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Equity Crowdfunding as Economic Development?

David Groshoff

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Equity Crowdfunding as Economic Development?

DAVID GROSHOFF

ABSTRACT

The so-called “JOBS Act” became law in 2012. Part of the JOBS Act was to make obtaining financial capital for the small businessperson or entrepreneur more easily available by making equity crowdfunding permissible under the securities laws and regulations promulgated thereunder. I have defined “crowdfunding” and its different flavors in several prior publications and will not repeat that exercise here. Although the United States Securities and Exchange Commission (SEC) has promulgated regulations regarding some portions of the JOBS Act, and

* Department Chair and Associate Professor of Business, American Jewish University, Los Angeles. J.D., The Ohio State University; Ed.M., Harvard University; M.B.A., Northern Kentucky University; B.A., Indiana University. The author thanks Dr. Effendi Leonard, Kent Plunkett, Yong Zhang, Peter Crosby, Mi Tang, and Nick Pacifico for their contributions to his knowledge regarding the material covered in this Article. The author also thanks Jeff Keith for sparking the intellectual curiosity to wade into technology controversies. See, e.g., TESLA, THE GREAT RADIO CONTROVERSY (Geffen Records 1989).


2. See id. § 306, 126 Stat. at 315 (codified as amended at 15 U.S.C. § 77(d) (2012)). For purposes of this Article, small businesses are those that desire to remain as small businesses, whereas entrepreneurial businesses are those that seek to scale to levels permitting them to one day have a public offering.


some outsiders believe the SEC’s move to clarify rule A+ offerings in 2015 was a positive. This Article, however, reiterates that, until full implementation of the JOBS Act’s necessary regulatory environment occurs, penalties will continue to accrue to start-up enterprises, individual investors, and potential employees facing rigged employment numbers that negate those individuals who have simply stopped their respective job searches because of the economic environment.⁶

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INTRODUCTION

This Symposium Article first provides a brief background on the JOBS Act by focusing on law and global economic development theory and its relationship to equity crowdfunding as a means of economic development for entrepreneurs emerging from a weak economy.7 Second, the Article explains the concepts of debt and equity crowdfunding, and their distinctions, benefits, and potential pitfalls. Third, this Article compares the types of permissible equity crowdfunding websites’ regulatory forms—registered investment advisers (RIAs), Broker-Dealers (B/Ds), and Funding Platforms. Fourth the Article argues the current state of inaction by the SEC—despite some added movement by Congress and the states8—fails to benefit the economic actors involved, whether entrepreneurs, small investors, or potential employees. This Article argues that due to the broad-based nature of securities regulation, even if states such as North Carolina wished to pass a robust equity crowdfunding law, the necessary intra-state nature makes the efficacy of such a theoretical law questionable. Finally, this Article concludes that finalizing equity crowdfunding rules remains an important component to the entrepreneurship needed to assist market growth in what remains a fragile American economic recovery in the face of global economic uncertainty.9

I. LAW AND DEVELOPMENT ECONOMICS IS FOUNDATIONAL TO EQUITY CROWDFUNDING

This Part describes why, despite potential objections from some scholars, I believe that equity crowdfunding is ultimately derived from the field of law and development economics. First, this Part provides a brief history of development economics, second this Part describes microfinance

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8. See infra Part III.

as a middle territory between development economics and equity crowdfunding. Next, this Part describes equity crowdfunding from a broad overview, and finally, this Part synthesizes development economics and equity crowdfunding.

A. History and Contextualization of Development Economics

Beginning from a broad economic standpoint, the Malthusian argument that a geometric progression of population growth relative to an arithmetic progression in agricultural output would trigger poverty and suffering among a society’s poorer classes “ignored the importance of technological progress to increasing productivity and output . . . .”10 What Malthus and the SEC have ignored since the drafting of the 2012 JOBS Act and the SEC’s failure to promulgate final rules on equity crowdfunding, is that “[i]mprovements in technology . . . are precisely what permit a shifting upward of a nation’s production function such that more output from the same resources is possible . . . . It is through increases in technology and higher productivity of society’s inputs that a growing population can be accommodated.”11

Further, at a high-economic level, I have described rent-seeking behavior in the past.12 In this context, however, perhaps a better contextualization comes from law and economic development scholar Raphael Kaplinsky, who described economic “rent” as “a situation where the parties who control a particular set of resources are able to gain from scarcity by insulting themselves from competition. This is achieved by taking advantage of or by creating barriers to the entry of competitors.”13 J. Schumpeter created the idea of a framework whereby rents could be created—Schumpeterian rents have become known as “entrepreneurial rents,” along with innovation.14 Further, Kaplinsky discussed entrepreneurial surplus.

11. Id. at 110 (emphasis added).
14. JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 150–53 (Redvers Opie trans., Harvard University Press, 1961); KAPLINSKY, supra note 13, at 62–63 (stating that innovation exists if an entrepreneur is able to extract a super-profit or
But law and development economics is not limited to so-called developing economies, as scholarly discussions of the “developed world” occur relative to the U.S. and European Union (E.U.) in the context of law and economic development. Nor is development economics necessarily limited in theory to nations to the exclusion of developing enterprises. For example, as Deepak Lal indicated while contrasting the varied views of development economists, “[D]evelopment economists nevertheless accept that developing countries are ‘unequal partners’ in the current world trading and payments system, and the rules of the . . . economic order must be changed to serve their interests.” This paradigm is similar to developing business enterprises, wherever those businesses may be geographically located in the cybernetic world that followed much of the law and development economic research and publications.

Professors Cypher and Dietz argued, 

[T]he challenge for the development analyst is . . . to attempt to identify the most significant barriers to development in each country and to formulate effective measures, including public policy, that can begin to undo, remove, or at least minimize the effects of those obstacles to progress that slow or thwart the development process.

Further, when considering the sources of economic growth, other economists have asserted that investment represents an important component. While understanding the interrelation between law and economic development dates back to the 1800s, several authors indicate that the explicit reason for law and economic development theory was to “[i]nitially . . . turn[] law as an instrument for state policy aimed at generating economic growth.”

Harvard Law Professor Duncan Kennedy discussed how law and economic development functioned in the context of geographic diffusion

“entrepreneurial surplus” from entrepreneurial activity relative to barriers to entry, exceeding the costs of innovation).


17. *See Cypher & Dietz, supra* note 10, at 20. Cypher and Dietz also distinguish between economic growth and economic development by indicating that growth based on income-per-person levels serve as reasonable measures for understanding progress, while development is too complex and must be determined by wholly different criteria. *Id.* at 28–29.


20. *Id.*
and combining emerging legal regimes with existing regimes in a given geographic region. Kennedy further asserted,

"[I]t is no more possible to understand the second and third globalizations than the first without an analysis of how the liberal idea (of a regime based on state action to guarantee the exercise of free will and also the limits on free will necessary for everyone to enjoy it) worked in symbiosis with or in contradiction of the counterideal, counterethic, counterreality represented by the household,

and by the 1960s, a critique of the first globalization of law and development occurred as being "individualist," leading to "innovation across the whole juristic field" of law and economic development. The first stage of the rule-of-law reaction to law and economic development—approximately occurring in the mid-1990s—required economic constitutionalism and democratic empowerment, market-oriented growth and direct poverty alleviation (that would occur as a spillover from economic growth itself), efficiency and distribution, and endogenous growth.

Also a Harvard Law Professor, David—not Duncan—Kennedy indicated that between 1980 and 1995, that neoliberal law and economic development policy moved toward an economic view that "was no longer imagined primarily as an input-output production cycle open to macroeconomic strategies to manage the relationship among economic aggregates such as 'savings' or 'investment,' . . . or 'technology.' Viewing savings, investment, and technology in a vastly different legal and regulatory paradigm via equity crowdfunding also represents why reviewing law and economic development underpins and may serve as a guide for spurring economic growth for a shrinking U.S. middle class. As Kerry Rittich stated, "[M]any policy documents from the IFIs

21. See Duncan Kennedy, Three Globalizations of Law and Legal Thought: 1850–2000, in The New Law and Development, supra note 19, at 19, 23 (describing the so-called "first globalization" of law and economic development). This Article intentionally excludes the discussion of colonialism as outside the scope of this project.

22. Id. at 36–37.

23. Id. at 44–46.


[International Financial Institutions] . . . point to the importance of the rule of law and good governance in securing the social dimension of development . . . ." so as to "expect a widened conception of development to be reflected in the prescriptions about the legal and policy environment for economic growth and greater participation and democratization to inform the processes through which it [law and economic development] is to be generated." Further, "[g]rowth may be limited by lack of social capital. But if development occurs it may deepen social capital, and a favorable interactive process can evolve." Further, Total Factor Productivity (TFP) is a factor of human capital, knowledge capital, social capital, and other elements of technical change (the residual). "An increase in TFP results in a reduction of real costs within enterprises." As Meier indicated,

[It is technical progress that is most significant in forestalling diminishing returns from the tendency for the marginal product of capital to fall. In the long run, growth depends on the rate of technical progress—on an exogenous shift in the production function . . . . Most significant in the residual of TFP are the "production" of human capital and improvements in the level of technology.

In contrast to Solow’s view, Paul Romer indicated that imperfect competition, endogenous technological progress based on ideas and innovations that come from private provision, and differences in technology are all "features of growth that are not endogenized in the Solow analysis." Further, "[e]ndogenous technical change in Romer’s analysis takes the form of R&D [research and development]-yielding innovations by imperfectly competitive firms that result in new products, new processes, and a greater variety of capital goods." In Meier’s view


29. See id. at 97 (explaining Y1=A1(FK1,L1), where A is the technological level, and A1+Y(FKt,Lt), with the second equation representing a shift in TFP due to technical progress). Y+F(K, A(L)) may represent labor supplanting technological progress, where Y=F (AK, L) may represent capital-supplanting technological progress); see id. at 116 (indicating that TFP promotes human capital); see also id. at 95–97 (describing technical progress’ relation to the production function movement and Robert Solow of MIT’s contributions to economic growth theory, which earned him a Nobel prize in 1987).

30. Id. at 116.
31. Id. at 97–98.
32. Id. at 98.
33. Id.
of modern growth theory, simply put, “[g]overnment policies that promote real cost reductions are therefore of prime importance.” The government’s currently proposed policies relative to equity crowdfunding promote real cost additions, rather than reductions, thereby turning away from the growing economy theory that served as the policy basis behind the JOBS Act of 2010 and the JOBS Act of 2012.

As a result, the need for capital, the need for businesses to develop, and the need for structural paradigms to permit for economic development to occur in the shadow of recent legislation lead me to believe a strong underpinning exists between equity crowdfunding and law and development economics.

B. Microfinance and Law and Economic Development

This Article asserts that Crowdfunding of all sorts is derived from principles of microfinance, which seeks to assist both entrepreneurs and micro-entrepreneurs, because, in part, an empirical study asserted that microfinance helped increase “social mobility and living standards,” and also in part because microfinance can reduce the agency costs of the lending investor.

i. Microfinancial Background and History

According to Eugenia Macchiavello, “[m]icrofinance is the provision of a wide range of financial services to financially excluded people. It became renowned worldwide in its basic form of microcredit—small loans to poor prospective entrepreneurs excluded from the formal financial sector because of their perceived risk and lack of traditional forms of guarantees.” William Langer defined microfinance as “the practice of providing small, working capital loans and other financial services to

34. Id. at 117; cf. infra Part III (discussing Proposed Equity Crowdfunding Rules’ costs).


36. Id. at 45 (citing Syed Muhammad Qasim Hamdani & Hummayoun Naeem, The Impact of Microfinance on Social Mobility, an Empirical Evidence from Pakistan, 3 INTERDISC. J. CONTEMP. RES. BUS. 81, 87 (2012)).


individuals unable to obtain access to commercial sources of credit." Further, and more generally, "microfinance is any activity expanding financial access to low-income people"; however, definitions of microfinance vary from country to country. Hunt indicated that while traditional financial relationships come from nations with already-developed economies, aspects of the financial relationship in microfinance remain constant, regardless of geography. Macchiavello asserted that innovation to various forms has contributed to microfinance’s global expansion.

Although some definitions of microfinance appear to restrict the term’s use to credit-based financial infusions, given that approximately 25% of microfinance is equity-based, this Article uses the broader definitions of microfinance to expand financial access to lower income people, otherwise the term would be “microcredit,” rather than microfinance. That is also why this Article uses equity crowdfunding to describe investment crowdfunding that may also be debt or some other security. Further underscoring this usage, microfinance-backed enterprises have received private equity investment and undergone global initial public offerings (IPOs). Additionally, “[p]rivate equity investment

40. Macchiavello, supra note 38, at 129.
41. Hunt, supra note 35, at 8. Hunt also includes in her view of microfinance the concepts of “microsavings, microinsurance, and microbanking, like money transfer via mobile phones.” Id. at 9.
42. Macchiavello, supra note 38, at 129.
43. See generally Langer, supra note 39, at 5 (“MIV [Microfinance Investment Vehicles] investment grew from $2 billion in 2006 to an estimated $3.2 billion by the end of 2007. Approximately 75% of this investment is debt, 22–25% is equity, and 2% consists of guarantees for local investors.”); see also id. at 4 (“While microfinance traditionally receives funding through government grants and non-profit subsidized loans, private investors have become increasingly interested in microfinance investment given the favorable financial and social returns.”).
45. See John Berlau, Comment Letter on Proposed Rule Regarding Crowdfunding, 78 Fed. Reg. 66,428 (Feb. 3, 2014) (“Equity crowdfunding refers to firms raising money from a variety of individuals with the promise of a share of the venture’s proceeds and/or a specified return on investment.”).
46. Langer, supra note 39, at 10–11 (“Private equity investment can be especially useful for start-up MFIs that, according to their business plans, typically operate at a loss for their first few years and thus are unlikely candidates for debt investment.”); id. at 14

http://scholarship.law.campbell.edu/clr/vol38/iss3/3
can be especially useful for start-up MFIs that, according to their business plans, typically operate at a loss for their first few years and thus are unlikely candidates for debt investment.\textsuperscript{47} Further, "[i]nterest rates on microfinance loans have a global median of 32\%."\textsuperscript{48} While these returns may be good for a debt investor, such returns are not unexpected compared to what an early-stage equity investor could get through diversified investment as a personal Venture Capital (VC) firm.\textsuperscript{49}

Current microcredit-type financial services were derived from various practices, including tontines in Africa and India's Rotating Savings and Credit Associations,\textsuperscript{50} were formally recognized as beginning in the mid-1970s in Bangladesh and Bolivia to provide loans to working poor micro-entrepreneurs,\textsuperscript{51} but differed in microfinance's tilt toward credit-based capital investment, decentralized decision-making, and human resource and internal control risks.\textsuperscript{52} These initial microcredit forms of microfinance transformed to the growth of Microfinance Investment Vehicles (MIVs) that invest both in socially conscious as well as purely for-profit investment in various forms that include peer-to-peer (P2P) lending.\textsuperscript{53}

Regardless of the view one takes relative to microfinance being a debt, equity, or mixed component of financing those people or enterprises outside of the traditional financial system, "there is enough evidence to suggest that microfinance does not have a negative effect on economic development, it does not cost society or the government excessive amount of fund[s] to support it, and thus, it may be an appropriate system" to allocate capital to undercapitalized entrepreneurs.\textsuperscript{54} And microfinance

\textsuperscript{47} Id. at 11.
\textsuperscript{48} Hunt, supra note 35, at 23.
\textsuperscript{49} Returns for PE and VC firms have been known to be expected to be in the 30\% range, hence the investor bowing to some "three and thirty" methods of compensation for fund managers. See also Hunt, supra note 35, at 24 (comparing this rate of return to a typical unsecured loan in the form of a credit card as not being materially higher).
\textsuperscript{50} Macchiavello, supra note 38, at 129–30.
\textsuperscript{51} Langer, supra note 39, at 1.
\textsuperscript{52} Macchiavello, supra note 38, at 129–30.
\textsuperscript{53} Id. at 131–52; see also Jesse R. Gero, Financing Social Enterprise—Realizing Political Equality: How the Consumer-Beneficiary Model of Social Enterprise Secures Beneficiary Participation and Why We Should Care, 9 N.Y.U. J.L. & BUS. 617, 619 (2013) ("[T]oday a credit card and access to the Internet are all one needs to participate in social impact work in almost any corner of the world.").
\textsuperscript{54} Hunt, supra note 35, at 6 (internal citations omitted).
indeed goes to entrepreneurs. For example, “[m]icrofinance has transformed the lives of over 100 million micro-entrepreneurs throughout the world. Modern microfinance began in the mid-1970s with initiatives, first in Bangladesh and then in Bolivia, to distribute small loans to the working poor.”

In that regard, this Article treats microfinance and crowdfunding as economic development techniques, regardless of whether the financial activity occurs in or across developed economies or developing economies. And while Macchiavello proposed a global public-private system of microfinance regulation that would avoid regulatory arbitrage, a key is that the proposed regulatory framework would, in fact, come to fruition.

Although various authors may have been concerned about different methods of protecting repayment to investors, is it even efficient to examine such constructs when, for example, in 2015, Greece closed its banking system for over a week, leaving its populace without access to even the purported safest savings, or when China—also in 2015—devalued its currency, leaving those people holding the nation’s currency with a

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55. Langer, supra note 39, at 1 (emphasis added).
56. Macchiavello, supra note 38, passim.
tremendous loss of purchasing power? If established governments of at least quasi-developed economies cannot keep savers' and investors’ financial capital safe, then what is the purpose of debating regulation formats for “protecting” the microfinance investor?

ii. Analyzing Regulation for the Microfinance Investor

Regardless of the purpose of debating regulation, this Sub-Part discusses regulation of microfinance and economic development. Macchiavello asserted that governments and regulators “can be fundamental” to “spur or hamper” the economic development. Further supporting such a thesis, Katherine Hunt stated, “Regulation has the potential to directly affect the financial sustainability of MFIs, through restricting or supporting their business operations regarding obtaining capital and product design.” And as Langer indicated, “A country’s regulatory environment can profoundly influence the ability of domestic [Microfinance Institutions (MFIs)] to achieve growth and sustainability, and to obtain access to capital.” Further, “while private investors are interested in helping MFIs bridge the gap between current supply and total demand for microfinance services, they are restricted by the regulatory environment.” Hunt asserted, “[R]egulation is especially important for situations where the poor can potentially be worse off. This does not mean that no regulation at all is needed, it simply highlights that different regulation is necessary if the socioeconomic goals of microfinance are to be achieved.” Further, “[w]orks by the IMF have highlighted the adverse consequences of regulation, not only in terms of its costliness, but also in terms of potential regulatory failure.” These paradigms appear to be of no material difference than currently exists in the equity crowdfunding universe.

As Hunt asserted,

Supportive legislation is still required to ensure that MFIs are able to be financially sustainable while achieving development and distributional goals. Given this, the legislator must do something to support

60. Macchiavello, supra note 38, at 133.
61. Id.
63. See Langer, supra note 39, at 24. For further discussion of microfinance regulation, see id. at 24–31.
64. See id. at 72.
65. See Hunt, supra note 35, at 65.
microfinance. The development of specific microfinance law in various
developing and developed countries is evidence of this already taking
place. MFI legislation may allow MFIs to overcome risk management
problems and facilitate market functioning.67

That is to say, the President of the United States and the U.S.
Congress spoke legislatively—three years ago—regarding the SEC’s
mandate to promulgate regulations on equity crowdfunding, and no
material movement has occurred in the interim.68 This assertion in essence
mirrors the conclusion of “a study issued by the Consultative Group to
Assist the Poor (CGAP) and the World Bank [that] concluded that a
country’s microfinance industry cannot reach its full potential until MFIs
are regulated and supervised in a coherent and prudent manner.”69 And
still the U.S. awaits final rules from the SEC with no demonstrable reason
for such a material delay to alleviate a shaky U.S. and global economy.

C. Synthesizing Law and Economic Development with Microfinance and
Equity Crowdfunding

Whether law and development economics and microfinance is viewed
through an optic of private economic activity, public economic activity, or
some combination of the two, I argue that recent examples of government
instruments for state policy aimed at generating economic growth are the
2012 JOBS Act (which contains the controversial equity crowdfunding
provision), and its precursor of sorts, the Small Jobs Act of 2010,70 which
had a basis of helping small businesses to the point of U.S. Environmental
Protection Agency (EPA) Administrator Lisa P. Jackson claiming at the
Department of Energy’s Small Business Conference that the Small
Business Jobs Act of 2010 represented “the most significant piece of small
business legislation in over a decade.”71 Administrator Jackson further

67. Id. at 20. For a discussion of public policy and economic development, using the
Argentine economy as the backdrop, see Carlos F. Diaz Alejandro, The Argentine State and
Economic Growth: A Historical Review, in GOVERNMENT AND ECONOMIC DEVELOPMENT

68. Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17
66,428, will be referred to throughout this Article as Proposed Equity Crowdfunding Rules.
Comments on the proposed regulations were open for ninety days, which closed in 2014.
Still, as of this Symposium, the Proposed Equity Crowdfunding Rules neither have been
amended nor published in final form.

69. See Langer, supra note 39, at 24.


71. Lisa P. Jackson, U.S. Envtl. Prot. Agency Administrator, Remarks at the
Department of Energy’s Small Business Conference, Kansas City, Missouri (May 11, 2011),
asserted, "As entrepreneurs, the opportunities that are available to you today are possible because we live in a country that embraces the spirit of those who are willing to take a chance and succeed. As small businesses, your initiative and enterprise hold the promise for winning the future."  

This assertion does not even mention the U.S. Treasury Department’s 2011 Press Release stating that President Obama’s 2012 proposed budget “puts in place a strategy that promotes future economic growth by making better investments in . . . innovation [to help] foster continued economic growth” and that the “Treasury’s Budget also aims to encourage private sector investment in start-ups and small businesses operating in low-income communities . . . .” But several statutes may also contain provisions that protect vital interests of powerful groups. Opening up capitalism to the poor will not be as simple as running a bulldozer through garbage. It is more like rearranging the thousands of branches and twigs of a huge eagle’s nest—without irritating the eagle. Although this rearrangement will impose only small inconveniences on this tiny minority, when compared to the nationwide benefits of bringing capital to the poor, those affected will not see this unless reform is driven by strong political initiative with the message and numbers to back it up. 

Further, “[o]nly at the highest political level can reform command overwhelming support and wipe out the willful inertia of the status quo. Only the top level of government can prevent bureaucratic infighting and political conflicts from paralyzing the progress of reform.” Many people reasonably believed that progress occurred when President Obama signed into law the bipartisan JOBS Act of 2012 in April of that year. Specifically, when signing the bill, President Obama stated, that securities “[i]laws that are nearly eight decades old make it impossible for [non-accredited investors] to invest” in small enterprises, and “a lot has
changed in 80 years.”

President Obama further stated that “[b]ecause of this bill, start-ups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.”

Crowdfunding is simply the process of an investor going to an e-platform and making an investment of capital. Sometimes that investment expects nothing in return, and sometimes that investment expects something in return, such as a reward, a thank you, or a piece of merchandise. But unless the investor is accredited under the securities laws and rules and regulations promulgated thereunder, equity crowdfunding remains elusive for most investors in the United States. This issue was, as stated above by President Obama, supposed to have been eliminated by the JOBS Act of 2012.

Christine Hurt asserted that optimistic commentators are hopeful that “crowdfunding eases access to capital markets for promising for-profit ventures [including for-profit social entrepreneurs], creating a new step in the life cycle of a startup: friends and family funding, crowdfunding, angel investing, venture capital (VC), and then IPO.”

Later in 2012, seemingly making his pro-entrepreneur, pro-small investment stance appear more robust, President Obama issued a proclamation making November 2012 National Entrepreneurship Month and November 16, 2012, as “National Entrepreneurs’ Day.” The President further commented, “Earlier this year, I signed the Jumpstart Our Business Startups (JOBS) Act into law, which...will also allow ordinary Americans to go online and invest in the startups and small businesses they believe in through crowdfunding platforms.” President Obama further asserted that “the new businesses created by entrepreneurs are responsible for most of the new jobs in our country...”

However, until the Proposed Equity Crowdfunding Rules finally are promulgated, investing via crowdfunding in the debt or equity tranches of...
an enterprise’s capital structure generally remain impermissible for most investors,\(^8^5\) because as Hurt asserted, “[T]he sale of participatory interests to the general public over the internet, will violate the Securities Act by selling unregistered securities without an exemption.”\(^8^6\) As Joan MacLeod Heminway and Shelden Ryan Hoffman analyzed, equity crowdfunding to unaccredited investors\(^8^7\) currently does not qualify for an exemption under federal securities laws,\(^8^8\) and no meaningful federal regulation of unaccredited investor equity crowdfunding currently exists, despite the mandate of the JOBS Act.

Yet President Obama seems to have ignored the JOBS Act after signing it into law. Meanwhile accredited investors appear to thrive via equity crowdfunding platforms such as Angel List. As de Soto stated, “No group—aside from terrorists—is better positioned to sabotage capitalist expansion [than lawyers]. And unlike terrorists, the lawyers know how to do it legally. Although entrepreneurs and ordinary people are the builders of capital and capitalism, it is the lawyers who fix [and define]... those concepts in statutes.”\(^8^9\)

More than two years after enacting the JOBS Act, United States Senator Jerry Moran of Kansas, in an October 2014 letter to SEC Chairwoman Mary Jo White, indicated that as a proponent of entrepreneurship, he “strongly urge[d] the Securities and Exchange Commission (SEC) to complete its work to implement the key components of the Jumpstart Our Business Startups (JOBS) Act of 2012 pertaining to regulation crowdfunding.”\(^9^0\)


\(^8^6\) Hurt, supra note 59, at 238–39.

\(^8^7\) 17 C.F.R. § 230.501(a)(5)–(6) (2015) (defining an “accredited investor” as a person (1) “whose individual net worth, or joint net worth with that person’s spouse, exceeds $1,000,000,” excluding the value of the person’s primary residence or (2) “who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person’s spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year”); Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).


\(^8^9\) DE SOTO, supra note 75, at 197–98.

Specifically underscoring the broad support of the JOBS Act of 2012, Senator Moran stated, “[T]he JOBS Act passed both houses of Congress with broad bipartisan support and was signed into law by President Obama on April 5, 2012 (P.L. 112-106). One key feature of the JOBS Act was Title III . . . [and t]he SEC was required by law to promulgate rules relating to these crowdfunding provisions by the end of 2012. The SEC has now missed that deadline by nearly 550 days”91 (onto which one can tack at least an additional 365 days between Senator Moran’s letter and this Symposium, for more than an 850-day missed deadline by the SEC regarding providing final rules on equity crowdfunding under Title III of the JOBS Act).

Moran correctly asserted,

Following the passage of the JOBS Act, dozens of companies across the country built platforms, raised funds from investors, and anxiously awaited the final crowdfunding rulemaking from the SEC . . . . In some cases, these companies have been forced to pivot to new business models or worse, they no longer exist because of the lack of a finalized federal rulemaking.92 Moran concluded that startups, investors, and other stakeholders need capital to “create vital economic growth.”93

The next Part analyzes some reasons why meaningful equity crowdfunding may have been delayed and may never occur.

II. BRIEF BACKGROUND ON THE JOBS ACT, EQUITY CROWDFUNDING, AND QUESTIONABLE FEARS OVER EQUITY CROWDFUNDING

This Part provides a brief contextualization of the JOBS Act and what the lexical unit “equity crowdfunding” means in both law and finance and explores how grounded certain fears may be that seem to be a cause in the SEC’s delay in finalizing equity crowdfunding rules under the JOBS Act.

A. What Is Equity Crowdfunding?

Equity crowdfunding is not limited to equity.94 The SEC defines equity crowdfunding as “a new and evolving method to raise money using

91. Id. (emphasis added).
92. Id.
93. Id.
94. See, e.g., John Berlau, Comment Letter, supra note 45 ("'Equity crowdfunding' refers to firms raising money from a variety of individuals with the promise of a share of the venture’s proceeds and/or a specified return on investment.").
This Part begins with the historical underpinnings and then moves to the differences between debt and equity crowdfunding, despite both using the umbrella lexical unit of "equity financing."  

i. Brief Securities Law Overview

Title III of the JOBS Act creates an exemption from an issuer needing to register an offering with the SEC under new section 4(a)(6) of the Securities Act of 1933 if the offering is based on crowdfunding. Under Title III, Congress instructed the SEC to promulgate rules and regulations to appropriately implement Title III's mandate of exempting crowdfunding offerings from registration. On October 23, 2013, the SEC released proposed rules. As of this Symposium date, essentially two years later, the SEC has not issued final rules and has proverbially thumbed its nose at a bipartisan law. Despite the SEC's refusal to follow the law, the agency proudly issued a press release in early 2015 when it finalized rules for Title IV of the JOBS Act.

ii. Equity Crowdfunding's Potential Promises

Christine Hurt indicated that "crowdfunding has reignited a desire among both entrepreneurs and investors to harness technology to assist smaller issuers in the funding of their business ventures." Hurt further acknowledged that crowdfunding has the potential to disrupt, disintermediate, and democratize the traditional early-stage fundraising process for both the retail investor and the entrepreneur.

While Professor Hurt stated, "If the securities laws were meant to protect investors, then surely they were meant to protect the amateur investor clicking on projects created by unknown strangers," several colleagues and I have argued to the contrary. Elsewhere, the SEC's current stance, in essence, solely protects the wealthy accredited investors by allowing them to invest in early stage companies via equity crowdfunding,

98. Hurt, supra note 59, at 220.
99. Id. at 224–25.
100. Id. at 242–43.
while keeping the rest of the crowd behind a regulatory barricade.101 Further, government-mandated transaction costs, which include the costs of "transmitting information by and to market participants . . . drive[s] a wedge . . . between the buyer's and the seller's price[, and t]he market for a particular good will cease to exist if the wedge is so large as to push the lowest price at which anyone is willing to sell above the highest price anyone is willing to pay."102 As Deepak Lal further asserted, "There are few, if any, instruments of government policy which are non-distortionary, in the sense of not inducing economic agents to behave less efficiently in some respects. Neither markets nor bureaucrats as they exist can therefore be expected to lead an economy to a full welfare optimum."103 Having said that, "[w]hat is a hindrance to [economic] progress in one setting and at one stage may be helpful under different circumstances."104

Further, the Proposed Equity Crowdfunding Regulation provides a host of frictions that turn what could be a simple crowdfunding process into a regulatory minefield of financial disclosure requirements, portal (or Broker/Dealer) registration requirements, accredited investor certifications, and financial caps on investors seeking returns and investee enterprises seeking funding.105 As a result, scholars such as Professor Hurt have written that "currently the outlook for equity crowdfunding looks doubtful."106

iii. Crowdfunding's Potential Pitfalls—Fraud

According to Gabison, "[f]raud, incompetence, and lack of exit strategies jeopardize equity crowdfunding. Fraud constitutes the biggest threat to crowdfunding."107 Further, "scholars worr[y] that exempting capital raising by and among strangers over the internet would open the floodgates to fraud."108 Contrarily, however, several issues arise in this context. First,
crowdfunding fraud remains a statistical anomaly and is exceedingly rare.\textsuperscript{109} Second, as Hurt describes, “The transparency and centralized nature of crowdfunding portals will make fraud harder rather than easier.”\textsuperscript{110}

iv. Crowdfunding’s Potential Pitfalls—Oversight

It is laughable to claim that the SEC has been exemplary in protecting investors with the SEC’s oversight relative to public companies, which require a massive amount of disclosure and compare that reality to the hobgoblin of what-ifs in an equity crowdfunding scenario, as the SEC has failed miserably when it comes to ex-ante or contemporaneous oversight of issuers, gatekeepers, and investors. Simply put, “[c]ritics of crowdfunding were not comforted by the CROWDFUND Act\textsuperscript{111} or the proposed regulations because of the paucity of provisions aimed at combating
Have these critics so quickly forgotten, ignored, or were they immune to the attention surrounding heavily regulated—yet massively successful—fraudsters? Examples of these include (1) issuers such as Enron, Worldcom, MCI, Tyco, or more recently United/Continental Airlines, whose CEO’s past history was that of large corporations’ General Counsel; (2) investors such as Raj Rajaratnam and Bernard Madoff; and (3) gatekeepers such as accounting firms/auditors Arthur Andersen, and more recently, BDO, who cost investors far more than the entire crowdfunding space currently has in assets or contributions.

v. Public Company Potential Pitfalls—Issuer Fraud that SEC Disclosures Neglected To Prevent

While readers have likely read their fill about the scandals at Enron, Worldcom, and Tyco at the turn of the millennium that paved the way for the Sarbanes-Oxley (SOX) legislation, these problems did not magically go away because of the SOX legislation. As I have indicated previously, the answer to the failure of regulation is not necessarily additional regulation, but rather is correct, if any, regulation. And so, nearly fifteen years following SOX’s enactment, from the issuer perspective, the year 2015 has witnessed what appears to be fraud from issuer UAL/Continental, as the company’s board of directors terminated the services of Chief Executive Officer (CEO) Jeff Smisek in September amid a scandal—including a federal investigation—alleging corruption among Smisek, two additional UAL executives—Nene Foxhall (Executive Vice President, Government Affairs) and Mark R. Anderson (Senior Vice President, Communications and Government Affairs)—and the Port Authority of New York and New Jersey. According to SEC disclosure documents, Smisek is entitled to separation payments of at least $28.6 million and flight benefits grossed-up for taxes for life on the carrier.

Unlike many CEOs with backgrounds in business, Smisek, graduated from Harvard Law School and began his career as General Counsel for Continental Airlines prior to its merger with UAL. Despite the suspect

112. See Hurt, supra note 59, at 252.
circumstances of Smisek's hasty dismissal, he is entitled to a presumption of innocence in the corruption accusations. While Smisek is certainly entitled to a presumption of innocence in this matter, it raises suspicion when a board of directors moves as quickly and as forcefully to replace a CEO as it did in this case, replacing Smisek mid-day with existing board member and CSX CEO Muñoz. Not only do the alleged acts go back to 2011, prior to the signing of the JOBS Act, but the company disclosed references to certain of the allegations earlier in 2015 in the company's annual report to shareholders. When buried in one paragraph of a 144-page disclosure document, this value-destroying behavior may not be reflected in the shares' stock price. When made the main story on its own, causing the termination of employment of the CEO, however, the disclosure caused stock price stagnation during one of the strongest weeks for stock price increases in 2015.
vi. Gatekeeper Fraud that Neglected to Prevent Shareholder Destructive Behavior

In 2012, investors sued the Top-10 accounting firm BDO Siedman, LLP (BDO). Primarily, the suit involved a $285 million loan BDO made to a company it audited, which had been indicted for swindling its investors out of approximately $800 million.\(^{119}\) Apparently that settlement by the supposed gatekeeper was insufficient. In September 2015, BDO agreed to pay approximately $2.1 million to settle SEC charges that included issuing false and misleading audit opinions regarding the financial statements of General Employment Enterprises in 2009 and 2010.\(^{120}\) BDO admitted to the wrongdoing as part of the settlement.\(^{121}\) Further, the former lieutenant governor of Kentucky,\(^{122}\) Stephen B. Pence, as CEO of General Employment Enterprises, signed the 2009 10-K, and is being charged by the SEC.\(^{123}\) Despite all of this, some members of Congress believed that more, not less, robust regulations would prevent such specific post-SOX abuses.\(^{124}\)

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121. See id.


124. Cf. 158 CONG. REC. S1714, S1715 (daily ed. Mar. 15, 2012) (statement of Sen. Reed) (“We could literally roll back the clock to pre-Enron, pre-WorldCom, where because of creative accounting, because of the lack of adequate audit procedures within the company, real abuses occurred. The result was Enron collapsed and their shareholders were left with virtually nothing. One of the more tragic ironies is that many of their shareholders were their employees who had their entire pensions invested in the company, particularly in the case of Enron. Ultimately, the pain to these people, caused by the lack of good standards—which have since been put in place—was significant. If we proceed on this, we might, once again, have a situation where we are repeating industry—and a history we have seen already.”).
B. Synthesis

If this fraud exists in what is regulated by the SEC, and no evidence of meaningful fraud has yet existed in crowdfunding, then what is the SEC truly protecting? While Enron-type issues may seem years away, the UAL and BDO scenarios—arising out of substantial businesses in the United States—not only occurred during 2015, but also occurred within six weeks of the Symposium for which this Article was written.

The next Part considers potential alternative scenarios to move forward with equity crowdfunding, which will permit such economic development and growth to exist for entrepreneurs, investors, and other stakeholders.

III. COMPARING THE PROPOSED EQUITY CROWDFUNDING WEBSITE “TYPES”: REGISTERED INVESTMENT ADVISERS, BROKER-DEALERS, AND FUNDING PLATFORMS

Registered Investment Advisers (RIAs), Broker Dealers (B/Ds), and crowdfunding portals (funding portals) are potential entities by which true equity crowdfunding websites may be operated.

A. General Level Examples in Existing Landscape

A number of entities in the online financial services world have chosen differing licensures and registrations for their business models.

i. Commercial Bank Affiliations

The following businesses, while not banks, are examples of entities maintaining commercial bank affiliations—as needed operational partners—to complete crowdfunding transactions that would otherwise be deemed a security: (1) SmartyPig deposits funds with BBVA Compass, an FDIC-insured bank, which pays high-yield interest; and (2) Prosper is a person-to-person (P2P) lending platform using WebBank, a Utah-based FDIC-insured bank (like LendingClub, below) in which people can choose whose projects to fund via an intermediary bank providing the actual funds.125

Some equity-like crowdfunding sites have chosen to reject bank and bank-affiliate models, however. For example, Fundation is an online

lending (Small Balance Commercial Loan) platform where businesses can get fixed rate term loans of up to $500,000. The company states, "Unlike banks, our loan funding does not come from customer deposits. Private investment firms invested a significant amount of money in our company to permit us to fund and hold every loan with our own capital." Fundation conducts its underwriting technology via data aggregation. Another example in this regard is Funding Circle, which discusses on its website about how it is different from a bank. Nonetheless, Funding Circle has been online lending platform of up to $500,000 for small businesses from institutional and accredited investor capital sources.

**ii. Multi-Faceted Approaches**

Several multi-faceted approaches, such as LendingClub, also exist. There, people invest in self-directed loans funded and issued by WebBank, a Utah-chartered FDIC-insured bank (like Prosper, below), with each series of Notes corresponding to an individual member loan, sold to LendingClub after closing. LendingClub offers investment accounts, including 401(k) rollovers and Individual Retirement Accounts. Lending Club Notes are done via prospectuses filed with the SEC, and the enterprise conducts private placements through its wholly-owned RIA subsidiary, LC Advisors, LLC. LendingClub also owns a Delaware Business Trust related to loans. LendingClub’s maximum loan amount is $40,000. It cannot

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134. See LENDINGCLUB, supra note 129.
operate in Idaho, Indiana, Iowa, Maine, Mississippi, Nebraska, and North Dakota. CommonBond provides new and refinanced student loans primarily to MBA students. In 2014, the company expanded to law and medicine and other professional schools. Bank of Lake Mills, serves as the ultimate creditor.

B. State-Level Registrants

Several state-level registrants exist as well, and this Sub-Part provides several examples. SoFi works in the student loan space. SoFi’s loans are originated by SoFi Lending Corp (DBA SoFi) California Finance Lender #6054612. SoFi carries NMLS Consumer Loan Company License #1121636 (Nationwide Mortgage Licensing System), and is thereby regulated by the Washington State Department of Financial Institutions. CircleBack launched in July 2013 specifically to compete with Prosper and LendingClub, and claimed to be a P2P lender, although it seemed to invest with its own funds, seek only Accredited Investors, and lend exclusively in New Mexico and Georgia.

135. See Trust Agreement, supra note 133.
C. Registered Investment Adviser Platforms

A number of RIA platforms exist that could make very interesting equity crowdfunding platforms, and this Sub-Part describes several of those enterprises.

i. RIA Requirements and Exemptions

A three-prong requirement exists to register as an RIA: (1) receiving compensation;\(^{144}\) (2) being engaged in the business,\(^{145}\) and (3) providing advice about securities.\(^{146}\) Once registered under the Investment Advisers Act of 1940, \(15\) U.S.C. \(\S\) 80b-2(a)(11) (2012). The compensation element of the definition can be satisfied by the receipt of any economic benefit. Applicability of the Investment Advisers Act, Investment Advisers Act Release No. IA-1092, 52 Fed. Reg. 38400, 38403 (Oct. 16, 1987). Compensation can be a separate advisory fee or be part of a single fee for total services rendered in addition to investment advisory services. \(Id.\) The SEC has also interpreted this element to include indirect compensation from a third party other than the recipient of the advice, such as a sales commission paid by the promoter of an investment product to the adviser who recommends the product to a client. \(Id.\)

144. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11). The SEC looks to the frequency and regularity that a person engages in advisory activities when determining if it satisfies the second element of the definition. Applicability of the Investment Advisers Act, Investment Advisers Act Release No. IA-1092, 52 Fed. Reg. 38400, 38402 (Oct. 16, 1987). The SEC interprets this element broadly and does not require advisory activities to be an entity’s primary business. \(Id.\) Rather than list activities deemed to be in the investment advisory business, Release 1092 outlines three interrelated factors that the SEC considers when determining if this element of the definition is satisfied: (1) Publicity: Entities that publicly represent themselves as providing advisory services can be deemed to be an investment adviser; (2) Compensation: The receipt of separate or additional compensation that can be clearly traced to providing investment advice is evidence that an entity is engaged in the business of an investment adviser; and (3) Specificity and Regularity: Entities that give specific investment advice, other than in rare, isolated and non-periodic instances, are deemed to be in the investment advisory business. \(Id.\) Specific investment advice means recommendations, analysis, or advice about either specific securities and categories of securities, or recommendations that clients should allocate specific percentages of assets to certain investment products. \(Id.\)

145. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11); see also 17 C.F.R. § 275.202(a)(11)-1 (2015) (defining what are considered securities). Some examples of activities that have been deemed to be giving advice about securities include: (1) providing financial planning services to clients, including advice regarding allocations among securities and other investments; (2) advising employee benefits plans on funding plan benefits by investing in securities as opposed to other investments; (3) advising clients about the selection of an investment manager or managers; and (4) acting as a general partner to, and identifying, acquiring, and monitoring investments for, a private equity fund. Applicability of the Investment Advisers Act, Investment Advisers Act Release No. IA-1092, 52 Fed. Reg. at 38402. The SEC uses a relatively opaque “facts and circumstances” approach.
Act of 1940 (Advisers Act), investment advisers must, among other things, maintain books and records, disclose various information to clients and potential clients, comply with various conduct restrictions, and submit to inspection by the SEC.

The Advisers Act defines investment advisers as entities who are in the business of, and are compensated for, giving advice, either directly or using publications, regarding securities. For the purposes of the definition, advice can mean directly providing advice on securities, such as a specific recommendation, and also includes providing analysis or reports concerning securities. Advisers Act regulation is limited to advisers in securities, including stocks, bonds and securities futures. Investment advisers must register with the SEC, subject to certain exclusions from the definition of investment adviser (such as B/Ds).

The following entities are exempt from the definition of investment adviser and can perform limited advisory activities without registering under the Advisers Act: (1) Banks and Bank Holding Companies; and (2) B/Ds, if the B/D (a) provides investment advice solely incidental to its business as a broker or dealer; or (b) receives no special compensation for providing the investment advice. Additionally, other exemptions from registration for entities that may otherwise fit within the definition of a RIA include: (1) intrastate advisers; (2) advisers to insurance companies; (3) investment advisers with a limited number of clients (often Hedge Funds) that (a) had fewer than 15 clients in the preceding 12 months; (b) do not advise registered investment companies or companies that elect to be regulated as business development companies; or (c) do not hold itself out generally to the public as an investment adviser.

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148. See id.
150. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11); see also 17 C.F.R. § 275.202(a)(11)-1(a)(2). Special compensation is generally deemed to be any compensation received by the B/D for giving investment advice, other than a brokerage commission. B/Ds who offer fee-based, as opposed to commission-based, brokerage accounts are subject to the Advisers Act and must dually-register as an investment adviser. B/Ds who only offer commission-based brokerage accounts are not subject to the Advisers Act.
151. Some activities that are deemed to be holding oneself out to the public include: (1) advertises financial planning services; (2) maintains a listing as a financial planner in a telephone or building directory; (3) lets it be known by word of mouth or otherwise that new financial planning clients will be accepted; or (4) uses letterhead or business cards referring to financial planning services.
ii. Prohibition from Federal Registration for Advisers with Limited Assets Under Management

Certain entities that otherwise fit the definition of an investment adviser but who manage a limited amount of assets are prohibited from registering under the Advisers Act and therefore must register in individual states. These investment advisers are prohibited from federal registration because the National Securities Markets Improvement Act of 1996 (NSMIA) allocated responsibility for regulating investment advisers with limited assets under management to individual states. This prohibition applies to investment advisers who: (1) are regulated, or must be regulated, in a state where they maintain a primary office; (2) maintain assets under management under $25 million; or (3) do not advise a registered investment company.

Particular investment advisers who are otherwise prohibited from federal registration are allowed to register with the SEC to avoid multiple-state registrations. Without the exemption, multiple-state registration would require registration from (1) advisers to registered investment companies; (2) advisers in states without an investment adviser statute; (3) affiliated investment advisers; and (4) new investment advisers (a) expecting to become eligible; and (b) who have a reasonable expectation that they will become eligible within 120 days may register under the Advisers Act. This exemption, however, only requires that investment advisers agree at the time of registration that they will withdraw their registration if they do not become eligible for registration under the Advisers Act.

Ways an investment adviser can become eligible for

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153. See id.
155. See id.
157. See id.
158. See id.
registration within 120 days of filing their registration request include: (1) crossing the $25 million assets under management threshold; (2) becoming the adviser to a registered investment company; or (3) being required to register as an investment adviser in at least thirty states.

Finally, internet investment advisers are exempt from the prohibition on registration for investment advisers with less than $25 million in assets under management. These internet investment advisers get to the nub of a choice for an internet equity crowdfunding platform. To be eligible for the internet investment adviser exemption, an investment adviser must do three things. First, they must "provide[] investment advice to all of its clients exclusively through the adviser's interactive website, except that the adviser may advise fewer than 15 clients through other means during the preceding 12 months." For the purpose of this exemption, an interactive website means "a website in which computer software-based models or applications provide investment advice to clients based on personal information provided by each client through the website." Second, advisers must "maintain records demonstrating that it provides investment advice to its clients exclusively through an interactive website in accordance with the limits of the exemption." And third, advisers must not be in a control relationship with another investment adviser registered with the SEC using the affiliated investment adviser exemption based on the internet investment adviser’s registration with the SEC.

For example, Personal Capital is geared toward higher-asset investors, and its CEO is the former CEO of Intuit and PayPal. JemStep represents a budget and goal-oriented tool to make recommendations based on Monte Carlo simulations. SigFig is another budget and goal-oriented website that is registered as a RIA. SigFig’s CEO’s background includes having built the Amazon Visa Loyalty Card.

160. See id.
161. Id.
162. Id.
163. Id.
164. Id.
D. B/Ds Registration Process

i. Background

A broker is any person engaged in the business of effecting transactions in securities for the accounts of others.169 Well-known examples of brokers are E*Trade or Charles Schwab whose retail businesses charge a fee to buy and sell securities for the benefit of individual customers.170

B/Ds are exempt from the definition of "investment adviser" and also are exempt from registration under the Advisers Act if the advice they give is solely incidental to their business as a B/D and they receive no special compensation.171

The SEC requires broker dealers to make "suitable" recommendations and to advise if any conflicts of interest exist.172 Registered B/Ds are subject to regulatory oversight by the SEC and must also register with a self-regulatory organization (SRO).173 SEC registration occurs via a Form BD filing.174 Guidance about whether specific activities require registration can be found in the decisions of federal courts and in SEC no-action and interpretive letters.175


170. See 17 C.F.R. § 240.3a5-1 (2015). The regulation defines a dealer as any person engaged in the business of buying and selling securities for their own account through a broker or otherwise. Individuals who buy and sell securities for their own account, either for themselves or as a fiduciary, but not as part of a regular business, are exempt from the definition of dealer (known as the trader exemption). The trader exemption allows individual investors to purchase and sell securities as investments without having to register as a B/D. Examples of entities acting as dealers include investment banks such as Goldman Sachs or J.P. Morgan that underwrite securities.


172. See, e.g., In re Application of Raghavan Sathianathan, Exchange Act Release No. 54,722, 89 SEC Docket 710, 715 (Nov. 8, 2006) (“NASD Conduct Rule 2310 requires that, in recommending a transaction to a customer, a registered representative ‘shall have reasonable grounds for believing that the recommendation is suitable for such customer . . .’”).


174. Id. § 15(b), 48 Stat. at 895.

An affirmative answer to any of the following questions may indicate the entity is acting as either a broker or a dealer and should register with the SEC:\footnote{176}

1. Does the activity involve solicitation, negotiation or execution of securities transactions?
2. Does the activity require the entity to handle money or securities for someone else?
3. Does the compensation for the activity depend on the size or outcome of the transaction?
4. Does the activity involve the extension of credit to purchase securities?
5. Does the activity involve the giving of investment advice to investors (giving investment advice may require separate registration under the Advisers Act)?
6. Is the activity publicly advertised as involving the buying and selling of securities?

Some examples of activity that may require registration as a B/D include:

(A) Effecting securities transactions for the account of others for a fee or purchasing or selling securities at a regular place of business for the entity's own account.
(B) Operation of an electronic or other platform to trade securities.
(C) Acting as a placement agent for the private placement of securities.
(D) Acting as a finder of investors for issuers or the sale of securities.
(E) Participating in a selling group or underwriting of securities.
(F) Providing support services (such as clearing and settlement) to registered B/Ds.\footnote{177}

\paragraph{ii. Exemptions from Registration\footnote{178}}

The Exchange Act provides specific exemptions from registration as a B/D, which apply to entities that are normally deemed to effect securities transactions.\footnote{179} Exemptions from registration apply to these six types of entities.\footnote{180}

177. \textit{See id.}
178. \textit{See id.}
179. \textit{See id.}
180. \textit{See id.}
a. Exclusively Intrastate Businesses

This means the B/D cannot participate in transactions effected on a national securities exchange (such as NASDAQ or the NYSE) or post information on the internet accessible by entities in another state. A B/D loses the right to this exception if it effects any interstate transaction, even transactions in exempted securities. In addition, an exclusively intrastate B/D may still need to register with a state securities regulator.

b. Business Limited to Excluded and Exempted Securities

B/Ds that transact business only in commercial paper, bankers’ acceptances, and commercial bills do not need to register with the SEC under the Exchange Act.

c. Issuers of Securities

Issuers of securities are generally not deemed to be brokers because they only sell securities for their own account and not as an agent for others.

d. Associated Persons of Issuers of Securities

Associated persons of issuers of securities, including employees of an issuer who participate in the sale of the issuer’s securities, are exempt from registering as a B/D if at the time of participation the employee is not subject to a statutory disqualification, does not receive transaction-based compensation, is not an associated person of a broker or a dealer, and limits its activities to those items set out in Rule 3a4-1 of the Exchange Act.

iii. Where to Register

After determining that an individual or business must register under the Exchange Act, registration can occur with multiple entities at the same time. A B/D must register with:

(A) The SEC. B/Ds must register with the SEC under Section 15(b) of the Exchange Act by filing a Form BD in the manner prescribed by the SEC’s rules. Within 45 days of filing Form BD, the SEC either grants or denies the registration.

181. See id.
182. See id.
183. See id.
184. See id.
185. See id.
(B) SROs. Before beginning to do business, a B/D must become a member of an SRO. The SROs include the FINRA and the national securities exchanges.

(C) SIPC. Every registered B/D must become a member of SIPC unless they limit their business to activities outside of the US or limit their sales and distributions to only investment company shares, variable annuities or insurance. SIPC members must pay annual fees to SIPC.

(D) Individual states. Each state has laws and regulatory agencies governing entities conducting business as B/Ds within the state. Further information regarding individual state regulators can be found at the North American Securities Administrators Association (NASAA).186

To begin the registration process, an applicant files a single uniform application for registration as a B/D on Form BD via the Central Registration Depository (CRD), FINRA’s internet-based registration and reporting system. Applicants can use Form BD to indicate each regulator to which they are applying. The information on Form BD is also sent electronically to the SEC, any SRO to which the applicant is applying, and to each jurisdiction (U.S. states and territories) where the B/D plans to do business. Once the application is filed via the CRD, each regulator may contact the applicant to ask for specific information necessary to complete the registration process. Once registered, B/Ds must update their information on Form BD via the CRD system.

iv. Burdens of Registration

Once an entity is registered as a B/D, it is subject to regulation and oversight by the SEC, any SROs of which it is a member, and SIPC. Registered B/Ds are subject to general anti-fraud rules.187 These provisions broadly prohibit misstatements and misleading omissions of material facts, or the use of fraudulent or manipulative acts in connection with the purchase or sale of securities.

The SEC’s interpretive statements and enforcement actions under the general anti-fraud provisions have found that B/Ds owe their customers a duty to deal fairly.188 In practice this includes duties to: (1) execute customer orders quickly; (2) disclose material information to investors; (3) charge reasonable prices; and (4) disclose any conflicts of interest. The SEC has also interpreted that the Exchange Act’s anti-fraud provisions impose an obligation on B/Ds to only recommend investments and

186. See id.
188. See generally STUDY ON INVESTMENT ADVISERS, supra note 171, at 15–16.
strategies suitable for their customers. This means that the B/D must have a reasonable basis for its recommendation.189

The SEC has also interpreted the Exchange Act anti-fraud provisions to mean that B/Ds owe their customers a duty of best execution. This duty requires B/Ds to perform reasonable diligence into the current securities market to find the most favorable price possible for a customer under the current market conditions. B/Ds must provide their customers with specific information at or before the completion of a securities transaction.190 This information includes the date, time, and price of the transaction, and the B/D’s compensation for the transaction whether from commissions, markups (which is a fee above the cost the B/D paid for the security) or third party remuneration.

v. Financial Responsibility Rules

Registered B/Ds must comply with specific financial requirements designed to maintain minimum liquid assets and safeguard customer funds.191 These rules include the net capital rule, which states that B/Ds must maintain enough liquid assets to promptly satisfy customer claims if the B/D goes out of business.192 This rule sets minimum capital levels based on the securities activities of the B/D and a calculation using certain financial ratios.193 The second rule requires the use of customer balances, and states that B/Ds that use their customers’ free credit balances must set up procedures to provide specific information to those customers, including the amount due to the customers and that such funds are payable on demand of the customer.194 Third, the customer protection rule requires that B/Ds maintain physical possession or control of a customer’s fully-paid securities.195 B/Ds must also make periodic computations to determine how much money it is holding that is owed to customers.196 These customer funds must be deposited into a special reserve bank account for the benefit of the customers.197 Finally, there are books and records requirements.198 Under this rule B/Ds must make and keep current

189. Id. at 22.
190. See id. at 5.
191. See generally id. at 85.
192. See id.
194. See id.
195. See id.
196. See id.
197. See id.
198. See id.
books and records detailing securities transactions, money balances, and securities positions. The rules also require B/Ds to make certain periodic reports to the SEC and to notify the SEC and appropriate SROs when problems arise relating to net capital, record keeping, and operational problems.

The Exchange Act rules and the rules of the SROs impose many other specific requirements on B/Ds. First, B/Ds are subject to examination by the SEC and the SROs. Newly registered B/Ds are generally examined by their SRO within the first six months of their operation. All B/Ds must permit the SEC to inspect its books and records when given reasonable notice. Second, B/Ds are subject to Anti-Money Laundering (AML) programs. B/Ds must set up a written AML program reasonably designed to monitor and report suspicious transactions. Finally, business continuity planning is mandated, as the SROs have adopted rules requiring B/Ds to maintain a business continuity plan that includes emergency contact information to address wide-scale market disruptions.

Several platforms either are B/Ds or partner with B/Ds. The company Betterment represents a goal-oriented “savings” platform with crisp visuals of achieving financial goals via B/D registration and FINRA/SIPC membership, not an FDIC-insured bank. Betterment takes in IRA accounts and 401(k) transfers as well as new taxable money. The company positions itself to be geared to low-asset investors. Meanwhile, Realty Mogul claims that this is Real Estate Crowdfunding but seems to be a technology platform allowing accredited investors to connect independently with issuers of securities relating to real estate investments, relying on exemptions under Regulations D and S. Itself, Realty Mogul is not a registered B/D, funding portal, or investment adviser but offers

199. See id.

200. See id.


203. See id. § 240.17d-2(c).


205. See id.

securities through WealthForge, LLC, a Virginia-based B/D registered with the SEC and Financial Industry Regulatory Authority (FINRA). 207

E. Contrasting RIAs’ Ease of Registration and “Smaller” Regulatory Burden with Those of B/Ds

Unlike the B/D registration requirements, which potentially require multiple filings with the SEC, at least one self-regulatory organization (SRO), and multiple states, an investment adviser can submit a single form to the SEC and the states while currently avoiding any requirement to join an SRO. 208 Beginning in 1997, after the National Securities Markets Improvement Act (NSMIA) became effective, the SEC and the states created a single framework for registration using an electronic filing system known as the Investment Adviser Registration Depository (IARD). 209 The IARD is managed by FINRA. 210 Investment advisers who are eligible for federal registration are not required to register in individual states but can use the system to make informational filings with individual state regulators as necessary. 211

The states may not require federally registered investment advisers to register with their state securities regulators, but they do retain some regulatory authority over advisers that conduct business within their borders. 212 In most cases, states require federally registered investment advisers to make a notice filing to the state securities regulator. 213 This typically occurs when filing or updating an SEC Form ADV, by indicating which states should get copies of the electronic filing. 214 State regulators also retain the authority to require licensing and registration for the individual, investment adviser representatives with a place of business


210. See id.; see also 17 C.F.R. § 275.203-1(d).

211. See 17 C.F.R. § 275.203A-1.

212. See 17 C.F.R. § 275.203-1(b)(2) (note to paragraph (b)(2)).


within the state. An RIA that engages in brokerage activities, however, must register as a B/D unless the RIA is subject to an exemption. The SEC has granted no-action relief from B/D registration for investment advisers who: (1) transmit orders to brokers for execution; (2) do not hold client funds or securities; or (3) do not receive compensation for brokerage services provided in connection with their advisory services.

i. Fiduciary Duties and Related Requirements

Investment advisers have a fiduciary duty to their advisory clients and must act in the best interest of their clients. This fiduciary duty requires an investment adviser to either eliminate or disclose all potential conflicts of interest that limit its ability to render disinterested advice. This fiduciary duty also requires that investment advisers carefully consider the following situations to ensure compliance with SEC guidance:

- Obtaining best price and execution;
- Disclosing principal or cross transactions. If an investment adviser is acting as principal for its own account and intends to buy or sell securities from a client's account, it must disclose the practice in writing to the client and obtain the client's consent for each transaction before settlement;
- Providing annual and other reports, including (i) Form ADV (see infra), as RIAs must annually update their Form ADV filing within ninety days after the end of their fiscal year; and (ii) Form 13-F: investment advisers who exercise investment discretion over certain equity securities with an aggregate value of $100 million

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215. See id.; see also Advisers Act, 17 C.F.R. § 275.203A-3 (defining an investment adviser representative as a supervised person of the investment adviser who has: (1) more than five clients that are natural persons; and (2) an overall client base consisting of more than 10% of natural persons).
216. For a discussion of B/D exemptions, see supra notes 151–52.
217. Id.
218. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963). The Court stated: The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.
219. See id.
221. See 17 C.F.R. § 275.206(3)-3T(a)(1)-3.
222. See 17 C.F.R. § 275.206(3)-2(a)(3); see also id. § 275.204-1(a)(1).
must file a *Form 13-F* each quarter. Form 13-F requires disclosure of the names of institutional investment managers, the names, classes of and CUSIP numbers of the securities they manage, the number of shares owned, and the total market value of each security.

- Maintaining written compliance programs. Registered investment advisers must adopt written policies and procedures designed to prevent violations of the Advisers Act and designate a chief compliance officer in charge of administering the policies and procedures.

- Drafting, maintaining, training regarding, testing, and complying with codes of ethics and insider trading. Registered investment advisers must adopt a code of ethics that sets out the business conduct standards of supervised persons and must address the personal securities trading of supervised persons. The code of ethics must address insider trading and require certain supervised persons to report their personal securities transactions to the chief compliance officer for review.

- Providing advisory clients and prospective clients with a written disclosure document. RIAs may comply with this requirement by providing a copy of Part II of Form ADV or another document that at a minimum contains the same information as Part II of the Form ADV, to clients and prospective clients. RIAs must deliver, or *offer to deliver in writing*, a disclosure document to each client once a year. Investment advisers must deliver their disclosure document to prospective clients at least 48 hours before entering into an advisory contract.

- Maintaining certain books and records. RIAs must maintain specific books and records and keep those records for a period of at least five years in an easily accessible location and subject to SEC inspection.

- Including provisions in advisory contracts. RIAs must include certain provisions in their advisory contracts with clients, which are set out in section 205 of the Advisers Act. These specific


227. *See* 17 C.F.R. § 275.204-3.

228. *See* 17 C.F.R. § 275.204-2.
provisions are: (1) limitations on assignment of the advisory contract without client’s consent; (2) mandatory disclosure of partnership changes if the investment adviser is organized as a partnership (The SEC has not required a limited partnership to disclose changes in its limited partners.); (3) restrictions on investment adviser compensation based on a share of capital gains or appreciation of the client’s funds; (4) prohibition on a waiver of compliance with the Advisers Act or its rules; and (5) prohibition on hedge or arbitration clauses. The SEC has stated that any clause that would lead a client to believe that it has waived any rights of action against the investment adviser may violate the anti-fraud provisions of the Advisers Act, and are therefore generally not permitted in an advisory contract.

- Adopting and adhering to proxy voting policies. RIAs having voting authority over proxies for their client’s securities must adopt policies and procedures designed to ensure that they vote proxies in the best interest of their clients and disclose information about these policies to clients.
- Ensuring appropriate custody. RIAs that have custody or possession of client assets must take steps to protect those assets from loss or theft. Essentially, investment advisers with custody must maintain client funds and securities with a qualified custodian. The custodian needs to be a bank with certain minimum capital or a B/D.

F. Other Exemptions from B/D and RIA Registration

FundersClub and AngelList chose to get specific RIAs and exemptions from B/D registration. According to the Proposed Equity Crowdfunding Rules, funding portals are not permitted to provide investment advice or make recommendations. Funding portals are also prohibited from soliciting purchases, sales, or offers to buy the securities offered or displayed on its website or portal, and compensating employees, agents, or other persons for such solicitation or based on the sale of

229. See 17 C.F.R. § 275.206(4)-2(c)(1).


The Proposed Equity Crowdfunding Rules further restrict these portals from holding, managing, possessing, or otherwise handling investor funds or securities or engaging in any other activities the SEC restricts.\(^2\)

The SEC must create and finalize rules governing funding portals before permitting anyone to register with the SEC as a funding portal. These rules will address the form and process needed to register with the SEC as a funding portal. Funding portals also must become members of a national securities association that is registered under section 15A of the Exchange Act. Today, FINRA is the only national securities association in existence that is registered under section 15A of the Exchange Act.

RIA and Broker inquiries on the SEC’s website indicate that no entities beginning with names such as “Kickstarter,” “Indigogo,” “GoFundMe,” and the like were registered as RIAs or B/Ds, or had state-level registration information available.\(^3\) Having said that, even funding portals will have to register with the SEC. As a result, the proposed funding portals appear to face many of the same regulatory burdens as B/Ds but much less of the flexibility in permissible activities.

IV. PROPOSED ALTERNATIVES FOR EXISTING EQUITY CROWDFUNDING BUSINESSES, WHETHER A PROPOSED ISSUER, INVESTOR, OR PLATFORM

Despite the SEC’s status as an executive branch administrative agency, given that President Obama has seemingly ignored the issue of job creation and investment through equity crowdfunding in Title III since the year of signing the JOBS Act of 2012 into law, despite the literature that indicates that laws and regulations can promote economic development, despite the call by members of Congress to the SEC to move forward with equity crowdfunding for non-accredited investors, and despite the concerns of equity crowdfunding opponents occurring in the public markets where anyone can invest, regardless of net worth, and regardless of the caps imposed by the equity crowdfunding rules, this Part attempts to cogitate on some potential alternatives for placing equity crowdfunding rules in final form.

\(^2\) See id.
\(^3\) See id.

A. Congressional Passage of a Revised Equity Crowdfunding Rule?

North Carolina Congressman Patrick McHenry, the Republican Chief Deputy Whip in the House of Representatives, has stated,

The rest of the world and many states in the United States are moving forward with equity crowdfunding. However, we are no longer known as the world leader when it comes to crowdfunding . . . . But when it comes to equity crowdfunding, regimes around the world have caught up and surpassed us. I’ve shared my concern about the SEC’s over 600-page regulation of equity crowdfunding. They’ve [the SEC has] made things more onerous and complex than they need to be. I think it’s important that we have investor protection front and center when it comes to equity crowdfunding, as well as with all securities regulations. But it’s also important that we keep the other very important part of this in mind, capital formation . . . . [I]f you look at the JOBS Act, and if we’re just being very frank about it, the Securities and Exchange Commission could have done through regulation what Congress had to force them to do. That was, in my view, a bipartisan response to the SEC’s unwillingness to update the regulations.235

Congressman McHenry indicated that as of early 2015, “we’re still a long way from” having the JOBS Act fully implemented.236 And some commentators have asked, following the final rules surrounding Title IV of the JOBS Act, if the SEC should even implement final rules for equity crowdfunding under Title III.237

One way that Congress could bring this SEC failure to the attention of the president would be to pass a provision aimed squarely at Title III of the JOBS Act. As Congressman McHenry indicated in early 2015, “In terms of the regulations they have written, I think [the SEC] missed the mark, and I think it will take Congress to address it legislatively to fix it.”238 But this response appears unlikely. In mid-2014, such a bill appeared before the

236. Id. at 302.
237. See, e.g., Michael Raneri, Who Needs Equity Crowdfunding? 3 Critical Questions About Title III of the JOBS Act, FORBES.COM (Apr. 16, 2015, 5:30 PM), http://www.forbes.com/sites/mraneri/2015/04/16/who-needs-equity-crowdfunding-3-critical-questions-about-title-iii-of-the-jobs-act/#6f50ee708b05 [https://perma.cc/HQ3Z-LTXD] ("Now that the SEC has taken action defining rules for Title II (Regulation D) and Title IV (Regulation A+) of the JOBS Act, the next question on the startup world’s mind is when, if ever, the SEC will rule on the last key piece of the puzzle, namely Title III.").
The bill was referred to the House Committee on Financial Services and has apparently gone nowhere since May 2014. Having said that, Congressman McHenry indicated in 2015 that members of Congress continue to work on a “JOBS Act 2.0” and “more news” will arrive regarding that piece of proposed legislation.

B. Are State Exemptions Ineffective?

In the absence of SEC movement regarding equity crowdfunding, some states have chosen to pursue equity crowdfunding legislation or regulation of their own. These state-level changes tend to occur under the intrastate offering exemption under section 3(a)(11) of the Securities Act, rather than the still-unavailable new section 4(a)(6) of the Securities Act. But these state actions, regardless of one’s opinion of the 10th Amendment to the U.S. Constitution, are ineffective to draw capital to a start-up enterprise, because the capital is limited—the capital must be from the “home” state of the startup. As a result, regardless of the attempts of a number of states to move forward as best they can under extant law, state exemptions are, in this Article’s opinion, wholly—not materially—ineffective, thanks to the sheer incompetence of the SEC.

C. Defer Wholly to Rules on Regulation A+ of Title IV of the JOBS Act?

The SEC appeared very proud of itself when it finalized rules for Title IV of the JOBS Act, which is divided into two tiers of financings, and is more generally known as Regulation A+, which permits for preemption of


241. See, e.g., Oregon Dep’t. of Consumer & Bus. Svcs., Div. of Fin. & Corp. Sec., Rule Caption: Establishes a Securities Registration Exemption for Oregon Intrastate Offerings by Oregon Small Businesses, 54-2 Or. Admin. R. Bull. 76 (Feb. 1, 2015) (stating in part “Title III of the Jumpstart Our Business Startups Act (JOBS Act), enacted in 2012, created a federal exemption for equity crowd-funding. Federal rules under the JOBS exemption have not yet been finalized. Under the federal intrastate exemption, Oregon may enact its own exemption from securities registration for purely domestic offerings unrelated to federal law”).
some state securities regulations. As SEC Chairwoman Mary Jo White indicated, "It is important for the Commission to continue to look for ways that our rules can facilitate capital-raising by smaller companies." Yet, if Ms. White were anything but disingenuous in her statement, it would be more than "important," it would actually be incumbent on the SEC to follow the mandate of the U.S. Congress and the president, despite some media calling these rules a "bombshell" and a "stunning development" coming from a "clever legal maneuver."

Regardless, the SEC’s final rules regarding Title IV have two tiers of offerings in a twelve-month period: (1) issuer offerings up to $20 million (no more than $6 million to affiliates); and (2) issuer offerings up to $50 million (no more than $15 million to affiliates). Both tiers are subject to certain preemption of state securities law requirements, sales to "qualified purchasers." The choice of Tier 1 or 2 is held by the issuer and subject to more requirements, similar to Title III, including audited financial statements, regular disclosure reporting, and a limitation on the number of unaccredited investors in a Tier-2 offering. Some states have taken action as a result of the SEC’s Tier-2 offering regulation.

As a result, some people believe that Regulation A+ offerings discount the need for final rules under Title III of the JOBS Act. Regardless of the de facto result of Regulation A+, the law remains the law, and Title III of the JOBS Act nonetheless requires the SEC to implement rules regarding equity crowdfunding.

The preemption discussed in Regulation A+ raised Tier-1 Regulation A offering exemptions to $20 million from $5 million and made "pre-emption" a so-called "coordinated review" between states and the SEC. Further, under the Tier-2 Regulation A+ exemption, unaccredited


investor friends and family may invest, subject to certain limitations, making this provision more similar to Title III equity crowdfunding provisions. Having said that, a disclosure document essentially similar to an S-1 is required as an “offering circular.” Tier-2 offerings require audited financials, but Tier-1 offerings require only reviewed financials. As discussed in Part IV-C, audited financials make no material difference in protecting investors or the integrity of the capital markets.

As billionaire entrepreneur and television reality show, Shark Tank, investor Mark Cuban sarcastically indicated in a March 2015 column, “Equity Crowd Funding allows you to join the masses to chase investments with as little as 5K dollars. Oh the possibilities!” Cuban further stated, more seriously, “The SEC made sure that there is no market for any of these [equity crowdfunded companies] to go public and create liquidity for their Angels [early-stage investors]. The market for sub 25mm [million] dollar raises is effectively DOA. Gone. Thanks[,] SEC.”

CONCLUSION

This Article demonstrated the links between law and economic development theory, the basis of microfinance, and equity crowdfunding as a tool to help the U.S. economy. The Article further demonstrated that the SEC’s delay in finalizing rules under Title III of the JOBS Act has hindered the bipartisan bill signed into law approximately three years ago and caused confusion, frustration, and lost business opportunities. The Article concluded with some potential alternative scenarios that might be considered should the SEC simply not implement final rules under Title III of the JOBS Act and rely on other rules promulgated under the JOBS Act, such as Regulation A+. While some positives may exists in Regulation

246. See Mark Cuban, Why This Tech Bubble Is Worse Than the Tech Bubble of 2000, ENTREPRENEUR.COM (Mar. 5, 2015), http://www.entrepreneur.com/article/243650 [https://perma.cc/Q4EF-WXJC]; see also David Schechter, Mark Cuban Wins Insider Trading Case, Slams Government, YOUTUBE (Oct. 16, 2013), https://www.youtube.com/watch?v=F82EHPP3bkM (unediting Mark Cuban’s comments following his no-liability verdict, following nearly a decade of prosecution by the SEC in which Cuban accused the SEC of lying). Cuban also accused its then-current chair, Mary Jo White Shapiro, of being a “problem” of the SEC, an entity who Cuban believed regulates through litigation by going after “little offenders.” Cuban, as a billionaire, went after the SEC to prove a point that the prosecution was personal and not business, by bringing liars and witnesses against Cuban who misled, mischaracterized, and misquoted information. Cuban indicated he spent more on his legal defense to make a point than he would have spent on a fine to the SEC and devastating the law firm of Davis & Polk. The author of this Article admits his potential conflict of interest in favor of Mr. Cuban, who has given significant monetary contributions to the author’s (and Mr. Cuban’s) alma mater, Indiana University.
A+, the SEC’s lack of movement on Title III regarding equity crowdfunding for the entire crowd of U.S. economic actors deserves not an “A+,” but rather an “F.”