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

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

TABLE OF CONTENTS

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is characterized as a key investor protection is instead revealed to be largely illusory and tied to metrics that are out of date by nearly forty years.

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

to have laid the matter to rest, noting that the term originated from a man named Mr. Joseph N. Dolley, a former State Bank Commissioner of Kansas.[5] Mr. Dolley was the driving force behind the 1911 Kansas blue sky law, which was essentially the first of its kind in the United

Clarence A. Dykstra, in an article for *The American Political Science Review*, wrote that the law "has attracted wide attention and so many States have considered or are considering the question of investment company regulations that the subject demands some notice."[11] Mr. Dykstra went on to say, "[t]he object of the Kansas law is to give the average investor every possible protection against the numerous companies which sell stock, bonds or securities of little or no value,"[12] and was widely promoted by Mr. Dolley as such. Those promotional efforts lead to similar enactments in several states, as well as several provinces in Canada.[13] The next twenty or so years found the various blue sky legislative schemes gaining wider a9 w1.2.07n

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

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

PUBLICATION OF JUDICIAL OPINIONS (1973).

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

20. Payne, *supra* note 16.

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

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

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

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

year" windfall she would make investing in the confidence man's scheme.[25] Of course, that windfall would fail to materialize, often leaving the purchaser penniless.[26]

Of these schemes, Mr. Dolley goes on to note, "the undertakings described in these applications [to sell securities in Kansas after the passage of the 1911 law] dot the Western Hemisphere from the Equator to the Arctic circle." The Arizona Department of Mines and Mineral Resources echoes the depth of fraudulent activity, at least

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However, with the new laws in place, consumers now had a specific statutory remedy at the federal level. This was important in two regards. First, even with the state blue sky laws in place, local enforcement officials had no means by which to prosecute offenders outside of their jurisdiction, leaving the fraudsters free to commit their scams via the mail.[39]

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

By and large, these exemptions were fairly benign, as they excluded from registration such issues as those from federal and state governments, those for non-profit purposes, such as churches and

blue sky laws of all states in which the securities are offered, sold, or delivered after sale."[51] Under this rule, a "notice of intention" was to be filed with the SEC, along with the admonition that "copies of all prospectuses, letters or other communications used at the commencement of the public offering" were to be filed with the agency prior to use.[52] They go on to state that "an integral part of this effort [is] to ascertain if alterati

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

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

67. *Id.*

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

69. *Id.*

70. *Id.* at 869–70.

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

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

"Regulation D" were first introduced.[73] As noted early on in those proposed changes, "Regulation D is intended to result in a more coherent pattern of exemptive relief, particularly as it relates to the capital formation needs of small business."[74] To this end, the SEC

offerings, create additional flexibility for issuers in the offering process, and establish an ongoing reporting regime for Regulation A issuers."[79] The JOBS Act also included significant changes to Regulation D, Rules 504, 505,[80] and 506,[81] as well as introducing a new scheme under Title III, known as the CROWDFUND Act.

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

This criterion excludes a person's primary residence from being listed as an asset, and any indebtedness secured by the investor's primary residence is to be further noted as a liability.[90] Of course, such characteristics don't necessarily impute a level of financial sophistication to an individual actor, not to mention that these are the same standards that were in the aforementioned Incentive Act of 1980. Regarding Rules 504 and 505, as of this writing, the proposed changes to those rules are still within the sixty day comment period and are not yet finalized.[91] The proposed changes contemplate raising the limit on Rule 504 offerings from $1 million to $5 million, as well as opening Rule 505 to public suggestion for improved utility, or in the alternative, rescission as an unnecessary rule.[92] Neither Rule 504 nor 505 currently enjoy much utilization in comparison to Rule 506, and as such, the changes as proposed are not significant to the discussion at hand. With that said, we may now turn our attention to Title III oftheN5o771845.7(.()-0E9)10.itodwn Inc1ipAt(od)12.5459J0I.01dayt12.5 n35(R4Tm(92)T3

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

A recent paper by Steven Bradford notes that there are currently

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million to $30 million as a trustworthy measurement overall that range correlates surprisingly well to the actual fund raising practice under Regulation D exemptions. From 2009 to 2012, the average mean of securities offered under Regulation D was nearly $30 million, while the average median was $1.5 million.[125] In recognizing the significantly lower median number, the DERA Study states that this is "indicating a large number of small offerings, consistent with the original regulatory objective to target the capital formation needs

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

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

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

households in the available investor pool, yet it does so with very little justification for the seemingly arbitrary selection of a $100,000 threshold. One might note that, the 10% amount quoted above is 10% of the lesser of income or net worth. As such, if an investor makes

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

To this end, let us turn to a hypothetical independent film venture. This is a fair target in that, on both of the two largest, non-equity crowdfunding sites,[160] film projects account for roughly twenty to twenty five percent and thirty percent of the total projects launched on those platforms.[161]

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

Our hypothetical filmmaker has complied with every rule, her statements seem reasonable e

does not control distribution."[167]

The point of the hypothetical is not demonstrate that investments can go wrong, but rather to illustrate that even an offering that sounds plausible and is carried out in an ethical fashion by an issuer with good intentions can easily be for an investment that has no possibility

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

The SEC states that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer,"[175] which would be barred under the rules. With that in mind, let us return to our previous hypothetical independent film for a moment. Suppose one of the lead actors has a friend that is a famous movie star, and that star has 400,000 people "following" her on a large social media site such as Twitter.[176] In conversation, the lead tells the star about the movie and the proposed crowdfunding. The star then, on her own accord, sends a link to the funding portal and the following message to her fans: "Check out this new movie my friend is in, you can be part of it and I

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

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

But, as noted above, this is not true in the crowdfunding sphere as contemplated. Therefore, there seems to be some fairly serious concerns regarding the use of

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

C. Registered Intermediaries

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

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

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

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

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

question the reliability of those representations."[182] While at first

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receipt of this information before every transaction they make.[188] And while disclosures may rarely be read, here the SEC finally utilizes the

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

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

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