[s] to have a full-time team of writers constantly updating educational materials based on feedback and questions from [its] users.”<sup>102</sup>

Reading between the lines, an ambitious intermediary can find suggestions as to what else to disclose in its educational materials. For example, though it did not adopt this recommendation, the SEC acknowledged a comment by the Crowdfund Intermediary Regulatory Advocates (CFIRA)<sup>103</sup> that “intermediaries should be required to provide a glossary explaining each type of security available for purchase in each of the offerings on its portal.”<sup>104</sup> Perhaps following CFIRA’s recommendation to have a glossary page would be an ideal way to ensure that investors trying to learn about securities crowdfunding are informed, especially about their own obligations.

These educational materials could also be a means of introducing every potential securities crowdfunding investor to both the SEC and FINRA<sup>105</sup> at

100. In allowing intermediaries flexibility in the context of investor educational materials, the SEC reiterates its faith in intermediaries: “[W]e believe that the better approach is to provide each intermediary with sufficient flexibility to prepare educational materials in a manner reasonably designed to provide the required information, based on the types of offerings on the intermediary’s platform and the types of investors drawn to its platform.” Crowdfunding, 78 Fed. Reg. at 66,467; *see also* FINAL REPORT OF THE 2012 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, SEC (Nov. 5, 2012), *available at* <http://www.sec.gov/info/smallbus/gbfor31.pdf>. The SEC acknowledges this report as “recommending that the market for transactions in reliance on Section 4(a)(6) should be permitted to develop best practices wherever possible.” Crowdfunding, 78 Fed. Reg. at 66,467 n.397.

101. *Id.* at 66,467 (referencing proposed Rule 303(b)(2)(i) of Regulation Crowdfunding (§ 227.303(b)(2)(i))).

102. Wefunder Letter 2, *supra* note 14.

103. “CFIRA is an organization formed by the crowdfunding industry’s leading platforms and experts. The group will work with the [SEC and FINRA], and other affected governmental and quasi-governmental entities to help establish industry standards and best practices.” *About CFIRA*, CFIRA, [http://www.cfira.org/?page\\_id=17](http://www.cfira.org/?page_id=17) (last visited Apr. 9, 2014).

104. Crowdfunding, 78 Fed. Reg. at 66,466 (referencing and quoting Klein & Molinari CFIRA Letter, *supra* note 83).

105. It is important to note that, while FINRA and the SEC work together in monitoring securities markets, FINRA is an independent regulator and the SEC is an administrative agency of the government. *See About the Financial Industry Regulatory Authority*, FINRA, <http://www.finra.org/AboutFINRA/> (last visited Apr. 9, 2014); *see also The Investor’s Advocate:*

the outset. It is vital that investors realize the agencies and associations holding together the crowdfunding system. Knowing the major players in securities crowdfunding is a simple way to empower investors. These materials could also introduce potential investors to the North American Securities Administrators Association (NASAA), the state-level securities regulators who work closely with small businesses in their capital formation,<sup>106</sup> especially because claims of fraud will most likely first be addressed by NASAA.<sup>107</sup> From the start, investors will know where to direct their complaints and concerns, and the data generated by those complaints will not be dissipated to the potentially unlimited places unsophisticated investors might think to

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*How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Apr. 9, 2014); Donna M. Nagy, *Is the PCAOB a "Heavily Controlled Component" of the SEC?: An Essential Question in the Constitutional Controversy*, 71 U. PITT. L. REV. 361, 387 (2010) (noting that FINRA has substantial autonomy and that the SEC does not control FINRA at every significant step); *Silver v. N.Y. Stock Exchange*, 373 U.S. 341, 352 (1963) (citation omitted) (quoting Justice William O. Douglas, former SEC Chairman, who said of the relationship between the SEC and self-regulatory organizations such as FINRA: "[T]he exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.").

106. Letter from Jack Herstein, President, North American Securities Administrators Association, Inc., to Marcia E. Asquith, Office Corp. Sec'y, Financial Industry Regulatory Authority, Inc. (Aug. 31, 2012), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticcomments/p163724.pdf>.

107. The enforcement of violations of the Securities Act are often carried out at the state level; NASAA recognizes this as it notes to FINRA: "[T]he JOBS Act essentially puts state governments in the unfortunate position of enforcing federal laws from which we may not deviate." *Id.* For example, NASAA cites that, in 2010, states brought more than 250 enforcement actions for fraudulent Rule 506 offerings. Letter from Jack Herstein, President, North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Sec'y, U.S. Securities & Exchange Commission (July 3, 2012), available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf>. After the JOBS Act was passed, crowdfunding was cited by NASAA as one of the top ten investor threats. Melanie Waddell, *Lawmaker Calls SEC's Delay on JOBS Act Promotion Rule 'Completely Unacceptable'*, THINK ADVISOR (Sept. 13, 2012), <http://www.thinkadvisor.com/2012/09/13/lawmaker-calls-secs-delay-on-jobs-act-promotion-ru>. Matt Kitzi, former Missouri Securities Commissioner and former chair of NASAA's Enforcement Section, noted that since the JOBS Act was passed "the number of entities pitching themselves as crowdfunding vehicles online has risen dramatically—from a couple hundred to about 1,700." *Id.* As of January 2013, NASAA was sifting through 9001 website names containing the word "crowdfund." Eaglesham, *supra* note 5. After reviewing 2000 of these sites, NASAA had flagged roughly 200 that needed further scrutiny. *Id.*; see also 158 CONG. REC. S1718–20 (daily ed. Mar. 15, 2012) (statement of Sen. Landrieu) (introducing letter from NASAA to Senate Majority Leader Harry Reid and Minority Leader Mitch McConnell). With regards to H.R. 3606 (the House-passed version of the bill sent to the Senate), NASAA asked the Senate to make sure that the legislation did not "needlessly preempt state securities laws." *Id.* at S1719. In other words, NASAA sought to ensure the Senate amendment took a tailored approach to how states were preempted because ultimately it was the states who act as the "cops on the beat." *Id.* at S1720.

complain. Such data will also allow the SEC, FINRA, and NASAA to spot problem areas quickly and address them promptly so as to uphold the integrity of the securities crowdfunding market.<sup>108</sup>

### 3. Promoters of Offerings

The SEC also proposed requiring intermediaries to make investors aware when they open an account:

[T]hat any person who promotes an issuer's offering for compensation . . . or who is a founder or an employee of an issuer that engages in promotional activities on behalf of the issuer on the intermediary's platform, must clearly disclose in all communications on the platform the receipt of the compensation and the fact that he or she is engaging in promotional activities on behalf of the issuer.<sup>109</sup>

The SEC further explained that promoters must “disclose this information each time they post a comment in the communication channels on the platform.”<sup>110</sup>

It is important that the intermediary satisfy the SEC's proposals here, but a prudent and ambitious intermediary would not stop with a simple notice of such a requirement.<sup>111</sup> Crowdfunding is premised on the “wisdom of the crowd,”<sup>112</sup> and that wisdom hinges on accurate information and minimizing information asymmetry. If the crowd is unaware that a commenter on a given project is compensated for what she says, the crowd will not be able to properly discount such an opinion, and the “wisdom of the crowd” will be thwarted. Ambitious intermediaries will seek for ways to absolutely ensure that promoters, founders, and the like are clearly marked as such in the communication channels. The SEC suggested one such way: “[A]n

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108. See Crowdfunding, 78 Fed. Reg. at 66,453 (“Monitoring the implementation of the crowdfunding exemption also would give the Commission more information to evaluate whether the rules include appropriate investor protections and facilitate capital formation.”); see also *id.* at 66,524 (“The ability to efficiently collect information on all issuers also could provide an incentive for data aggregators or other market participants to offer services or analysis that investors could use to compare and choose among different offerings.”).

109. *Id.* at 66,467–68 (referencing proposed Rule 302(c) of Regulation Crowdfunding (§ 227.302(c))).

110. *Id.* at 66,468 (referencing proposed Rule 303(c)(4) of Regulation Crowdfunding (§ 227.303(c)(4))) (footnote omitted).

111. The Missouri Securities Commissioner, Andrew Hartnett, would like to extend this to an affirmative obligation of intermediaries. See Letter from Andrew M. Hartnett, Mo. Comm'r Sec., to Elizabeth M. Murphy, Sec'y, U.S. Securities & Exchange Commission (Feb. 3, 2014) [hereinafter Hartnett Letter], available at <http://www.sec.gov/comments/s7-09-13/s70913-242.pdf> (requesting that the SEC “require that intermediaries prominently post the online identities of the issuer's paid promoters in the provided communication channels”).

112. Crowdfunding, 78 Fed. Reg. at 66,429 (citing Richard Waters, *Startups Seek the 'Wisdom of Crowds'*, FINANCIAL TIMES, Apr. 3, 2012, <http://www.ft.com/intl/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html#axzz2b7QxIH5L>).

intermediary could comply with this requirement in part by, for example, establishing a ‘pop-up’ window which reminds the investor of the requirement each time the investor accesses, or attempts to post a comment on, the communication channels on the intermediary’s platform.”<sup>113</sup> This is no simple task because, as the SEC acknowledges, “after opening an account, an investor may come to be compensated by, or become an employee of, an issuer or potential issuer.”<sup>114</sup>

Ensuring that promoters are identified, which is fundamental to the quality of the communication channel, is an area for exceptional intermediaries to shine. The intermediary is the vital link between the issuer and her investors. Practically, that link is the communication channel that the SEC proposes.<sup>115</sup> If that communication channel is corrupted because it becomes known that a given intermediary is very poor at ensuring that different market players such as promoters are clearly identified, an intermediary is failing an issuer at the vital task of communication. Intermediaries that make such mistakes will not last. Online communities, which are integral to the wisdom of the crowd enabling successful crowdfunding,<sup>116</sup> cannot survive in communication channels with unidentified promoters or founders. Perhaps the pop-up window the SEC mentioned or other machine-generated reminders are necessary.<sup>117</sup> Perhaps an intermediary will need to have employees troll through the communication channels for unidentified promoters.<sup>118</sup> Additionally, the intermediary could make clear that it periodically checks communication

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113. *Id.* at 66,468 n.403.

114. *Id.* (emphasis added).

115. *See id.* at 66,557 (§ 227.303(c)).

116. Letter from Ethan Mollick, Professor, The Wharton School, University of Pennsylvania, to Dr. Ivanov (Dec. 17, 2012) [hereinafter Mollick Letter], available at <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-189.pdf>. Professor Mollick believes it is vital that “portals be required to either sustain or enable communities around crowdfunding efforts, including having persistent investor and commentator identities that remain after the initial funding of a new crowd-funded venture through the portal.” *Id.* Mollick believes such persistent communities are key to the success of sites such as Kickstarter because, among other things, they are helpful in fraud prevention. *Id.*

117. *See also* ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 7 (“Notice to investors can be achieved by highlighting comments or postings by promoters or affiliates of the issuer.”); *see also id.* at 70 (“For example, with a simple checkbox, a poster can allow the intermediary to visually highlight the post as one made by a founder or employee.”); *see also* Hartnett Letter, *supra* note 111, at 2 (“[A]n intermediary could format its communication channels to always display the paid promoters’ onscreen names, along with other information such as the issuer’s name, security, and offering amount,” or “some intermediaries could configure their communication channels to display paid promoters’ names and onscreen communications in noticeably different font or text color to signal their relationship to the issuer.”).

118. *See* ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 70 (“Furthermore, the intermediary must have the right to block and remove the comment of any user who is using the public forum for advertising or promotional purposes.”).



channel participants at random to ensure they are who they purport to be.<sup>119</sup> Wefunder expresses doubt at the efficacy of requesting promoters to identify themselves at account opening.<sup>120</sup> To address this concern, an intermediary might also follow Wefunder's suggestion that "as soon as a user clicks on the text field to make a comment in the communication channels . . . [t]he sudden appearance of text underneath the comment box" can be used to draw the promoter's eye.<sup>121</sup> Then the promoter could simply click a link to disclose their status.<sup>122</sup> In any event, intermediaries should not hesitate to dole out a hefty penalty to offenders such as banishment from the platform.<sup>123</sup>

Additionally, a prudent intermediary, recognizing that an issuer also has an obligation to make sure promoters are disclosed,<sup>124</sup> should require that an issuer provide the intermediary with all the names of founders and promoters and update this list of names throughout the offering.<sup>125</sup> The intermediary could also require that the issuer contract with all promoters along certain lines. The SEC acknowledged that an issuer might "contractually require any promoter to include the required statement about receipt of compensation, confirm that the promoter is adhering to the intermediary's terms of use that require promoters to affirm whether or not they are compensated by the issuer,

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119. *See id.* at 5 ("Portals must also maintain the ability to 'police' their own platforms for inappropriate content. For example, nearly every web-based business, which allows users to post comments or content, moderates the forums where content is posted. Intermediaries must be allowed to remove content that is unlawful, harmful, threatening, abusive, harassing, defamatory, vulgar, obscene, invasive of another's privacy, hateful, or racially, ethnically or otherwise objectionable. Intermediaries must also be allowed to suspend or ban users who repeatedly abuse the system.").

120. *See* Wefunder Letter 2, *supra* note 14 ("As .01% of our users at the account opening stage are likely to be promoters, and 99.9% potential investors, we believe the text at the account opening stage is better devoted to discussin [sic] the risks of startup investing. We don't want to have a lot of fine print that no one reads.").

121. *Id.*

122. *Id.*

123. *See, e.g.*, Hartnett Letter, *supra* note 111 (recommending that the SEC "consider amending the rule to disqualify any issuer from the exemption for a specified time if that issuer pays any promoter who (1) is not disclosed to the intermediary and (2) promotes the offering in the communication channels").

124. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,555 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 227) (§ 227.205(a)).

125. CFIRA recommends as a best practice "that all issuers, and officers, directors, and other agents, identify themselves in all communications on such platform." Letter from Joy Schoffler, Bd. Member, & Kim Wales, Exec. Bd. Member, Crowdfund Intermediary Regulatory Advocates, to Elizabeth M. Murphy, Sec'y, U.S. Securities & Exchange Commission, at 2-3 (Jan. 27, 2014), available at <http://www.sec.gov/comments/s7-09-13/s70913-269.pdf>; *see also* Hartnett Letter, *supra* note 111, at 2-3 (calling on the SEC to "amend the proposed rules to require issuers to provide intermediaries notice of who their paid promoters are" because "the issuer is best positioned to establish both who its paid promoters are and that the required notice is provided to the intermediary").

[and] monitor communications made by such persons.”<sup>126</sup> An intermediary could also require that an issuer contractually require its promoters to “take the necessary steps to have any communications that do not have the required statement removed promptly from the communication channels, or retain a person specifically identified by the intermediary to promote all issuers on its platform.”<sup>127</sup>

#### 4. Importance of the Communication Channel

Intermediaries are required by the SEC’s proposal to provide communication channels, the importance of which cannot be overstated.<sup>128</sup> The SEC “believe[s] that requiring the communications channel to be on the intermediary’s platform would allow investors, particularly those who might be less familiar with online social media, to participate in online discussions regarding ongoing offerings without having to actively search for such discussions on external Web sites.”<sup>129</sup> It is a possibility, however, that investors without online savvy could miss out on what other investors are saying because investors are “not preclude[d] . . . from initiating additional discussions on external Web sites.”<sup>130</sup> The SEC recognizes the importance of the conversations that investors and others have and where they might take place: “[I]t is likely that investors and interested participants would provide relevant adverse information about an issuer or an offering through postings on chat sites, message boards, and other communication channels, including, but not limited to, the communication channels to be provided by the intermediary.”<sup>131</sup> Then, so as not to “lessen the incentive for an intermediary to thoroughly investigate,” the SEC notes something very scary for intermediaries: “These media would provide a potential source of information for intermediaries who may be subject to liability as ‘issuers.’”<sup>132</sup>

A prudent intermediary reading this statement by the SEC will see two key takeaways. First—and this ties back to the previous section discussing vetting issuers—minimalistic background checks of issuers will not suffice. If the crowd discovers and posts bad information about an issuer—even if it posts this information outside of an intermediary’s platform—an intermediary will be expected to know about this, verify it, and then act accordingly. If the

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126. Crowdfunding, 78 Fed. Reg. at 66,456.

127. *Id.*

128. *See id.* at 66,557 (§ 227.303(c)); *see also id.* at 66,471–72.

129. *Id.* at 66,530.

130. *Id.* That said, *issuers* can only communicate with investors about an offering via the communication channel. *Id.* at 66,472.

131. Crowdfunding, 78 Fed. Reg. at 66,531.

132. *Id.*

information is true, it will tarnish an intermediary's reputation that such an issuer was even allowed access in the first place.

Second, an ambitious intermediary will resolve to design the best communication channels possible. These channels need to be so effective and user-friendly that investors have little or no reason to go elsewhere to discuss a given offering. In designing these channels, intermediaries need to have ever-before them the policy driving the requirement that only investors with accounts can post in the channels,<sup>133</sup> namely the need "to establish accountability for comments made in the communication channels."<sup>134</sup> In addition to the requirements to indicate whether a commenter in the communication channel is a founder or employee, or a promoter or an issuer,<sup>135</sup> an intermediary should take the more general suggestions of Senator Brown: "Investors' credentials should be included with their comments to aid the collective wisdom of the crowd."<sup>136</sup> An intermediary might model its communication channel after Wefunder's two-part version, with the most important and active channel being an "Ask a Question," which only the issuer can answer.<sup>137</sup> This is in keeping with Wefunder's belief that "[o]ne of the most important criteria for startup investments is the quality of the [issuer's] team, and their ability to answer critical questions."<sup>138</sup>

Even after designing such an ideal communication channel, intermediaries need to help issuers understand how to respond to messages from outside of the communication channel, especially because the SEC proposed to require that issuers "disclose information about . . . how interested parties may contact the issuer."<sup>139</sup> Intermediaries should remind issuers of the requirement that all the issuer's communications regarding the offering must take place in the communication channel on the intermediary's platform so that no investor is privy to more information than any other investor.<sup>140</sup> The crowdfunding platform RocketHub foresees that "[i]ndividuals may publicly tweet an issuer, or post a question on their Facebook account."<sup>141</sup> "If the question pertains to the offering," intermediaries should inform issuers to handle this situation as RocketHub recommends: "[T]he issuer can respond to the investor with a link

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133. *Id.* at 66,472.

134. *Id.*; *see also* Mollick Letter, *supra* note 116.

135. Crowdfunding, 78 Fed. Reg. at 66,472.

136. *Id.* at 66,472 n.436 (referencing 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown)). Wefunder warns that "not a single anonymous forum is effective at providing intelligent critiques." Wefunder Letter 2, *supra* note 14.

137. Wefunder Letter 2, *supra* note 14.

138. *Id.*

139. Crowdfunding, 78 Fed. Reg. at 66,438 (referencing proposed Rule 201(a) of Regulation Crowdfunding (§ 227.201(a))).

140. *Id.* at 66,472 (referencing proposed Rule 204 of Regulation Crowdfunding (§ 227.204)).

141. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 69.

that directs the investor to the public communication channel on the intermediary platform.”<sup>142</sup>

There is another reason why an intermediary should provide robust communication channels that clearly identify the parties as the SEC proposes. The SEC “believe[s] it would be contrary to the intent and purpose of the statute and the proposed rules to declare an offering ‘sold’ on the basis of *non-bona fide sales* designed to create the appearance of a successful completion of the offering.”<sup>143</sup> “[N]on-bona fide purchases would include purchases by the issuer through nominee accounts or purchases by persons whom the issuer has agreed to guarantee against loss.”<sup>144</sup> The SEC is “not restricting directors and officers of an issuer from purchasing securities in an offering,” but it “expect[s] intermediaries to scrutinize any purchases by these individuals for ‘red flags,’ such as repeated investment commitments and cancellations, that would indicate that the purchase was designed to create an impression that the offering has reached, or will reach, its target amount.”<sup>145</sup>

RocketHub had identified this problem as “pump and dump,” whereby “[a]n unscrupulous issuer could have fake investors ‘pump up’ the campaign by committing large dollar amounts up front, in order to create the appearance of momentum, thereby attracting other investors.”<sup>146</sup> Then, those initial investors could slowly rescind their investments while new investors join the faux-investing momentum.<sup>147</sup>

RocketHub viewed this problem arising if the rescission period was too long, but “[t]he proposed rules . . . would give investors an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer’s offering materials.”<sup>148</sup> The SEC saw this as a balanced solution that would “giv[e] investors the continuing benefit of the collective views of the crowd . . . while providing issuers with certainty about their ability to close an offering.”<sup>149</sup> The fact that investors are given so long to deduct from the wisdom of the crowd shows that the SEC understands Senator

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142. *Id.*

143. Crowdfunding, 78 Fed. Reg. at 66,474 (internal citations omitted).

144. *Id.* (internal citations omitted).

145. *Id.* (internal citations omitted) (referencing proposed Rule 301(c)(2) of Regulation Crowdfunding (§ 227.301(c)(2))).

146. ROCKETHUB, REGULATION OF CROWDFUNDING: BUILDING ON THE JUMPSTART OUR BUSINESS STARTUPS ACT 7 (May 2012) [hereinafter ROCKETHUB WHITEPAPER], available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticcomments/p163715.pdf>; see also Crowdfunding, 78 Fed. Reg. at 66,476 nn.489–90 (SEC acknowledging pumping schemes). Others also recognize the possible threat of “pump and dump” schemes. See, e.g., Mollick Letter, *supra* note 116.

147. ROCKETHUB WHITEPAPER, *supra* note 146, at 7.

148. Crowdfunding, 78 Fed. Reg. at 66,476 (referencing proposed Rule 304(a) of Regulation Crowdfunding (§ 227.304(a))).

149. *Id.*

Merkey's distinction: "[T]he 'wisdom of the crowd'... [is different] than perhaps just the 'excitement of the crowd.'"<sup>150</sup>

In other words, because of the SEC's proposed rescission rule, pump-and-dump or non-bona fide purchases remain a very real threat for intermediaries to guard against.<sup>151</sup> Such schemes are the kind of thing that could be easily pulled from the data in retrospect (i.e., during a lawsuit), but easy enough to miss as the campaign is underway. Pump-and-dump is perhaps one of the most likely forms of fraud: even an issuer who completely checks out as far as background and experience is capable of committing such fraud. Knowing and clearly identifying anyone participating is the best way to guard against this fraud.<sup>152</sup>

Everyone wins if the discussion stays in the intermediary's communication channel: unsophisticated investors do not need to familiarize themselves with searching other forums to make sure they have the complete picture; issuers are allowed to address everything within the communication channels; intermediaries are able to monitor the discussions and make sure that promoters are properly identified, that improper comments are removed, and that pump-and-dump schemes are not being employed; and the data<sup>153</sup> of the deliberations is preserved in one place.<sup>154</sup>

As to the preservation of data, in one of its requests for comments, the SEC reveals that it is considering whether to require an "intermediary to maintain

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150. *Id.* at 66,476 n.496 (referencing 158 CONG. REC. S5477 (daily ed. July 26, 2012) (statement of Sen. Jeff Merkley)).

151. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 11 ("The Commission's proposal leaves investors open to considerable risk of 'pump & rescind' schemes. It also leaves issuers at risk of 'short fall' situations.").

152. Another important reason to know who the investors are stems from a comment that the SEC recognized that warned "a competitor could commit to invest and then cancel that commitment at a critical moment during the fundraising effort, causing the offering to fall short of the target offering amount." Crowdfunding, 78 Fed. Reg. at 66,476 n.493 (referencing Letter from Marshall Neel, Co-Founder, Crowdfunding Offerings, Ltd., to the U.S. Securities & Exchange Commission (May 11, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobtitleiii-59.htm>). Indeed, Wefunder has confirmed that this is a real problem: "Startups on our platform have seen investment applications from employees of competitors, as well as clearly deranged individuals." Wefunder Letter 1, *supra* note 87. To counter such a dilemma, RocketHub recommends that "invitation-only offerings" be allowed so that an issuer has the "right to not permit a competitor from investing in the offering through an intermediary." ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 20.

153. The SEC is adamant about collecting as much data as possible about securities crowdfunding so that it can be analyzed to see if the purposes of the JOBS Act are truly being implemented. *See, e.g.*, Crowdfunding, 78 Fed. Reg. at 66,507 ("With regard to any comments, we note that such comments are of particular assistance to us if accompanied by supporting data and analysis of the issues addressed in those comments.").

154. *See supra* note 108.

the communication channels of its platform during the post-offering period.”<sup>155</sup> An ambitious intermediary would see an opportunity to go above and beyond here by maintaining these communication channels indefinitely.<sup>156</sup> Issuers would especially find this feature of an intermediary attractive as an intermediary is an issuer’s communication lifeline to its investors. Also, these channels could help enforcement if ever the need arose. Maintaining the communication channels post-offering would be especially ideal if an intermediary was also going to serve as the platform for the secondary market.<sup>157</sup>

##### 5. Desire for Demographic Data

The SEC thinly veils a desire for intermediaries to collect other investor information, which may not be necessary for securities crowdfunding but which “could help [the SEC] and the applicable national securities association to better understand the level of investor sophistication in this market and investor protection needs, among other things.”<sup>158</sup> The SEC suggests that “demographic information about investors that excludes any personally identifiable information and is aggregated on a per offering basis, indicating characteristics such as education level, income, wealth, geographic distance from the issuer and professional affiliations” might “help in the evaluation of the effectiveness of crowdfunding in raising capital for startups and small businesses.”<sup>159</sup>

An ambitious intermediary should consider this thinly veiled hint as something extra it could do to assist the SEC. Throughout the proposed rules the SEC reiterates that “data and analysis” are “of particular assistance.”<sup>160</sup> An intermediary could include questions about the demographic information that the SEC suggested, but an intermediary should make clear to investors that disclosing such information is optional.<sup>161</sup> That said, an intermediary might

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155. Crowdfunding, 78 Fed. Reg. at 66,473 (Request for Comment No. 170).

156. Indeed this would comport with CFIRA recommended Best Practices. CFIRA, CROWDFUNDING BEST PRACTICES FOR PORTALS OPERATING PURSUANT TO TITLE II AND TITLE III OF THE JOBS ACT, SEC (Nov. 15, 2012), available at <http://www.sec.gov/comments/jobs-title-iii/jobtitleiii-204.pdf> (“Offering Retention and Display – regardless of whether an offering is successful or cancelled, it should be retained by the Portal and accessible online indefinitely, as it is part of the public record. And issuers *should not be permitted to delete or alter an offering memorandum in any way once it has been closed, cancelled or expired.*”).

157. Clearly funding portal intermediaries are not allowed to host secondary markets; they are exclusively allowed to handle Section 4(a)(6) offerings, which are primary market transactions, not resales. Crowdfunding, 78 Fed. Reg. at 66,459.

158. *Id.* at 66,468 (Request for Comment No. 152).

159. *Id.*

160. *See supra* notes 108 and 153.

161. Perhaps an intermediary could use the prevalent format of boxes or blanks marked with asterisks signifying required information, whereas those without asterisks are voluntary.

find good reason not to require any extra information. Wefunder minces no words in its compelling opposition to collecting unrequired information: “[E]ach additional input decreases cash available to startups,” because “[n]o one likes filling out long forms” and “each additional input box on a form decreases the likelihood that it will be filled out.”<sup>162</sup>

#### D. Requirements with Respect to Transactions

Within the context of the actual crowdfunding transaction, this section discusses requirements relating to (1) information about an issuer, (2) an investor’s qualification, (3) an investor’s acknowledgement of risk, and (4) the maintenance and transmission of funds.

##### 1. Issuer Information

The SEC proposed requiring that intermediaries “make available to the Commission and to potential investors any information required to be provided by the issuer under Rules 201 and 203(a) of proposed Regulation Crowdfunding.”<sup>163</sup> The SEC is “not requiring that intermediaries make the relevant information available in any particular format,” but it reminds intermediaries “that issuers would be required to file the information on EDGAR.”<sup>164</sup> Therefore, an intermediary that wants to attract issuers should help issuers design their campaigns in such a way that allows issuers to toggle back and forth between their campaigns and their EDGAR filings. This is easier said than done,<sup>165</sup> but it is another way that an intermediary could

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162. Wefunder Letter 2, *supra* note 14.

163. Crowdfunding, 78 Fed. Reg. at 66,468–69.

164. *Id.* at 66,469 n.407 (referencing proposed Rule 203 of Regulation Crowdfunding (§ 227.203)). EDGAR stands for the Electronic Data Gathering, Analysis, and Retrieval system, and it is where certain documents required to be filed with the SEC are electronically filed. *Important Information About EDGAR*, SEC, <http://www.sec.gov/edgar/aboutedgar.htm> (last updated Feb. 16, 2010).

165. Letter from Mary Juetten, Joy Schoffler, Trey Bowles, Bd. Members, & Kim Wales, Exec. Bd. Member, Crowdfund Intermediary Regulatory Advocates, to Elizabeth M. Murphy, Sec’y, U.S. Securities & Exchange Commission (Jan. 31, 2014) [hereinafter Juetten, Schoffler, Bowles & Wales CFIRA Letter], available at <http://www.sec.gov/comments/s7-09-13/s70913-254.pdf> (“We believe that all types of information, delivered in a variety of ways . . . should be on [an] intermediary’s platform. Our understanding is that EDGAR does not allow for filing of videos and graphics; however, we do not believe that everything on the intermediary site needs to be filed on EDGAR.”); see also Letter from Sara Hanks, Chief Exec. Officer, CrowdCheck, Inc., to Elizabeth M. Murphy, Sec’y, U.S. Securities & Exchange Commission 3 (Jan. 9, 2014) [hereinafter Hanks CrowdCheck Letter], available at <http://www.sec.gov/comments/s7-09-13/s70913-107.pdf> (“As EDGAR is currently configured, it can only accept a limited range of file formats. Videos, for example, cannot be filed on EDGAR, and yet videos are likely to be an important component of a securities crowdfunding offering. Videos present particular challenges with respect to issues of liability. In the words of the old saw, ‘a picture is worth a thousand

provide value, thereby attracting more issuers. This ability to toggle back and forth or to help issuers understand their campaign in terms of their EDGAR filings and vice versa will serve issuers especially well when they have to file updates or their required ongoing disclosure.<sup>166</sup>

Intermediaries need to realize the unique challenges of disclosing information about issuers. The proposed rules require disclosing the business experience of issuers' directors and officers over the past three years. Intermediaries need to be aware of something Wefunder noted: "[M]any high growth startup founders are so young that they do not have three years of work experience . . . ."<sup>167</sup> Intermediaries should focus on whatever work experience these officers and directors have so as not to "unreasonably prejudice investors against them."<sup>168</sup>

Further, intermediaries need to realize that, with brand new startups that have little or no operating history, the most meaningful disclosures from an investor's standpoint are "how much cash is in the bank, [the startup's] current monthly loss (i.e., 'burn rate'), and how much anticipated 'runway' the startup has until more capital is required."<sup>169</sup> Intermediaries might also follow one of Wefunder's habits, namely to "post[] all news articles [it] can find to a fundraising profile," and continue to do so even after the round closes.<sup>170</sup>

Intermediaries should also choose to save public data from issuers' campaigns. The SEC asked whether "some or all of the issuer's offering materials be required to remain on an intermediary's platform after the close of an offering."<sup>171</sup> The SEC recognizes that data on intermediaries will not necessarily be maintained indefinitely.<sup>172</sup> While it is wise that the SEC recognizes this, an ambitious intermediary would be wiser to assist the SEC in

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words,' and a video may be worth many more. It is possible to imagine a small software company giving the impression that it has many more employees than is actually the case by filming the CEO's presentation in front of a bank of workers in a co-working space. Or a video could show a loading bay filled with boxes, giving the impression of inventory ready to ship, whereas in fact the boxes are empty. A transcript cannot capture the statements that are made purely by visual means. In the event of litigation or enforcement, visual elements may be material."); *see also* Wefunder Letter 2, *supra* note 14 ("There will be text, videos, interactive graphics, charts, and graphics. Our goal is to enable a beautiful online presentation in rich HTML and give investors as much relevant information about an issuer as possible. . . . It will not be practical to embed videos and interactive graphics . . . in Form C filings, nor will the visual presentation be the same. More practical will be including a URL to the source material. While a video may be linked to directly, for technical reasons, some interactive exhibits will only work if loaded within the profile.").

166. *See* Crowdfunding, 78 Fed. Reg. at 66,554 (§ 227.202(a)).

167. Wefunder Letter 2, *supra* note 14.

168. *Id.*

169. *Id.*

170. *Id.*

171. Crowdfunding, 78 Fed. Reg. at 66,469 (Request for Comment No. 157).

172. *Id.* at 66,449.



its goal of preserving Section 4(a)(6) data<sup>173</sup> by establishing a policy that it would not remove any campaigns or their relevant data from its platform, as CFIRA Best Practices recommended.<sup>174</sup>

## 2. Investor Qualification

Section 4A(a)(6) obligates intermediaries to ensure that investors do not exceed the investor limits of Section 4(a)(6)(B). “[T]he proposed rules provide that an intermediary may rely on an investor’s representations concerning compliance with investment limitation requirements.”<sup>175</sup> The SEC qualifies this by noting: “[I]t would not be reasonable for an intermediary to ignore other investments made by an investor in securities sold in reliance on Section 4(a)(6) through an account with that intermediary or other information or facts about an investor within its possession.”<sup>176</sup> In light of this, intermediaries will want to ensure that investor accounts are unique so that they can track compliance at least within their platform. An intermediary could take some recommendations from the Grow VC letter that the SEC recognized, which highlighted the danger “that an investor may be able to establish multiple user accounts with a single intermediary and thereby exceed the maximum investment limit.”<sup>177</sup> Grow VC recommended that an intermediary could guard against this by “closely monitoring investment activity in any user account; requiring each user account to provide unique bank account details which are not used by any other user account; and requiring the investor to represent and warrant that such investor understands the maximum investment limit and will not exceed such limits.”<sup>178</sup>

Intermediaries that want to go the extra step could have a simple (even automated) process whereby they could provide a certificate to an investor stating how much the investor has invested as of what date. An investor could then submit this statement to a new intermediary where she seeks to open an

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173. *See supra* notes 108 and 153.

174. *See supra* note 156.

175. Crowdfunding, 78 Fed. Reg. at 66,470. Wefunder applauds the SEC for this recommendation because, in the “over \$3.5 million in investment applications for 506(c) offerings in amounts as low as \$100,” Wefunder has found that “[a]bout 80% of these potential investors refused to verify their income with documentation.” Wefunder Letter 1, *supra* note 87. Wefunder is not surprised that investors show such resistance “[i]n an era when Target leaks 40 million credit cards.” *Id.* Wefunder’s Target comment is bolstered by the recent hacking of the major crowdfunding platform Kickstarter. Andrew Dowell, *Kickstarter Says a Computer Attack Breached the Funding Site’s User Data*, WALL ST. J., Feb. 18, 2014, at B5.

176. Crowdfunding, 78 Fed. Reg. at 66,470.

177. *Id.*

178. *Id.* at 66,470 n.417 (referencing Letter from Jouko Ahvenainen & Valto Loikkanen, Co-founders, Grow VC, to Elizabeth M. Murphy, Sec’y, U.S. Securities & Exchange Commission (June 15, 2012), available at <http://www.sec.gov/comments/jobs-title-iii/jobtitleiii-88.pdf>).

additional account. This would bolster the new intermediary's reasonable basis for accepting an investor's representation, and it would tip off the initial intermediary that one of its investors was also opening an account elsewhere. Ideally, this could develop as an industry best practice where intermediaries would come to require that investors present such a certificate from the other intermediaries where they also have accounts.<sup>179</sup>

### 3. Investor's Acknowledgement of Risk

Section 4A(a)(4) requires intermediaries to ensure that investors are aware of the risk they are undertaking in securities crowdfunding. An intermediary is statutorily required to make sure that investors review the educational materials, affirm the risk they are taking on, and answer questions demonstrating their understanding of the risk. Fortunately for intermediaries, the SEC understands intermediaries' limitations: "[I]t would not be possible for an intermediary to ensure that all investors understand the risk disclosure."<sup>180</sup> The SEC clarifies that the goal is "provid[ing] investors with meaningful disclosures."<sup>181</sup>

Nonetheless, the SEC declined to propose a model form of acknowledgement or questionnaire that intermediaries could have used to satisfy the requirements of section 4A(a)(4).<sup>182</sup> In support of this grant of flexibility, the SEC acknowledges the ideal positioning and experience of intermediaries: "As with the educational material requirements, we believe that an intermediary's familiarity with its business and likely investor base would make it best able to determine the format in which to present the material required under the proposed rules."<sup>183</sup>

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179. Alternatively, intermediaries could use the services of CrowdBouncer, a crowdfunding compliance company that has created an application programming interface (API) to help "portals to track investors' investments across the whole Title III universe." *Title III Database*, CROWDBOUNCER, <https://www.crowdbouncer.com/title-iii-database> (last visited Mar. 15, 2014). A competitor of CrowdBouncer, Crowdentals, also plans to offer services in assisting with investor compliance under Title III just as it is already providing investor services under Title II of the JOBS Act. *Equity Crowdfunding Compliance Solutions*, CROWDENTALS, <http://crowdentals.com/titleIII.php?title=3> (last visited Mar. 15, 2014); see also Lora Kolodny, *Crowdentals Wants to Make Investor Verification 'TurboTax Easy' Online*, VENTURE CAP. DISPATCH, WALL ST. J. (Jan. 13, 2014, 2:21 PM), <http://blogs.wsj.com/venturecapital/2014/01/13/crowdentals-wants-to-make-investor-verification-turbotax-easy-online/>.

180. Crowdfunding, 78 Fed. Reg. at 66,471.

181. *Id.*

182. *Id.*

183. *Id.* (referencing proposed Rule 303(b)(2)(i) of Regulation Crowdfunding (§ 227.303(b)(2)(i))). Throughout the proposed rules the SEC acknowledges instances where the intermediary is best positioned to do a certain task. See *id.* at 66,531 ("We believe that intermediaries will be in the best position to take these steps and that these requirements will increase investor protections."); see also *id.* at 66,532 ("We believe that intermediaries would be

An ambitious intermediary could follow some of RocketHub's recommendations when it comes to disclosing risks to investors. RocketHub identifies four risks it wishes to make investors aware of. First, "100% of the funds invested are at risk because the business may fail."<sup>184</sup> Second, "[e]ven if the business is 'successful,' the investor may never get any money back because either: a) [t]he business never becomes successful enough, or b) [i]f investor payout (or other structure) is not guaranteed, management may decide there are better uses for the funds."<sup>185</sup> Third, "[t]he investor may not have any say in how the business is run."<sup>186</sup> Fourth, "[t]he investor may not be able to sell his/her stake in the business either because a) [n]o one wants to buy, or b) [i]t may be difficult to find a willing purchaser, or c) [i]t may be difficult to transfer."<sup>187</sup> RocketHub plans to "maximize [investor] engagement while presenting the educational content" by "us[ing] interactive text and images, time tracking, click tracking, and live webinars to make the material easy to understand and retain."<sup>188</sup> In addition to these important recommendations, intermediaries need to understand that requiring the acknowledgement of risks is a balancing act, which can lead to more investor risk if not done correctly.<sup>189</sup>

As with other areas of flexibility, this opportunity can also be seen as a burden. If a disgruntled investor decides to sue an intermediary, courts will scrutinize the disclosures that a particular intermediary chose to provide. Intermediaries that took "flexibility" as a null obligation or as an excuse to only do the bare minimum will likely not fare as favorably, regardless of the propriety of the investor's lawsuit.

#### 4. Maintenance and Transmission of Funds

Section 4A(a)(7) only allows an intermediary to provide an issuer with its funds if the issuer has met or exceeded<sup>190</sup> its target offering amount. Despite

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in an appropriate position to take such steps."); *see also id.* at 66,472 ("[I]ntermediaries . . . would be well placed to take measures to ensure . . .").

184. ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 65.

185. *Id.*

186. *Id.*

187. *Id.* at 66.

188. *Id.*

189. Wefunder makes this point. *See* Wefunder Letter 2, *supra* note 14. Wefunder encourages its investors to diversify their investments, and often investors heed this advice and "invest in up to 10 companies in one day after spending a week or two reviewing all the opportunities on the platform." *Id.* Wefunder expresses concern that, "[i]f investment commitments feel laborious because investors are forced to constantly reacknowledge the risks," investors might "'get tired' of filling out forms and not finish diversifying." *Id.*

190. As an aside, intermediaries should certainly recommend that issuers establish, in addition to their target amount, a maximum cap within the same disclosure requirement tier as the target amount, which the proposed rules permit. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,457 (proposed Nov. 5, 2013) (referencing proposed Rule 201(h) of Regulation Crowdfunding (§

one commenter's recommending that credit cards not be an acceptable payment mechanism,<sup>191</sup> the SEC is "not proposing to limit payment mechanisms."<sup>192</sup> The SEC acknowledged the commenter's concern that charge-back options on credit cards could complicate the funding process, and the SEC said an intermediary is allowed to decline credit cards.<sup>193</sup>

A prudent intermediary should give serious thought as to whether to accept or decline credit cards; this is a difficult decision for an intermediary to make as it seeks to appeal to issuers.<sup>194</sup> An issuer will want the assurance that funds committed will not be reneged due to charge-backs, but at the same time, issuers will not want their investors to have another restraint on their ability to contribute. From the intermediary's standpoint, the intermediary wants the issuer's campaign to meet its goal, but it also realizes that using a credit card is a way for unsophisticated investors to overextend themselves. In some ways, an intermediary would be doing investors a (paternalistic) favor by not allowing them to use credit cards. From an interest standpoint, it does not make sense for an investor to use credit to invest if that credit is costing them on average fourteen percent interest.<sup>195</sup> To make the investment worthwhile, the investor would now need a return greater than fourteen percent. The odds are not in an investor's favor, and the most likely result is that an intermediary finds itself with more disgruntled investors that might drag the intermediary into court over the matter.

If intermediaries opt to allow credit cards, they should plan for how they will deal with charge-backs after issuers' campaigns have completed because

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227.201(h)). Wefunder exhorts issuers to "take the advice of Paul Graham, an investor in over 500 startups collectively worth \$14.4 billion, who wrote, 'It's a mistake to have fixed plans in an undertaking as unpredictable as fundraising. The right strategy, in fundraising, is to have multiple plans depending on how much you can raise.'" Wefunder Letter 1, *supra* note 87.

191. Crowdfunding, 78 Fed. Reg. at 66,474 & n.465 (citing ROCKETHUB WHITEPAPER, *supra* note 146).

192. *Id.* at 66,474.

193. *Id.* RocketHub would also like the SEC to understand that there is a cost involved: "[A]ccepting funds from users comes at a considerable cost to the intermediary, and in the situation of a cancelled investment commitment, the intermediary or issuer may have to potentially bear this unavoidable cost." ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 73.

194. See ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 74 ("Permitting debt-based payment vehicles, such as credit cards, which have their own rescission policies, (i.e. charge backs) is problematic. . . . Less experienced Portals may be unaware of the risk to which accepting debt-based payments exposes them and issuers, and may generate serious misperceptions in the market, that will in the long-run jeopardize the viability of the marketplace, as well as expose issuers to significant fees.").

195. See Ruth Simon, *Credit-Card Rates Climb: Levels Hit Nine-Year High as New Rules Limiting Penalty Fees Help Fuel Rise*, WALL ST. J., Aug. 23, 2010, <http://online.wsj.com/news/articles/SB10001424052748704094704575443402132987676> ("[T]he average interest rate on existing cards reached 14.7%.").

technically an intermediary would be violating the statutory requirement that an issuer not receive any funds unless the issuer's target amount is met.<sup>196</sup>

*E. The Challenges Surrounding Material Changes*

If a material change to an offering's terms or other information occurs, the SEC proposed requiring "the intermediary to give or send to any potential investors who have made investment commitments notice of the material change, stating that the investor's investment commitment will be cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice."<sup>197</sup> If the investor fails to recommit, the proposed rules also require sending a notice to the investor of the cancellation and return of funds.<sup>198</sup> The proposed rules say nothing, however, about sending additional reminders to an investor who does not recommit. Given the tendency of inertia, a prudent intermediary might also include an additional warning message (if not multiple additional reminders) on the last of the five business day window to make sure that an investor is aware of what is about to happen, i.e., that their investment is about to be rescinded for failure to recommit.

This proposed requirement to recommit is significant.<sup>199</sup> It is enough of a hassle to have friends and other investors commit to invest the first time, and many will do this and likely forget to check back. Now all of sudden they need to recommit. If they do not check email regularly, this could be especially surprising.<sup>200</sup> Too many surprised investors could cause significant sums of committed funds to be canceled. Seeing this, a discouraged issuer might think that their material changes angered their investors. More likely than not, investors simply did not realize the need to recommit. This is also a problem for investors who are more active in following their investment. When they see that there have been significant cancellations, they might deduce that the wisdom of the crowd is telling them that this investment is no longer a good idea, and, if they are more than 48 hours out from the closing, they might also cancel.

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196. JOBS Act, Pub. L. No. 112-106, § 302(b), § 4A(a)(7), 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. § 77d-1(a)(7)).

197. Crowdfunding, 78 Fed. Reg. at 66,476-77 (referencing proposed Rule 304(c)(1) of Regulation Crowdfunding (§ 227.304(c)(1))).

198. *Id.* at 66,477.

199. *See* Wefunder Letter 2, *supra* note 14 ("Given the ambiguity of what is 'material', we expect startups to be conservative, and nearly always toggle material changes requiring a re-confirmation.").

200. *See id.* ("From our current experience with 506(c) offerings, we believe a large segment of investors would prefer not to have to re-confirm their investment. In the past, we've had investors upset when they missed a deadline and had their investment cancelled. They assumed they are confirmed investors when funds hit escrow, and they are not happy to find out otherwise, if they were too busy to read their emails on a timely basis.").

This hypothetical stresses the importance of ensuring an offering statement is right the first time<sup>201</sup> so as to minimize material changes<sup>202</sup> that require investors to recommit. Second, it puts into high relief the necessity that ambitious intermediaries establish multiple means of communication with investors. Perhaps intermediaries should also seek social media accounts and cell phone numbers so that they could send out Facebook messages or messages to LinkedIn accounts and also text messages reminding investors to recommit. Again, as previously discussed, the intermediary is the vital communication link between issuers and investors. If an intermediary does not develop additional ways to make sure that investors recommit, an issuer has little means of doing so on its own.

#### F. *Payments to Third Parties*

The proposed rules would not allow an intermediary to compensate someone for providing the intermediary with the personally identifiable information of any investor or potential investor.<sup>203</sup> An intermediary, however, would be allowed “to compensate a person for directing issuers or potential investors to the intermediary’s platform” so long as two requirements are met.<sup>204</sup> First, “the person does not provide the intermediary with the personally identifiable information of any potential investor.”<sup>205</sup> Second, “the compensation, unless it is paid to a registered broker or dealer, is not based, directly or indirectly, on the purchase or sale of a security offered in reliance

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201. See CrowdCast, *Crowdfund Update with Sara Hanks of CrowdCheck*, YOUTUBE (Dec. 19, 2013), [https://www.youtube.com/watch?v=QCWO9lXaZ\\_4](https://www.youtube.com/watch?v=QCWO9lXaZ_4) (starting around 4:40:00) (though talking in the context of Rule 506(c) of Regulation D, stressing how important it is to “have all your ducks in a row” when seeking funds in the online world as opposed to the offline world where investors are more forgiving).

202. See Juetten, Schoffler, Bowles & Wales CFIRA Letter, *supra* note 165, at 2 (“It is important to recognize that all businesses evolve during the development life cycle and require necessary pivot points in the operating model, product development, staffing, etc. . . . Requiring the issuers to update . . . could result in confusion to investors and an unnecessary time burden on issuers.”); see also Hanks CrowdCheck Letter, *supra* note 165, at 2 (“Online, disclosure will likewise evolve in response to investor questions, and it is important that this process, reflecting the ‘wisdom of the crowd,’ . . . be encouraged. Material disclosure may be elicited from the questions of the crowd, and issuer responses to crowd questioning may result in frequent updates to the disclosure presented.”); see also Wefunder Letter 2, *supra* note 14 (“The world of startups is by nature ambiguous and chaotic—problems occur every single day. Some of these problems are solvable with time and effort—it’s not always immediately clear what is a permanent material change, and what can be fixed with a little time.”).

203. Crowdfunding, 78 Fed. Reg. at 66,477 (referencing proposed Rule 305(a) of Regulation Crowdfunding (§ 227.305(a))).

204. *Id.* at 66,478 (referencing proposed Rule 305(b) of Regulation Crowdfunding (§ 227.305(b))).

205. *Id.* (referencing proposed Rule 305(b) of Regulation Crowdfunding (§ 227.305(b))).

on Section 4(a)(6) on or through the intermediary's platform."<sup>206</sup> The SEC stated that it did "not believe Congress intended to disrupt current practices, such as paying for advertising based on Internet search rankings," and so it clarified that "an intermediary [could] make payments to advertise its existence, provided that in doing so, it [did] not pay for the personally identifiable information of investors or potential investors."<sup>207</sup>

An ambitious intermediary is grateful to hear the SEC proposed this approach of not disrupting current practices.<sup>208</sup> Many crowdfunding portals frequently promote top trending campaigns,<sup>209</sup> and also compensate sites such as Twitter and Facebook for placing such promotions on their platforms.<sup>210</sup> When Twitter and Facebook users express an interest in a crowdfunding promotion and consent accordingly, those platforms will provide the interested user's information to the crowdfunding portal and receive compensation.<sup>211</sup> This is an important aspect of current practices. An ambitious intermediary would be wise to use this flexibility to follow the example of RocketHub, which is engaged in numerous partnerships with well-known academic institutions, non-profit organizations, creative organizations, and large corporations, and these relationships generally leverage the partner's pre-existing user base or community to drive traffic to the crowdfunding portal.<sup>212</sup>

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206. *Id.* (referencing proposed Rule 305(b) of Regulation Crowdfunding (§ 227.305(b))).

207. *Id.* (referencing proposed Rule 402 of Regulation Crowdfunding (§ 227.402)).

208. Imagine what would happen if the regulations substantially upset standard internet marketing practices—it would have the potential to undermine the valuation of many internet companies. A clear example would be Facebook, whose value is largely derived from its marketing abilities. Shayndi Raice, Anupreeta Das & John Letzing, *Facebook Targets \$96 Billion Value*, WALL ST. J., May 3, 2012, <http://online.wsj.com/article/SB10001424052702304746604577382210530114498.html>. In 2011, eighty-five percent of Facebook's total revenue was accounted for by its ad business. *Id.*; see also Nicole E. Hong, *If You Look Good on Twitter, VCs May Take Notice*, WALL ST. J., Sept. 30, 2013, <http://online.wsj.com/news/articles/SB10001424127887324659404578499702279196058> ("A growing group of venture capitalists are taking social media into consideration before they decide to pour millions of dollars into a startup. They're checking how many online followers a company has, and how fast the numbers are growing.").

209. Wefunder Letter 2, *supra* note 14 ("Paid advertising and referral programs are standard practice and integral to any well functioning web platform."). Wefunder recommends that algorithmic preferencing of campaigns should be used by intermediaries. Wefunder Letter 1, *supra* note 87 ("If the methodology is clearly disclosed to investors, it should be permissible for a Funding Portal to sort offerings with an algorithmic score that takes into account any objective, numeric data that is reasonably likely to provide meaningful and non-misleading information to potential investors, such as numeric ratings by accredited and unaccredited users on the platform, number of commitments from investors (weighted by valuation of their portfolios), and page views.").

210. ROCKETHUB WHITEPAPER, *supra* note 146, at 9.

211. *Id.*

212. *Id.* In response to the proposed rules, RocketHub elaborates:

*G. Making Liquidity as Accessible as Possible for Investors*

Most investors do not want securities or equity for their own sake but for the ability to cash out.<sup>213</sup> A significant problem with investing in startups and small businesses is the issue of illiquidity. In fact, Section 4A(a)(4)(C)(ii) requires an intermediary to ensure that a potential investor understands the illiquidity risk.<sup>214</sup> The issue becomes how companies that are initially crowdfunded are prepared for the secondary market, which is where liquidity is most likely to be attained.<sup>215</sup> While the issue is complicated, the intermediaries are the ideal place to facilitate liquidity.

Though “[f]acilitating crowdfunded transactions alone would not require an intermediary to register as an exchange or as an alternative trading system (i.e., registration as a broker-dealer subject to Regulation ATS),”<sup>216</sup> an intermediary would be more attractive to investors seeking liquidity if it did register as an exchange or alternative trading system and was able to facilitate the secondary market for the securities it was crowdfunding. Again, most investors ultimately want liquidity, which is most likely obtained in the secondary market.

At the very least, an intermediary could seek to facilitate liquidity for its investors by providing a mechanism for certain limited transfers.<sup>217</sup> The SEC notes that “provisions that allow investors to transfer the securities within one

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There is a clear distinction between an issuer hiring an individual or entity for promotion and more standard web-based advertising, such as Google ads, Facebook ads, or sponsored tweets [sic]. When an issuer hires an individual or entity for promotion, investors may not be aware of the commercial relationship between the parties. The Commission should not enact rules that may interfere with promotional compensation, but should rather require simple disclosure of a commercial relationship where it would not otherwise be apparent to investors.

ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 6–7.

213. Wefunder Letter 2, *supra* note 14 (“[W]e have had the chance to speak with hundreds of first time investors, many of whom have never before invested in a private placement,” and “[o]ne of the primary concerns we hear from these new investors is the fact that they may not be able to gain liquidity for upwards of 7 years or longer.”).

214. JOBS Act, Pub. L. No. 112-106, § 302(b), § 4A(a)(4)(C)(ii), 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. § 77d-1(a)(4)(C)(ii)).

215. Per the statutory restriction, funding portals are not able to facilitate the secondary market because “a funding portal, by definition, is limited to acting as an intermediary in transactions involving the offer or sale of securities for the account of others solely pursuant to Section 4(a)(6), which are primary issuances of securities.” Crowdfunding, 78 Fed. Reg. 66,428, 66,459 (proposed Nov. 5, 2013) (internal citation omitted); *see also supra* note 157.

216. Crowdfunding, 78 Fed. Reg. at 66,459.

217. *See* ROCKETHUB WHITEPAPER 3.0, *supra* note 13, at 59–60 (“The proposed rules should not bar Portals from assigning and/or transferring securities . . . . Since the Portals hold a record of securities owned by various investors, on request the Portals are able to print and provide paper certificates. This will allow Portals to enforce transfer restriction by physically printing requirements on certificates.”)



year of issuance by reselling the securities to accredited investors, back to the issuer or in a registered offering or transferring them to certain family members or trusts of those family members” should mitigate some illiquidity costs.<sup>218</sup>

In the interest of liquidity, perhaps intermediaries would be wise to simplify things and declare that there is heavily diluted or no voting power associated with Section 4(a)(6) securities.<sup>219</sup> This recommendation is strengthened by pondering the nature of who will likely use Title III crowdfunding—those who have no other options.<sup>220</sup> Maurice Lopes, a co-founder of the crowdfunding platform EarlyShares, admonished that “many of the top angels, VCs [Venture Capitalists], lawyers, and pundits in the industry [stated] that ‘direct, equity-based, common stock crowd funding as envisioned by the JOBS Act would absolutely, positively preclude future investment by any serious professional investor, either angel or VC.’”<sup>221</sup> In other words, a

218. Crowdfunding, 78 Fed. Reg. at 66,526.

219. Intermediaries should adopt the crowdfunding website WeFunder’s policy. Recognizing that “[v]enture capitalists are uncomfortable when startups have many small investors,” WeFunder created a WeFund, which:

[I]s a series of an LLC that exists for the sole purpose of investing in one specific startup.

All the investors pool their capital in the WeFund, which then invests as one entity in the startup. The startup only has one direct investor: the WeFund. If you invest through a WeFund, you will hold an interest in the fund instead of holding the company’s securities directly.

*Common Questions*, WEFUNDER, [https://wefunder.com/faq/common\\_questions](https://wefunder.com/faq/common_questions) (last visited Mar. 15, 2014). “WeFunds are managed by our fully-owned affiliate, Wefunder Advisors, an investment advisor,” and “[a]ll voting and information rights are proxied to . . . Wefunder Advisors.” *Id.* In other words, for the sake of liquidity, likely provided by future financing (if provided at all), investors effectively give up their voting rights. Wefunder’s impressive results are compelling: “Startups seed funded on Wefunder have since raised over \$20 million in venture capital.” Wefunder Letter 1, *supra* note 87. *But see* Miller & White CFIRA Letter, *supra* note 78, at 2 (“If the intent of the JOBS Act is to democratize the ability of individuals to invest in and share in the creation and growth of new and small businesses, we do not see the purpose in creating some kind of entity that would purport to ‘represent’ investors . . . . We do not believe in the creation of some kind of paternalistic nominee to ‘represent’ shareholders; rather we believe that that would be a step away from the democratization of the capital markets.”).

220. Rani Doyle, Jeffrey A. Baumel, Margaret H. Kavalaris & Walter Van Dorn, Dentons, *United States: SEC Proposals For Securities Crowdfunding Under Title III Of The JOBS Act*, MONDAQ (Jan. 27, 2014), <http://www.mondaq.com/unitedstates/x/288874/Securities/SEC+Proposals+For+Securities+Crowdfunding+Under+Title+III+Of+The+JOBS+Act> (“Nevertheless, the smallest, earliest stage companies may focus on the potential of securities-based crowdfunding transactions where friends and family or banks cannot provide needed financing.”); *see also* Wefunder Letter 1, *supra* note 87 (filing their comments on the proposed rules to avoid the “worst outcome” that “only companies who are rejected by professional investors—and have no other option—will raise funds from the crowd”).

221. Letter from Maurice Lopes, Chief Exec. Officer, EarlyShares.com, Inc., to Marcia E. Asquith, Senior Vice President & Corp. Sec’y, Financial Industry Regulatory Authority, Inc.

crowd of investors with voting power in securities crowdfunding emits a warning signal and professional investors who might otherwise have bought into a crowdfunded company (and thereby provided at least some crowd investors with liquidity) steer away from such investments.

That same EarlyShares letter provided a good solution: an investor syndicate.<sup>222</sup> After crowdfunding, all crowdfunding investors would be rounded into a single vehicle with a professional manager.<sup>223</sup> The letter explained that the concept is not new to the crowdfunding industry—it is already in use in the Netherlands.<sup>224</sup> There, Symbid, a major equity-based crowdfunding platform, organizes the investors of a successful crowdfunding investment round into a single purpose vehicle (which it calls an “Investor Cooperative”).<sup>225</sup> The investor syndicate will be heard as a group and stand behind one powerful vote representing the entire amount of the equity offered in the fundraising campaign; in other words, the whole investor syndicate gets one vote.<sup>226</sup> This ensures that the investors’ voices are heard, but it also keeps the business attractive to future rounds of financing, which is the key to investors’ ultimate goal of liquidity.<sup>227</sup> While the idea of a syndicate seems relatively straightforward, this is a complicated area of financing. The idea will require serious deliberation by an intermediary as to how it might implement such a mechanism; once seasoned veterans of venture capital and their lawyers

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(Aug. 16, 2012) [hereinafter Earlyshares Letter to FINRA], *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticcomments/p153478.pdf>, (quoting David S. Rose, *Crowdfunding: How Do Venture Capitalists Feel About Following a Crowdfunding Capital Raise?*, QUORA, <http://www.quora.com/Crowdfunding/How-do-venture-capitalists-feel-about-following-a-crowdfunding-capital-raise>). Some would like to see a “crowdfunding fairness opinion” in order to make securities crowdfunded ventures more attractive to venture capital firms and strategic investors. *See* Letter from HamiltonClark Sec. Co, to the Financial Industry Regulatory Authority, Inc., at 1 (July 25, 2012), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticcomments/p147322.pdf>.

222. Earlyshares Letter to FINRA, *supra* note 221. After the recent lifting of the ban on general solicitation under Rule 506(c) of Regulation D, angels’ use of investor syndicates is gaining momentum. *See* Spencer E. Ante & Evelyn M. Rusli, *New Rules Break Down the Walls for New Angel Investors*, WALL ST. J., Oct 9. 2013, at B1. In their comments on the proposed rules, Wefunder is calling for a “special purpose vehicle” (SPV), which is akin to the Wefund discussed *supra* note 219, because “[n]o startup can take the risk of endangering their follow-on financing.” Wefunder Letter 1, *supra* note 87. This SPV would “group[] an unlimited number of investors into one fund, sponsored by the intermediary, and that may invest as a single shareholder into the issuer.” *Id.*

223. EarlyShares Letter to FINRA, *supra* note 221.

224. *Id.*

225. *Id.*; *see also* *The Symbid-model*, SYMBID, <http://www.symbid.com/pages/model> (last visited Apr. 22, 2014).

226. EarlyShares Letter to FINRA, *supra* note 221.

227. *Id.*

are brought into the equation, unsophisticated investors stand at a significant disadvantage.<sup>228</sup>

The SEC recognizes that improving the liquidity of crowdfunded securities “could increase investor participation in securities-based crowdfunding offerings.”<sup>229</sup> Both intermediaries and issuers win if more investors participate, and investors will seek to invest in crowdfunded securities on platforms where they can exit as easily as the statute allows. A prudent intermediary would either register as an exchange or alternative trading system, or, at the very least, have a mechanism in place to allow for the limited transfers discussed. Also, a prudent intermediary should consider heavily diluting or doing away with voting rights of Section 4(a)(6) securities through an investor syndicate or its equivalent. A crowd with voting rights is a red flag to serious investors contemplating providing follow-on financing for a startup; also, most unsophisticated retail investors would likely prefer liquidity over having voting rights. Easier access to liquidity in such an illiquid market as early-stage financing will attract investors. There is nothing more attractive to an entrepreneur seeking capital than a platform replete with investors.

#### CONCLUSION

Throughout the proposed rules, the SEC touted the flexibility that it was allowing intermediaries as it proposed rules for the underlying statutory framework of the CROWDFUND Act. Intermediaries should not take this flexibility for granted. This flexibility respects the expertise of intermediaries, and it allows them to develop optimal methods to make securities crowdfunding under Title III of the JOBS Act a success. By analyzing the proposed rules, ambitious intermediaries can lay bare the underlying policies and challenges of crowdfunding, which will persist regardless of the content of the final rules, and intermediaries can extract ways to address these challenges and policies. Ultimately, the intermediaries that succeed will be the ones who best understand and address these concerns; by so distinguishing themselves, these intermediaries will attract more issuers and investors.

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228. See John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 635 (2013). Wroldsen argues that “crowdfunding statutes and regulations should seek to protect crowdfunding investors from the horizontal risks of sophisticated venture capitalists without unduly burdening the developing market of crowdfunding investment.” *Id.* Wroldsen points out “a potentially greater danger than fraud or failure: success” as he discusses the example of Eduardo Saverin, one of the original founders of Facebook, who learned the hard way that “venture capitalists and their lawyers have developed intricate strategies for protecting the value of their investments.” *Id.* In contrast, Wefunder argues that an SPV would allow intermediaries to look out for the rights of smaller, unsophisticated investors in follow-on financings by venture capitalists. Wefunder Letter 1, *supra* note 87.

229. Crowdfunding, 78 Fed. Reg. 66,428, 66,526 (proposed Nov. 5, 2013).

If intermediaries simply treat this flexibility as a null obligation or as an excuse to only perform bare minimum compliance, however, they should not be surprised to have issuers or investors drag them into lawsuits over issuers' and investors' own compliance failures. Equally as undesirable, intermediaries could potentially see this flexibility regulated away in response to such lawsuits. Ambitious intermediaries will not let this happen. They will view "flexibility" as a challenge to prove to the SEC that, when given the flexibility, they can devise more effective systems than the SEC could have hoped to create by regulation.

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