

12-31-2013

Crowdfunding for Biotechs: How the SEC's Proposed Rule May Undermine Capital Formation for Startups

Brian J. Farnkoff

Follow this and additional works at: <https://scholarship.law.edu/jchlp>



Part of the [Administrative Law Commons](#), [Banking and Finance Law Commons](#), [Biotechnology Commons](#), [Finance Commons](#), [Growth and Development Commons](#), [Law and Politics Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Brian J. Farnkoff, *Crowdfunding for Biotechs: How the SEC's Proposed Rule May Undermine Capital Formation for Startups*, 30 J. Contemp. Health L. & Pol'y 131 (2014).

Available at: <https://scholarship.law.edu/jchlp/vol30/iss1/9>

This Comment is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Journal of Contemporary Health Law & Policy (1985-2015) by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.

CROWDFUNDING FOR BIOTECHS: HOW THE SEC’S PROPOSED RULE MAY UNDERMINE CAPITAL FORMATION FOR STARTUPS

*Brian Farnkoff**

TABLE OF CONTENTS

INTRODUCTION	132
I. THE NEW ROLE OF CROWDFUNDING IN FEDERAL SECURITIES LAW	137
A. THE EXEMPTIONS TO SECURITIES ACT REGISTRATION	137
B. DEBT AND EQUITY CROWDFUNDING	140
C. REG. D AND SMALL OFFERING EXEMPTIONS	143
II. LEGISLATIVE HISTORY OF THE CROWDFUND ACT	153
A. CONGRESSIONAL WILLINGNESS TO CAPITALIZE ON A RECENT CROWDFUNDING PHENOMENON LED TO A BRIEF LEGISLATIVE HISTORY	153
B. BIPARTISAN PASSAGE OF THE JOBS ACT AMID VOCIFEROUS DISSENT	154
III. THE POTENTIAL CROWDFUNDING BOON FOR HEALTH STARTUPS	156
A. WHERE VENTURE CAPITALISTS SEE HIGH RISK IN LIFE SCIENCES, CROWDFUNDING INVESTORS MAY SEE OPPORTUNITY FOR A CURE	156
IV. THE POTENTIAL FOR HEIGHTENED FRAUD AMONG HEALTH CARE ISSUERS	160
A. UNIQUE RISKS FOR FRAUD REMINISCENT OF PENNY STOCK SCANDALS	160
B. HEALTH CARE STARTUPS MAY ATTRACT BAD ACTORS	162
V. INVESTMENT LIMITS POSE COMPLIANCE AND ENFORCEMENT PROBLEMS	163
A. INVESTMENT LIMITS ARE AMONG INVESTOR PROTECTION MEASURES	163
B. SEC CROWDFUNDING RULE PROPOSAL DETAILS LIABILITY OF INTERMEDIARIES AND THEIR DUTY TO “ENSURE” INVESTMENT LIMITS	167
C. SELF-VERIFICATION: ADVANTAGES AND DISADVANTAGES OF RELYING ON INVESTOR ASSURANCES	171
D. SEC REJECTS CALLS FOR CENTRALIZED DATABASE, WHICH WOULD BE SAFEST, BUT POTENTIALLY COST-PROHIBITIVE OPTION TO ENFORCE AGGREGATE INVESTMENT LIMIT	177
E. MULTIPLE VERIFICATION SERVICES COULD INTRODUCE ECONOMIC COMPETITIVENESS, BUT MAY COMPLICATE INFORMATION-SHARING	180
F. SUMMARY OF INVESTMENT LIMIT ENFORCEMENT OPTIONS	181
CONCLUSION	181

* J.D. Candidate, The Catholic University of America, Columbus School of Law (May 2014); B.A. in Public Policy, Hamilton College (2005); Former Director of Research for U.S. Senator Richard Blumenthal (2010), and research associate in economic affairs at the Democratic National Committee in Washington, D.C. (2007-09). I would like to thank Sara Hanks (M.A. (Oxon)) for her invaluable expertise in securities law and Prof. David A. Lipton (Columbus School of Law) for his dedication to Catholic University as director of the Securities Law Certificate Program. I am indebted to *Journal* editors Brianna Williams, Mollie Gelburd, and Alyson Horn for their tireless work. This Comment is dedicated to my parents, Daniel and Angela Farnkoff of Boston for their love and support. Any errors are solely my responsibility.

INTRODUCTION.

Technological developments in life sciences have revolutionized health care, with the biotechnology and pharmaceutical industries leading the way in job creation and economic growth in the United States.¹ Advances in information technology have sparked the Internet's social media platforms, transforming the way citizens interact.² Now, social media has the potential to transform the landscape of entrepreneurship in health care by providing more capital to currently-overlooked startups through crowdfunding.³

For instance, in 2010, a medical student at Johns Hopkins University, Dr. Jimmy Lin, founded the Rare Genomics Institute ("RGI") because he was devastated as he listened to a colleague explain to a patient's mother that no treatments existed for her child's rare genetic disease.⁴ What is unique about RGI is that it employs crowdfunding, the raising of small amounts of money online from multiple sources, to fund part of its operations.⁵ Although RGI represents a donation-based model of crowdfunding, where there are no securities or investors but only donors, its success demonstrates that

1. For instance, nationwide investment in the human genome project is credited with a revolutionizing genomic science, contributing to millions of new jobs and hundreds of billions in economic growth. BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO), *BATTELLE/BIO STATE BIOSCIENCE INDUST. DEV.* 2012 2 (June 19, 2012), http://www.bio.org/sites/default/files/v3battelle-bio_2012_industry_development.pdf ("\$10.4 billion investment in basic sciences during the 1993 to 2010 period drove \$796 billion in economic impact, and created 3.8 million job-years of employment over this period.").

2. See *Fair Hous. Council of San Fernando Valley v. Roommates.Com, LLC*, 521 F.3d 1157, 1176 (9th Cir. 2008) (J. McKeown, concurring in part, dissenting in part) (observing the "vast number" of interactive websites like Facebook and Google that increasingly allow people to, "[o]n a daily basis, . . . rely on the tools of cyberspace to help [them] make, maintain, and rekindle friendships; find places to live, work, eat, and travel; exchange views on topics ranging from terrorism to patriotism; and enlighten [them]selves on subjects from 'aardvarks to Zoroastrianism.'" (quoting *Ashcroft v. ACLU*, 535 U.S. 564, 566 (2002)); see also *World Internet Usage and Population Statistics*, INTERNET WORLD STATS (June 30, 2012), <http://www.internetworldstats.com/stats.htm> (indicating there to be 2.4 billion "Internet users" worldwide as of June 2012, representing 34% of the estimated world population).

3. See generally David Chase, *This Could Change Healthtech Startup Funding Forever*, FORBES BLOG, (Jul. 8, 2012, 10:27am), <http://www.forbes.com/sites/davechase/2012/07/08/this-could-change-healthtech-startup-funding-forever/> ("MedStartr is like most crowdfunding sites that are non-equity. They have plans later to have an equity model once SEC rules are clarified.").

4. E.B. Solomont, *Lin's Rare Genomics: Crowdfunding A Way To A Cure*, ST. LOUIS BUS. J. (Aug. 3, 2012, 5:00 am), <http://www.bizjournals.com/stlouis/print-edition/2012/08/03/lins-rare-genomics-crowdfunding.html>.

5. *Id.*

crowdfunding has the power to bring disparate individuals with common concerns together through the internet to actually fund an enterprise—in this case an organization addressing rare genetic disorders.⁶

Although some patient-focused innovations have emerged, such as smartphone applications for heart rate monitoring and microscopic computer chips for measuring athletic performance,⁷ the decentralization of the Internet has been slow to organically deliver more consumer-driven, low-cost innovations in the health care industry.⁸ Companies such as Google have tried to introduce a consumer-based model for storing personal medical records,⁹ but really it took Congressional action to begin the mass integration of electronic medical records.¹⁰

The Jumpstart Our Business Startups Act (“JOBS Act”),¹¹ signed by President Barack Obama on April 5, 2012, is intended to harness the internet

6. Interview with Dr. Jonathan Franca-Koh on Rare Genomics Institute’s Use of a Grass Roots Approach to Raise Funds for Patients (May 22, 2013), <http://www.youtube.com/watch?v=2fmY1EDT2P0> (explaining that there is a “very large group of people affected by rare diseases because, although each particular rare disease affects few people, there are so many of them that the population is actually very great,” but that “the resources made available to these communities is a lot less,” thus providing the incentive and opportunity for RGI to use grassroots fundraising like crowdfunding).

7. See Adam Sege, *Monitoring Your Body, Unobtrusively: New Flexible Sensors on Skin Yield Crucial Data: Chips Check Routine Things Like Hydration, Threats Like Concussion*, BOS. GLOBE, Dec. 31, 2012, at B.5, available at <http://bostonglobe.com/business/2012/12/31/body-sensors-from-cambridge-firm-poised-for-market/ERVhZpkBHtQy9MO2eS1Pgl/story.html>.

8. See Kathleen Sebelius, *The New Momentum Behind Electronic Health Records*, KAISER HEALTH NEWS (Aug. 26, 2010), <http://www.kaiserhealthnews.org/Columns/2010/August/082610Sebelius.aspx> (“Today, in almost every other sector besides health, electronic information exchange is the way we do business. . . . [D]espite the clear benefits of health IT, only two in ten doctors and one in ten hospitals use even a basic electronic record system. . . . Over the last 30 years, we’ve watched information technology revolutionize industry after industry, dramatically improving the customer experience and driving down costs.”) (emphasis added).

9. Aaron Brown & Bill Wehl, *An Update On Google Health And Google PowerMeter*, GOOGLE OFFICIAL BLOG (last updated Jul. 15, 2011), <http://googleblog.blogspot.com/2011/06/update-on-google-health-and-google.html>.

10. The Recovery Act, not private industry, was the major catalyst for the development of electronic medical records. See Fred Schulte, *Stimulus Fuels Gold Rush For Electronic Health Systems*, HUFFINGTON POST, (last updated May 25, 2011, 3:35pm), http://www.huffingtonpost.com/2009/11/05/stimulus-fuels-gold-rush_n_347311.html (“The government’s \$45 billion plan to jump-start a national shift to electronic medical records has touched off a gold rush.”).

11. Pub. L. No. 112-106, 126 Stat 306, 315-23 (2012) (codified as amended in scattered sections of 15 U.S.C.).

to modernize small business capital formation.¹² This Comment posits that the subsection of the JOBS Act concerning crowdfunding could have a transformative impact on the financing of health care startups, particularly emerging biotechnology companies.¹³ Title III of the JOBS Act (“CROWDFUND Act” or “Title III”)¹⁴ legalized equity-based crowdfunding by establishing a new exception under federal securities laws. On October 23, 2013, the Securities and Exchange Commission (“SEC” or “Commission”) voted unanimously to propose a set of crowdfunding rules (hereinafter “Proposed Crowdfunding Rule”),¹⁵ with a public comment period ending on February 3, 2014.¹⁶

The CROWDFUND Act permits the online sale of securities to an unlimited number of investors (i.e. a large “crowd”) in small amounts using the power of social media.¹⁷ The CROWDFUND Act permits entrepreneurs to raise up to \$1 million in capital through “funding portals” (or

12. President Obama’s Remarks on Signing the JOBS Act, 2012 DAILY COMP. PRES. DOC. 1-2 (Apr. 5, 2012), *reprinted in* 2012 U.S.C.C.A.N. S4 (“[F]or start-ups and small businesses, this bill is a potential game changer. . . . For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.”).

13. Chase, *supra* note 4 (“With the need to reinvent health care and the challenge to getting a startup off the ground in the health care industry, [healthcare crowdfunding website] MedStartr seeks to fill an important market gap. By no means will it replace venture capital, but it can get more companies to that stage of their company’s development.”); *see also* Mari Serebrov, *Senate Adds Investor Protection for Crowdfunding to JOBS Act*, BIO WORLD TODAY (Mar. 26, 2012), <http://www.bioworld.com/content/senate-adds-investor-protection-crowd-funding-jobs-act-0> (“The reforms that make up the JOBS Act are especially important to biotechs that are forced to spend investor dollars on compliance when they don’t yet have product revenue, said Jim Greenwood, president and CEO of the Biotechnology Industry Organization.”).

14. CROWDFUND is short for the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012. JOBS Act, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315-23 (2012).

15. Press Release, Sec. Exch. Comm’n, *SEC Issues Proposal on Crowdfunding* (Oct. 23, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Unw1bfkqiJE> [hereinafter *SEC Issues Proposal*].

16. Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428 (Nov. 5, 2013) (amending 17 C.F.R. §§ 200, 227, 232, 239, 240 and 249); *see also infra* Part V.B.

17. *See* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L. J. 195, 196 (2012) [hereinafter *Promise Unfulfilled*] (discussing the JOBS Act and describing crowdfunding, as when “[a]n entrepreneur, or anyone else who needs money, publishes an appeal for funds on a publicly accessible web site, and that appeal is communicated to the general public through the site.”).

intermediaries)¹⁸ by offering and selling securities over the Internet, without triggering the registration requirements of the Securities Act of 1933 (“the 1933 Act”).¹⁹ The CROWDFUND Act attempts to harness the Internet and social media to boost capital-raising prospects for small issuers.²⁰ To accomplish this goal, Congress significantly altered decades-old federal securities laws,²¹ and after some initial delay,²² on October 23, 2013 the Commission unanimously voted to propose eagerly-anticipated crowdfunding rules.²³

Before the adoption of the JOBS Act, the 1933 Act prohibited companies from selling securities online in this fashion.²⁴ For example, intermediary websites intending to host a startup company’s offering of securities could

18. “Funding portals” are a new type of regulated entity created by the CROWDFUND Act and are essentially the websites empowered to host the offering of securities by the crowdfunding issuers online. See JOBS Act, Pub. L. No. 112-106, § 302(a), (codified at 15 U.S.C. § 77d(a)(6)(C) (2012)) (requiring “funding portal” to comply with certain conditions for exemption to be effective); see also Securities Exchange Act of 1934 § 3(a)(80), JOBS Act, Pub. L. No. 112-106, § 304(b), 126 Stat. 306, 322 (2012) (codified at 15 U.S.C. § 78c(a)(80) (2012) (defining funding portal). “Issuer” is defined *infra*, note 20.

19. JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d(a)(6)) (establishing an exemption from registration requirements of the Section 5 of the 1933 Act).

20. An “issuer” is defined in the 1933 Act as “every person who issues or proposes to issue any security.” Securities Act of 1933 § 2(a)(4), (codified at 15 U.S.C. § 77b(a)(4)). Once an issuer’s offering or sale of securities implicates registration requirements under the federal securities laws, the issuer becomes subject to civil and criminal liability for noncompliance or materially false misstatements in various required disclosures. See, e.g., the Securities Act of 1933 §§ 11, 12, 17, 24 (codified as amended in scattered sections of 15 U.S.C.). For this and other reasons, it is desirable for smaller issuers to find ways to avoid triggering the registration requirements of the 1933 Act.

21. JOBS Act, Pub. L. 112-106, §§ 302-306, 126 Stat. 315-323 (2012) (enacting 15 U.S.C. §§ 77d-1 and enacting and amending 15 U.S.C §§ 77d, 77r, 78c, 78l, and 78o); *JOBS Act Significantly Alters Federal Securities Laws*, BALLARD SPAHR LLP (Apr. 6, 2012), http://www.ballardspahr.com/alertspublications/legalalerts/2012-04-06_jobs_act_significantly_alters_federal_securities_laws.aspx.

22. J.D. Harrison, *Deadline Approaching For Crowdfunding Regulators*, WASH. POST, Nov. 19, 2012, at A09, available at http://www.washingtonpost.com/business/on-small-business/as-deadline-approaches-regulators-face-mounting-concerns-over-crowdfunding-rules/2012/11/16/fb3f1e02-3031-11e2-ac4a-33b8b41fb531_story.html (pointing out that the JOBS Act set a deadline of December 31, 2012 for the SEC to adopt crowdfunding rules, and the self-regulatory body for broker-dealers, the Financial Industry Regulatory Authority (“FINRA”), is also required to draft rules—but with no corresponding deadline).

23. *SEC Issues Proposal*, *supra* note 15.

24. Bradford, *Promise Unfulfilled*, *supra* note 17, at 249 (pointing out “formidable obstacles under federal securities laws” to crowdfunding).

be required to register as brokers,²⁵ investment advisors, or both.²⁶ Additionally, the startups, known in securities and corporate law as “issuers,” soliciting investors for crowdfunding investments would themselves be required to register such securities offerings with the SEC,²⁷ which can be burdensome and costly.²⁸ To grease the wheels of commerce, the CROWDFUND Act created a new exemption from these requirements just for crowdfunding, which could potentially fill a critical capital gap among startups in the health care industry.²⁹

Due to the passage of Title III, startups like Dr. Lin’s Rare Genomics Institute can utilize social media not merely to solicit donations from sympathetic strangers, but to actually offer strangers an equity stake in his growing business. Individuals scattered throughout the country that share medical concerns³⁰ or that occupy similar roles in the health care system (e.g. nurses, doctors) could be united through social media and attracted to innovative solutions in the industry. This Comment considers the potential impact that the CROWDFUND Act could have on startup financing for emerging biotech companies, and assesses the appropriate level of supervision of this emerging industry by the SEC, in particular regarding the statutory investment limits.

25. Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines “broker” as any intermediary “engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78c(a)(4) (2012).

26. Bradford, *Promise Unfulfilled*, *supra* note 17, at 196 (“[C]rowdfunding web sites hosting offerings of securities could be required to register as brokers under the Securities Exchange Act or as investment advisers under the Investment Advisers Act.”).

27. Absent an exemption, it is unlawful to sell securities unless a registration statement is in effect as to those securities. Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2012).

28. Thomas Lee Hazen, *Crowdfunding Or Fraudfunding? Social Networks And The Securities Laws—Why The Specially Tailored Exemption Must Be Conditioned On Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1744 (2012) (describing the registration of securities as “an expensive and otherwise burdensome process that presents barriers to small businesses’ access to the U.S. capital markets.”).

29. Timothy Hay, *MedStartr Thinks Crowdfunding Will Work For Med-Tech*, WALL ST. J. BLOG, (Jun. 26, 2012, 1:16pm), <http://blogs.wsj.com/venturecapital/2012/06/26/medstartr-thinks-crowdfunding-will-work-for-med-tech/>.

30. Larry Gerrans, *Sanovas Remarks on “How Crowdfunding Affects the Healthcare Market, and Your Wallet”*, SANOVAS CO. NEWS, http://www.sanovas.com/index.php?option=com_content&view=article&id=928:sanovas-remarks-on-qhow-crowdfunding-affects-the-healthcare-market-and-your-walletq&catid=46:company&Itemid=58 (arguing that “[w]ith social media as the driver, communities and industries can invest in their collective interest. The Life Science community is especially well suited to answer this call. . . . Sentimentally, Crowdfunding presents the entrepreneur with an incredibly meaningful socioeconomic mandate.”).

Section I of this Comment introduces the prohibitions of the Securities Act of 1933,³¹ its exemptions,³² and emphasizes the significance of the common law interpretation that the primary purpose of federal securities law is investor protection.³³ Section I also details how the JOBS Act's new registration exemption altered federal securities laws, and how the exemption is likely to impact the development of Internet-based crowdfunding for startups. Section II briefly summarizes the legislative history of the JOBS Act. Section III posits that crowdfunding presents a valuable capital-raising strategy for biotech startups. Section IV warns that investors, intermediaries, and especially biotech startup companies should be worried about fraudsters exploiting the crowdfunding space. Section V outlines the self-certification standard, whereby intermediaries are able to rely on investors' assurances concerning their income and investments in other crowdfunding ventures,³⁴ and discusses the advantages and disadvantages of the Proposed Crowdfunding Rule. The conclusion emphasizes the need for meaningful enforcement of the investment limits in the CROWDFUND Act for a stable crowdfunding industry, preferably with the use of third party verification services overseen by the SEC or the Financial Industry Regulatory Authority ("FINRA").

I. THE NEW ROLE OF CROWDFUNDING IN FEDERAL SECURITIES LAW.

A. *The Exemptions to Securities Act Registration.*

The Securities Act of 1933 ("1933 Act" or "Securities Act") was passed with the intention of protecting the investing public from fraud.³⁵ It requires any offering of securities³⁶ to be registered with the SEC, unless an

31. Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2012).

32. 15 U.S.C. §§ 77c-77d.

33. See *infra* note 43 and accompanying text.

34. 78 Fed. Reg. at 66,469-66,470.

35. At the time, President Franklin D. Roosevelt regarded the law's passage as a shift towards consumer protection. Hazen, *supra* note 26 (citing Message to Congress from President Franklin Roosevelt (Mar. 29, 1933), quoted in H.R. Rep. No. 73-85, 73rd Cong. (1933) ("This proposal adds to the ancient rule of caveat emptor, the further doctrine, 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.")).

36. The 1933 Act lists various financial products in its definition of a "security," which includes most forms of stock and notes. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012). It also includes any "investment contract," which courts have defined as any "transaction or scheme" involving an investment of money in a common enterprise with the expectation of profits based primarily on the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99, (1946); see also *United Hous. Found., Inc. v.*

exemption is available,³⁷ and imposes liability for fraud involved in such selling efforts.³⁸ Since the text states that “it shall be unlawful for *any person*, directly or indirectly” to offer to buy or sell securities unless a registration statement has been filed with the SEC,³⁹ it is the 1933 Act’s exemptions that shape the contours of federal securities regulation. One principal exemption is found in Section 4(1), which exempts transactions by any person other than an issuer, underwriter, or dealer.⁴⁰ Other provisions involve exempting certain securities and intrastate offerings.⁴¹

Judicial interpretations of section 4(2)’s “private placement” exemption reveal the courts’ generally expansive view of the scope of the 1933 Act’s protections. The Supreme Court, in *Sec. & Exch. Comm’n v. Ralston Purina Co.*,⁴² articulated the legislative intent of Congress in passing the 1933 Act, saying the intent was to protect investors who are not otherwise “able to fend for themselves” in public markets.⁴³ In subsequent cases where issuers tried to avoid registration requirements by claiming a private placement exemption,⁴⁴ lower courts looked to the investor’s financial sophistication and measured the extent to which the investor had access to information

Forman, 421 U.S. 837, 860 (1975); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

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

38. Securities Act of 1933 §§ 11, 12(a)(1), 12(a)(2), 15, 17, 24 (codified in scattered sections of 15 U.S.C. § 77).

39. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2012) (emphasis added).

40. The Securities Act of 1933 § 4(a)(1), 15 U.S.C. § 77d(a)(1) (2012). “Dealer” is defined in § 2(a)(12) as “any person who engages . . . in the business of . . . dealing or trading in securities.” “Underwriter” is defined expansively in § 2(a)(11) to include “any person . . . who offers or sells for an issuer in connection with . . . a distribution of any security,” any purchaser “with a view to . . . the distribution of any security,” or anyone who participates in any such undertaking.

41. *See, e.g.*, the Securities Act of 1933 Act § 3(a)(2).

42. 346 U.S. 119 (1953).

43. *Id.* at 124-25. The SEC filed suit against Ralston Purina, disputing the company’s policy of selling common stock to hundreds of key employees without registration. The defendant argued that such offers were exempt from securities laws because they constituted private placements under what is now § 4(2) of the 1933 Securities Act. The Court disagreed, holding that the registration exemptions ought to be viewed in light of the legislative intent of the Act, which is to promote full disclosure of company information so that investors can make informed decisions. The Court declared that non-executive personnel, such as the company’s chow loading foreman and stock clerk, were entitled “to have access to the kind of information which registration would disclose.” *Id.* at 127.

44. Section 4(2) exempts transactions by an issuer “not involving any public offering,” also known as a private placement. Among the exemptions for private placements are Regulation D offerings. The Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2).

adequate enough to make an informed investment decision.⁴⁵ Thus, unless an issuer can demonstrate⁴⁶ that a purchaser was sophisticated and had adequate access to information about the issuer, whether through disclosures made prior to the securities transaction or by virtue of his relationship to the issuer, the private placement exemption will not be available.⁴⁷

Courts have since varied in their approach to the relative weight given to this bifurcated information-sophistication test,⁴⁸ thus leading to uncertainty among issuers.⁴⁹ In response, the SEC adopted Regulation D (“Reg. D”),⁵⁰ a set of rules providing a reliable safe harbor to ensure a private placement

45. See *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 902-03 (5th Cir. 1977) (establishing that even sophisticated parties require information in order for the issuer to enjoy a private placement exemption); see also *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1975) (denying the availability of a § 4(2) exemption where investors had adequate access to information but were unsophisticated).

46. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953) (“Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.”).

47. For example, issuers are liable to purchasers for violating § 5 of the 1933 Act and a purchaser/investor is entitled under § 12(a)(1) to seek rescission of such transactions.

48. See, e.g., *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 11 (D.D.C. 1998) (“Courts applying [the *Ralston Purina*] mandate have identified various factors that should be considered in determining whether an offering is exempt under section 4(a): the number of offerees, the relationship of the offerees to each other and the issuer, the manner of the offering, information disclosure or access, and the sophistication of the offerees.”).

49. E.g., compare *Doran*, 545 F.2d at 906-08 (focusing on *quality of disclosure* by the issuer and the *level of investor access to information* in assessing propriety of a §4(2) exemption) (emphasis added), with *Lively v. Hirschfield*, 440 F.2d 631, 633 (10th Cir. 1971) (arguing for “strict” interpretation of *Ralston Purina* where a private placement exists for “only persons of exceptional business experience” with regular access to all the relevant information); see also John Coffee, Jr. and Hillary A. Sale, *SECURITIES REGULATION: CASES AND MATERIALS* 347-48 (12th ed. 2012), (comparing *Lively’s* focus on a “seemingly higher standard” of investor sophistication for a private placement exemption with *Doran’s* “focus more on the quality of the disclosure provided by the issuer.”).

50. The SEC may, “by its rules and regulations” exempt certain securities from registration requirements if it finds that “enforcement . . . with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering,” which shall not exceed \$5 million. Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1) (2012). The Commission has used this authority broadly. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 87 (2012) [hereinafter *Crowdfunding*] (pointing out that, even before passage of the JOBS Act, the SEC “clearly ha[d] the authority to exempt crowdfunding from the registration requirements of the Securities Act and to exempt crowdfunding web sites from registration as brokers or investment advisers” under section 3(b) and section 28).

exemption if certain conditions are met.⁵¹ For smaller issuers in particular, including the type of entrepreneurs who may be interested in crowdfunding, Reg. D has become a popular alternative to risking the uncertainty involved in a judicial or SEC administrative proceeding featuring discussions of the sophistication of a purchaser.⁵² Although Reg. D simplified the private placement pathway, it is worth noting that *Ralston Purina* is by no means antiquated, and endures as a guidepost for determining whether an issuer can properly claim a private placement exemption under the statute. *Ralston Purina* also serves as a useful backdrop against which to measure other exemptions and rules: “[t]he focus of inquiry should be on the need of [investors] for the protections afforded by registration.”⁵³ This basic proposition of securities law should be kept in mind as the SEC continues to draft the rules for a new crowdfunding exemption.

B. Debt and Equity Crowdfunding.

Crowdfunding refers generally to the raising of funds online in small amounts from a large group of people.⁵⁴ It is a phenomenon purely of the Internet-age, but its roots are derived from crowdsourcing and micro-finance.⁵⁵ Crowdsourcing is the pooling together of resources around a common goal,⁵⁶ while micro-finance, or micro-lending, refers to targeted lending in small amounts to borrowers, who are often in poorer, undercapitalized regions abroad.⁵⁷ Modern crowdfunding can be categorized into five types, “distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.”⁵⁸ Prior to the JOBS Act, and without any action by Congress or the SEC, companies could validly raise funds using crowdfunding by selecting

51. 17 C.F.R. §§ 230.501-508 (2013).

52. VLAD IVANOV AND SCOTT BAUGUESS, SEC. EXCH. COMM’N, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION (Feb. 2012), http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf.

53. SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953).

54. Bradford, *Crowdfunding*, *supra* note 50, at 5.

55. *Id.* at 27-28.

56. *Id.* (describing examples such as the Internet-based encyclopedia Wikipedia, open-sourced operating system Linux, and Google, “which captures the sites that everyone collectively is linking to and visiting.”).

57. *Id.* at 28-29. (explaining how micro-lending has ballooned from its modern origins as one \$27 investment in Bangladesh to a multi-billion industry).

58. *Id.* at 14. For a detailed account of these different approaches to crowdfunding, their respective prevalence, and which types most obviously run afoul of federal securities laws, see Professor Bradford’s comprehensive discussion. *Id.* at 14-42.

only some of these techniques— issuing securities (i.e. the equity model) was forbidden.⁵⁹ For instance, various websites like Kickstarter⁶⁰ and Indiegogo,⁶¹ already charge entrepreneurs fees for hosting an offering of “perks” or rewards in exchange for contributions from an online universe.⁶² However, because these sites are hosting enterprises that only seek donations⁶³ or give out products to contributors, such as an audio CD produced by an artist, federal securities law are not implicated.⁶⁴

In fact, Congressional action technically may not have been necessary to permit equity and debt investments (securities transactions) because the SEC already has the authority to exempt such transactions.⁶⁵ However, before the JOBS Act, it was uncommon in the U.S. for companies to even appear to be offering a stake in their enterprise in exchange for investments from online users because the SEC had not explicitly exempted such transactions, and the penalty of unwittingly triggering securities regulation can be costly.⁶⁶

59. Bradford, *Promise Unfulfilled*, *supra* note 17, at 196-97.

60. KICKSTARTER, <http://www.kickstarter.com/> (last visited Sept. 2, 2013).

61. INDIEGOGO: AN INTERNATIONAL CROWDFUNDING PLATFORM TO RAISE MONEY, <http://www.indiegogo.com/> (last visited Sept. 2, 2013).

62. Bradford, *Crowdfunding*, *supra* note 50, at 16-20.

63. See, e.g., Brett Zongker, *Crowd-Funding Draws Donations for Sandy Relief*, BOS. GLOBE (Dec. 22, 2012), <http://www.bostonglobe.com/news/nation/2012/12/23/crowd-funding-draws-donations-for-sandy-relief/ojJmbsJ1ou8rdXKdi7Z5H/story.html> (“While Congress considers a \$60 billion disaster aid package for the storm victims, hundreds of them have gotten quicker results by creating personalized fundraising campaigns on sites including GoFundMe, IndieGoGo and HelpersUnite.”).

64. Bradford, *Crowdfunding*, *supra* note 50, at 15-26 at 31-32. (observing that consuming a product is not indicative of investment contract and that “contributors to donation-model sites are offered nothing else, such as stock or notes, that would fall within the general definition of a security”) (citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Reves v. Ernst & Young*, 494 U.S. 56 (1990)); see also *supra*, note 36 (discussing the *Howey* test and definition of an investment contract).

65. Securities Act of 1933 § 3(b)(1), 15 U.S.C. §77c(b)(1) (2012) (allowing the SEC to exempt “any class of securities” if it finds that enforcement “is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering,” the aggregate offering amount of which is not to exceed \$5 million); see also *id.* § 28, 15 U.S.C. 77z-3 (stating the SEC “by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction . . . from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”).

66. Bradford, *Crowdfunding*, *supra* note 50, at 24 (citing “regulatory issues” raised by equity-based crowdfunding for its unpopularity in the U.S.).

One case demonstrates how, prior to the passage of the JOBS Act, two unsuspecting executives ran afoul of federal securities regulation.⁶⁷

In November of 2009, two advertising executives agreed to a cease-and-desist order from the SEC for failing to register a securities offering with the SEC.⁶⁸ They started a website called BuyBeerCompany.com, purportedly to purchase Pabst Blue Ribbon for \$300 million, and promoted the website over Facebook and Twitter, ultimately attracting \$200 million in pledges from five million individuals online.⁶⁹ Although the executives' attorney said they were only experimenting with crowdsourcing and did not expect such a response, the SEC was not amused. The Commission found that, although "[n]o monies were ever collected," this solicitation of investments over social media, in exchange for a "crowdsourced certificate of ownership" (as well as beer), on the premise of acquiring Pabst Blue Ribbon, constituted an offer of securities that "was not registered with the Commission, nor exempt from registration," and thus in violation of section 5(c) of the 1933 Act.⁷⁰ This high-profile case was later credited with sparking a Congressional hearing on crowdfunding.⁷¹

The CROWDFUND Act has provided a pathway for the sort of fundraising contemplated by the Pabst campaign, because it added section 4(a)(6) to the 1933 Securities Act, exempting all transactions where offers and sales of securities are made through crowdfunding portals online from the section 5(c) registration requirement.⁷² However, it is worth noting that the statute would not necessarily have paved the way for the \$300 million acquisition of Pabst because of the \$1 million cap.

67. Chad Bray, *Huge Beer Run Halted by Those No Fun D.C. Regulators*, WALL. ST. J. BLOG (June 8, 2011, 4:05 PM), <http://blogs.wsj.com/law/2011/06/08/huge-beer-run-halted-by-those-no-fun-d-c-regulators/> (outlining that "Steven Berkowitz, [the defendants'] lawyer, said the duo simply wanted to conduct an experiment online in crowdsourcing and saw that Pabst was for sale at the time.").

68. See Michael Migliozi II, Order Instituting Cease-and-Desist Proceedings Pursuant to section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, Securities Act Release No. 9216 (June 8, 2011), <http://www.sec.gov/litigation/admin/2011/33-9216.pdf>.

69. *Id.*

70. *Id.* at 2-3.

71. Andrew Ackerman, *Fizzled Beer Deal Prompts 'Crowd-Funding' Hearing*, WALL. ST. J. (Sept. 14, 2011, 3:53 PM), <http://online.wsj.com/article/SB10001424053111903927204576570614068591324.html>.

72. Securities Act of 1933 § 4(a)(6), JOBS Act.

C. Reg. D and Small Offering Exemptions.

The SEC may already have had the authority to exempt crowdfunding transactions under section 3(b) of the 1933 Act, which grants broad authority to the SEC to exempt from registration certain securities purchases where the Commission deems it “not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering.”⁷³ After all, the SEC’s mission is not only to protect investors and maintain orderly markets, but to facilitate capital formation.⁷⁴ To this end, in the 1980s the SEC acted on its section 3(b) authority to create rules fulfilling part of the purpose behind today’s crowdfunding exemption. As a result, in 1982 the SEC adopted Rules 501-508 to form Regulation D (“Reg. D”), which provides several safe harbors for the private offering exemption under section 4(2) of the Securities Act.⁷⁵

Reg. D offerings are the dominant capital raising strategy among private offerings, and Rule 506 is the most popular.⁷⁶ Rule 506 is the most prevalent capital-raising strategy under Reg. D because it permits companies to sell an unlimited dollar amount of securities to accredited investors and up to thirty-five non-accredited investors, so long as the issuer reasonably believes that those purchasers have “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment.”⁷⁷ Rule 504 and 505 offerings are capped at \$1 million and \$5 million, respectively, and Rule 505 is limited to thirty-five or fewer “nonaccredited investors.”⁷⁸ An accredited investor includes any individual with an income above \$200,000 (or \$300,000 along with a spouse), most banks, businesses, upper-level management of the issuer; and individuals with a net worth exceeding \$1,000,000.⁷⁹ Importantly, the valuation of net worth excludes one’s primary residence,⁸⁰ so as not to be over-inclusive.

73. Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1) (2012); *see also supra* note 65.

74. *FY14 CFTC, SEC Budget Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 113th Cong. (2013) (testimony of Mary Jo White, Chairman, SEC) (remarking on the SEC’s “three-part mission: to protect investors, maintain . . . efficient markets, and facilitate capital formation.”).

75. *Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales*, 47 Fed Reg. 11,251, 11,258 (proposed Mar. 16, 1982).

76. IVANOV & BAUGUESS, *supra* note 52.

77. 17 C.F.R. § 230.506(b)(2)(ii) (2012).

78. *Id.* § 230.505.

79. *Id.* § 230.501(a)(1-8).

80. *Id.* § 230.501(a)(5)(i)(A)

Under Rule 506, issuers are permitted to sell an unlimited number of securities to accredited investors because those investors are deemed financially sophisticated enough to comprehend the risks involved in the investment.⁸¹ To protect investors and the public broadly, limitations are in place regarding the manner in which securities are issued under Reg. D. For example, under Rules 505 and 506, resale limitations are put in place.⁸² Further, issuers and others are prohibited from engaging in “general solicitation or general advertising” through newspapers, magazines, TV, or radio advertisements,⁸³ unless all of the purchasers are accredited investors.⁸⁴

Reg. D is therefore important to understand for several reasons. As discussed above, Reg. D plays a dominant role in the recent trend of private placements eclipsing public offerings, suggesting that offerings made under the crowdfunding exemption could benefit from this market appetite for nonpublic offerings. Further, as discussed in greater detail below: (1) crowdfunding may compete with Reg. D as a capital formation strategy among life science and biotech startups; (2) some issuers may seek to combine these capital-raising strategies, raising novel regulatory issues for the SEC; and (3) the JOBS Act’s repeal of the general advertising ban, and the SEC’s recent rule implementing its repeal, may indicate the direction the SEC will take on other JOBS Act rulemakings.

1. Filling a Critical Capital Gap for Small Issuers.

Reg. D provides a significant and reliable safe harbor from registration requirements for small issuers, and accordingly, this has proven to be a popular route for small businesses wishing to avoid the costs of registration and provides an important capital formation function.⁸⁵ The primary policy goal of Reg. D offerings was to facilitate capital formation for small businesses.⁸⁶ The SEC staff has since observed a recent trend where the amount of capital raised in private placements (i.e. nonpublic offerings),

81. *Id.* § 230.501(e)(1)(iv) (excluding accredited investors from inclusion in § 230.506(b)(2)(ii)). *See also* supra, notes 48-50 and accompanying text (discussing policy rationale for Reg. D’s Rule 506).

82. *Id.* §§ 230.505(b)(1), 506(b)(1) (requiring that “offers and sales must satisfy” the terms of §§ 230.501 and 230.502).

83. 17 C.F.R. §230.502(c) (2012) (prohibiting the offering and selling of securities in Reg. D offerings “by any form of general solicitation or general advertising,” except as provided in § 230.504(b)(1)).

84. 17 C.F.R. § 230.506(c) (2012); *see also* 78 Fed. Reg. 44,771 (Jul. 24, 2013).

85. IVANOV & BAUGUESS, *supra* note 52.

86. *Id.* at 1 (referring to “the original regulatory objective to target the capital formation needs of small business”).

such as those through Reg. D, has actually eclipsed the capital raised in publicly registered offerings.⁸⁷ The amount of capital raised privately surpassed public offering amounts in 2010 and 2011 by, respectively, 8% (an estimated \$1.16 trillion compared to \$1.07 trillion) and 3%.⁸⁸

This trend accelerated dramatically in 2012, with private offerings eclipsing public ones by 42%,⁸⁹ which underscores the increasing importance of registration exceptions aimed at small business, in particular Reg. D.⁹⁰ Further, the SEC estimates that there were 37,000 Reg. D offerings initiated between 2009 and 2011 with a median offering price of \$1 million, surpassing \$900 billion worth of securities sold in 2010.⁹¹

However, even as Reg. D offerings and other private placements are surging, there are reports of severe capital shortages among small businesses from the last four years.⁹² Now that non-equity based crowdfunding has reached a certain height in popularity, the hope among crowdfunding advocates is that small issuers may choose Title III over Reg. D offerings, depending on the success of the SEC crowdfunding rule. Estimates find that as many as 19% of small business owners would pursue equity investments via a crowdfunding exemption to fill the void.⁹³ One crowdfunding service provider used these figures to estimate a potential market of 700,000 companies that could be soliciting investments through online funding

87. *Id.* at 3.

88. *Id.*

89. VLAD IVANOV & SCOTT BAUGUESS, SEC. EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, AN UPDATE TO THE FEB. 2012 STUDY 8 (2013), <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf> (“In 2012, registered offerings accounted for \$1.2 trillion of new capital compared to \$1.7 trillion raised through all private offering channels.”).

90. *Id.* at 5.

91. Luis A. Aguilar, Comm’r of the Sec. Exch. Comm’n, Public Statement on Investor Protection is Needed for True Capital Formation: Views on the JOBS Act, (Mar. 16, 2012), http://www.sec.gov/news/speech/2012/spch031612laa.htm#P41_18027.

92. THE NAT’L SMALL BUS. ASS’N, *Forward to SMALL BUSINESS ACCESS TO CAPITAL SURVEY* (July 11, 2012), <http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf> (“According to the survey, nearly half (43 percent) of small-business respondents said that, in the last four years, they needed funds and were unable to find any willing sources, be it loans, credit cards or investors.”).

93. *Id.* at 10; *but see* MICHAEL T. RAVE, ET. AL., DAY PITNEY LLP, JOBS ACT—ON REGULATION A, REGULATION D AND CROWDFUNDING PROVISIONS 5 (Apr. 19, 2012), http://www.daypitney.com/news/docs/dp_4117.pdf (predicting the opposite will occur, “relegating crowdfunding to the realm of companies that are unable to get the backing of professional investors”).

portals by the third year of crowdfunding.⁹⁴ This may be an optimistic assessment; estimates of the state of growth and size of the crowdfunding industry vary widely,⁹⁵ and predictions vary according to the assumptions made about growth and the veracity of the underlying data.⁹⁶ However, these trends in the growth of private placements may suggest, at the very least, a healthy appetite for alternative capital-raising strategies among small firms seeking to avoid SEC registration.

2. SEC Proposed to Allow Concurrent Crowdfunding and Reg. D Offerings.

One thing that may satisfy some of the critical funding gaps outlined above is the SEC's proposal to allow issuers to fundraise using both a crowdfunding 4(a)(6) and Reg. D. exemption simultaneously. For instance, one major question following passage of the JOBS Act was whether an issuer would be able to take advantage of new lax advertising rules mandated under Title II to attract accredited investors, while simultaneously employing the crowdfunding exemption under Title III to attract unaccredited investors.⁹⁷ The SEC's proposed crowdfunding rule⁹⁸ cleared

94. Brian Knight, Dir. of Entrepreneur Servs., Crowdcheck, Letter to SEC and Comment on Regulatory Initiatives Under the JOBS Act: Title III—Crowdfunding (Dec. 5, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-185.htm>.

95. See Bradford, *Promise Unfulfilled*, *supra* note 17, at 196 (describing crowdfunding as growing into “a billion-dollar industry”) (citing Natalie Huet, *European Start-Ups Court Crowds for Cash*, REUTERS (May 9, 2012), <http://www.reuters.com/article/2012/05/09/finance-crowdfunding-idUSL5E8G50RB20120509>); see also THE ECONOMIST, *The New Thundering Herd, Wanted: Small Sums Of Money To Finance Young Companies* (June 16, 2012), available at <http://www.economist.com/node/21556973> (claiming “[c]rowdfunding is booming. . . . [according to a] report by Massolution, a research firm, forecast[ing] that \$2.8 billion will be raised worldwide this year, up from \$1.5 billion in 2011 and only \$530m in 2009.”); see also Roger Yu, *Crowd Funding Fuels Businesses, Charities, Creative Ventures*, USA TODAY (May 31, 2012, 3:20 PM), <http://usatoday30.usatoday.com/tech/news/story/2012-05-29/crowd-funding-websites/55288516/1> (citing “a report by Crowdsourcing.org,” an industry group, to claim “[a]bout \$1.5 billion was raised in 2011 by about 450 crowd-sourcing Internet sites worldwide”); but see Felix Salmon, *Annals Of Dubious Statistics, Crowdfunding Edition*, REUTERS (July 27, 2012), <http://blogs.reuters.com/felix-salmon/2012/07/27/annals-of-dubious-statistics-crowdfunding-edition/> (questioning billion-dollar estimates).

96. Knight, *supra* note 94 (conceding that “there is a very limited amount of information available, and what information exists is often widely divergent”).

97. Chris Tyrrell, et al., *CrowdFund Intermediary Regulatory Advocates (“CFIRA”) Letter to SEC and Comment on SEC Regulatory Initiatives Under JOBS Act: Title III*, at 1-2. (Oct. 29, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-169.pdf> [hereinafter *CFIRA Comment Letter*] (calling it “unclear how the SEC’s historical integration criteria are implicated by the crowdfunding and Regulation D reforms of the

up this question, proposing to allow other exempt offerings concurrently alongside a crowdfunding-exempt offering by saying the Staff will not consider the two offerings “integrated.”⁹⁹ Generally speaking, the SEC’s integration doctrine prevents an issuer from doing indirectly what it is prohibited from doing directly.¹⁰⁰ It is designed to disallow issuers from piling exemption on exemption to circumvent the rules. However, in part because of the \$1 million cap on crowdfunding issuers, the SEC stated:

[W]e believe that an offering made in reliance on Section 4(a)(6) should not be integrated with another exempt offering made by the issuer, provided that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering. An issuer could complete an offering made in reliance on Section 4(a)(6) that occurs simultaneously with, or is preceded or followed by, another exempt offering.¹⁰¹

This proposal is particularly meaningful for issuers wishing to generally solicit accredited investors but who also want to seek crowdfunding investors. Title II of the JOBS Act directed the SEC to lift the ban on general solicitation and advertising of securities in smaller offerings.¹⁰² There were two important qualifications to the statutory exemption: all *purchasers* of the securities must be accredited investors,¹⁰³ and the issuer “[must] take reasonable steps to verify that purchasers of the securities are accredited investors.”¹⁰⁴ Congress thus mandated in the JOBS Act that the SEC permit the general solicitation and advertising of securities, previously

JOBS Act,” questioning “whether an issuer can conduct crowd-funded offerings concurrently with offerings under other exemptions, such as Regulation D,” and asserting “it is unclear whether integration will be applied to crowd-funded offerings at all”).

98. Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (amending 17 C.F.R. §§ 200, 227, 232, 239, 240 and 249), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf>.

99. 78 Fed. Reg. at 66,431.

100. 78 Fed. Reg. 66,431, at n.27 (“The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering.”).

101. 78 Fed. Reg. at 66,432.

102. The JOBS Act § 201(a)(1) (mandating the SEC to amend its regulations “to provide that the prohibition against general solicitation or general advertising contained in § 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to § 230.506, provided that all purchasers of the securities are accredited investors.”).

103. As defined by Securities Act Rule 501(a). The term accredited investor includes most banks, businesses, upper-level management of the issuer, and individuals with a net worth over \$1,000,000. 17 C.F.R. § 230.501(a)(1-8).

104. The JOBS Act § 201(a)(1). See *infra* notes 131-36 (listing the qualifying “reasonable steps” adopted in the final rule).

banned on, for instance, TV, the Internet, or newspapers,¹⁰⁵ so long as the ultimate purchasers are accredited investors.¹⁰⁶

After an initial rule proposal in August 2012, SEC Commissioners voted 4-1 in July of 2013 to adopt a new final Rule 506(c) under the Securities Act.¹⁰⁷ The final rule was published in the Federal Register on July 24, 2013.¹⁰⁸ As of September 23, 2013, issuers were cleared to begin soliciting investors by advertising unregistered securities over the Internet, provided that all purchasers are accredited investors.¹⁰⁹ Though the method of these communications is now unrestricted, these solicitations are still subject to the antifraud provisions of the federal securities laws.¹¹⁰

The SEC said it received “concerns” about the possible integration in the period before its proposed crowdfunding rule.¹¹¹ The Staff may receive even more comment letters considering whether or not the proposed non-integration is appropriate, given potential compliance concerns, not to mention the conflicting statutory goals of the repeal of the general solicitation ban and the adoption of the crowdfunding exemption. Regarding the latter, the general solicitation repeal targets accredited investors, while the crowdfunding exemption is associated with special investor protection measures to mitigate the risks of attracting the general public to an online offering.¹¹²

Regarding potential compliance issues, consider, for instance, that non-integration would permit firms to generally advertise to the public under Rule 506(c), inadvertently attracting non-accredited investors to its 4(a)(6) crowdfunding portal, which possibly circumvents the crowdfunding advertising rules.¹¹³ Under the Crowdfunding Rule Proposal, issuers are

105. 17 C.F.R. § 230.502(c)(1) (limiting the general advertising of securities offered or sold under Reg. D in any form, including “[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio”).

106. The JOBS Act § 201(a)(1).

107. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (Jul. 24, 2013) (to be codified at 17 C.F.R. pt. 230, 239 and 242).

108. *Id.*

109. *Id.* at 44,772 (“The final rule and form amendments are effective on September 23, 2013”).

110. *Id.* at 44,785.

111. Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428 at 66,431.

112. CFIRA Comment Letter, *supra* note 97, at 3.

113. *Id.* at 2-3 (“permitting an issuer to conduct a single offering in separate tranches and to treat each tranche separately for compliance purposes would enable the issuer to

prohibited from advertising the terms of a 4(a)(6) offering to the public, “except for notices that direct investors to the intermediary’s platform.”¹¹⁴ The content of a permissible crowdfunding advertising notice is restricted to essentially: 1) a statement that the issuer is conducting an offering (along with the name of the intermediary); 2) the terms of the offering; and 3) some limited factual information about the identity of the issuer.¹¹⁵

However, consider a circumstance where an issuer purchases a 506(c)-exempt Super Bowl TV advertisement viewed by the entire American football fan base, accredited and non-accredited investors alike. After the game, say a curious non-accredited investor conducts an Internet search to locate the issuer with the intent of investing, but finds the funding portal hosting that issuer’s ongoing crowdfunding offering. If the investor purchased shares via the crowdfunding intermediary, would the SEC staff interpret that investor to be a “purchaser” for purposes Rule 506(c)’s accredited status verification requirement? It is arguable that such a non-accredited investor is a purchaser because, technically, the first time he heard about the offering was in the commercial—not in a crowdfunding-limited notice. In this case, it would be debatable whether all of the purchasers involved in the generally-advertised offering could ultimately qualify as accredited investors, as required by 506(c),¹¹⁶ or whether the issuer was merely seeking to condition the market for its crowdfunding venture using a Super Bowl ad. With the ubiquity of internet search engines and smart phones, it is not unreasonable to imagine that many non-accredited investors’ first action would be to conduct a web search of the issuer after seeing such an ad, only to find the funding portal.

One crowdfunding group emphasized this very issue to the SEC, requesting that the “Commission provide clarification regarding the solicitation activities that are appropriate in concurrent or almost-so crowdfunding and 506 offerings.”¹¹⁷ For its part, the SEC’s crowdfunding rule proposal asked more questions than it answered in this regard.¹¹⁸

circumvent the 35-non-accredited investor participation limit and still claim the benefit of the Rule 506 safe harbor”).

114. 78 Fed Reg. at 66,555 (Nov. 5, 2013) (proposing C.F.R. §227.204(a)).

115. 78 Fed Reg. at 66,555 (Nov. 5, 2013) (proposing C.F.R. §227.204(b)(1-3)). The factual information is limited to the name of the issuer, its address, phone, email address, Web site, and a brief description of its business. *Id.*

116. CFIRA SEC Comment Letter, *supra* note 97, at 3.

117. *Id.* at 3.

118. Crowdfunding, Securities Act Release No. 33-9470, 78 Fed. Reg. 66,428 at 66,433 (asking no fewer than 10 integration questions, among them whether the Staff should “prohibit an issuer from offering securities in reliance on Section 4(a)(6) within a specified period of time after or concurrently with a Rule 506(c) offering under Regulation D involving general solicitation?”).

However, in the example above, it is doubtful the SEC would destroy the 506(c) exemption, since the investor was then subject to the investor protections of the crowdfunding offering. However, this is an example of potential timing and market conditioning issues that the SEC may confront in disallowing integration of 4(a)(6) offerings.

If permitted in the final rule on crowdfunding, the ability of an issuer to “piggyback” a \$1 million offering in crowdfund-exempt transactions along with other Reg. D safe harbors would be particularly significant for biotechnology and pharmaceutical startups, because such firms typically generate high administrative and research costs.¹¹⁹ These high costs at the outset are a major contributor to what makes life science startups characteristically high-risk ventures, driving up the cost of capital in the early stages.¹²⁰ While the crowdfunding exception could be a lifeline for some biotechnology startups,¹²¹ the \$1 million cap placed on issuers employing the crowdfunding exemption may also limit the value of the exemption for small businesses,¹²² and particularly, for life science companies.¹²³ Therefore, the SEC’s proposal to allow for concurrent offerings alongside crowdfunding may provide more hope for life sciences startups to raise far more than the \$1 million under the JOBS Act’s new exemptions, provided that the SEC clarifies potential timing and solicitation issues.

119. IAN COCKBURN & JOSH LERNER, ANALYSIS GROUP, THE COST OF CAPITAL FOR EARLY-STAGE BIOTECHNOLOGY VENTURES 2-3 (Jun. 29, 2006) http://www.analysisgroup.com/uploadedFiles/News_and_Events/News/Cockburn_Lerner_CoC_in_%20Biotech.pdf (estimating cost of capital for life science startups to be 20% compared to average for all public companies of 10%); *see also* Press Release, Nat’l Venture Capital Ass’n (“NVCA”), Cost of Capital For Early Stage Biotech Start-Ups Found To Be In Excess Of 20 Percent (July 10, 2009) (citing COCKBURN & LERNER) and Press Release, Office of Rep. Anna Eshoo (D-CA), Rep. Eshoo Hosts Briefing on Follow-On Biologics, (Jul. 10, 2009) (hyper-linking to COCKBURN & LERNER and stating that Congressional briefing featured NVCA presentation of study).

120. COCKBURN & LERNER, *supra* note 119, at 6 (identifying several challenging features unique to biotech ventures: long marketing timelines, illiquid assets, high levels of risk, and capital-intensive technology costs); *see also infra*, Part III.A.1.

121. Krist Werling, Bob Cohen, & Michael Pilo, *The Risks and Perils of Crowdfunding*, GENETIC ENGINEERING & BIOTECHNOLOGY NEWS (Mar. 5, 2013), <http://www.genengnews.com/gen-articles/the-risks-and-perils-of-crowdfunding/4760/>.

122. CFIRA Comment Letter, *supra* note 97, at 3 (“[I]ssuers will likely select raising capital via a Reg. D offering to avoid the \$1 million cap imposed upon crowdfunded companies”).

123. COCKBURN & LERNER, *supra* note 119, at 6; *but see* discussion of the economics of biotechnology capital formation, *infra* Part III.A.3.

3. *The SEC's "Accredited Investor" Verification Standard.*

The third reason Reg. D is implicated in the future of crowdfunding is because the SEC staff's choices throughout the implementation of Rule 506(c) may offer indications of what can be expected as the SEC processes comments on its first proposed crowdfunding rule.¹²⁴ The JOBS Act directed the SEC to lift the ban on general advertising of securities offerings, but section 201(a)(1) stated that "[s]uch rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, *using such methods as determined by the Commission.*"¹²⁵ The original 2012 Proposed General Solicitation Rule¹²⁶ adopted a hands-off approach to this verification requirement by suggesting a flexible standard that takes into account the facts and circumstances.¹²⁷ The Commission identified several factors that investors might use to determine what constitutes "reasonable steps," such as the nature of the purchaser, the type of accredited investor the purchaser claims to be, the amount and type of information that the issuer possesses about the purchaser, and finally, the nature of the offering.¹²⁸ However, commentators largely interpreted the 2012 Proposed General Solicitation Rule as specifically avoiding the adoption of a hard list of methods indicating what would evidence "reasonable steps" for future use by regulators and courts.¹²⁹

124. The public comment period for the crowdfunding rule proposal ends 90 days after its publication in the Federal Register. Securities Act Release No. 33-9470 (Oct. 23, 2013).

125. The JOBS Act § 201(a)(1) (2012) (emphasis added).

126. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54,464 (proposed Sep. 5, 2012) (to be codified at 17 C.F.R. pts. 230, 239).

127. *Id.* at § 54,467 (proposing a requirement that issuers "'take reasonable steps to verify' that the purchasers of the offered securities are accredited investors" as measured by an "objective determination, based on the particular facts and circumstances of each transaction.").

128. *Id.*

129. See Sara Hanks, *New Rule 506(c): General Solicitation in Regulation D Offerings*, CROWDCHECK.COM (Sept. 5, 2012), <http://www.crowdcheck.com/blog/analysis-secs-proposed-rule-506c> ("The SEC declined to specify even a non-exclusive list" of methods it would consider "reasonable steps to verify" that purchasers are accredited); Dean F. Hanley and Paul Bork, *Securities Alert: SEC Proposes JOBS Act Amendments To Rule 506 And Rule 144A To Remove Ban On General Solicitation*, FOLEY HOAG LLP (Sept. 11, 2012), <http://www.foleyhoag.com/publications/alerts-and-updates/2012/september/sec-proposes-jobs-act-amendments-to-rule-506-and-rule-144a> (stating that "[t]o the dismay of many, the SEC declined to establish what specifically will constitute 'reasonable steps,' instead indicating that each transaction would be judged based on the facts and circumstances.").

After public commenters requested more clarity,¹³⁰ the SEC outlined a nonexclusive list of four methods that would qualify under the statutory standard as “reasonable steps” under Rule 506(c). The General Solicitation Final Rule outlines four specific non-exclusive methods for issuers advertising broadly under 506(c) to verify the accredited investor status of individual purchasers.¹³¹ First, for an accredited investor claiming to qualify as a purchaser in the 506(c) offering by using his or her income level, an issuer’s reliance on any Internal Revenue Service (“IRS”) income statements from the last 2 years constitutes reasonable steps of verification.¹³² Second, an issuer is deemed to satisfy the verification requirement of an investor claiming to qualify based on his net worth by reviewing his assets (using bank statements, brokerage statements, etc.) and liabilities (using a credit report).¹³³ Third, and perhaps key for crowdfunding, is that an issuer can satisfy Rule 506(c)’s verification requirement by reasonably relying on the assurances of certain third parties that are already subject to robust regulation in their own right, such as registered broker-dealers, licensed attorneys, certified public accountants, and SEC-registered investment advisers.¹³⁴ Finally, the SEC will accept reliance on previous investor qualifications under Rule 506(b) as a way to grandfather in bona fide accredited investors with a pre-existing relationship with the issuer,¹³⁵ and the SEC will also continue to accept the traditional reasonable belief standard found in Reg. D.¹³⁶

The SEC conceded it “continue[s] to recognize that a person could provide false information or documentation to an issuer in order to purchase securities in an offering made under new Rule 506(c).”¹³⁷ As will be

130. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,777 (Final Rule published on Jul. 24, 2013) (“A number of these commenters cited the lack of legal certainty that the verification requirement has been satisfied in any given situation as the reason why, in their view, the Commission should include a non-exclusive list of verification methods in Rule 506(c).”); see also Hanley and Bork, *Securities Alert*, *supra* note 129 (“Many practitioners feel that the SEC should have provided a real safe harbor about what constitutes a ‘reasonable basis’ for believing that an investor is accredited.”).

131. 78 Fed. Reg. 44,780 (Jul. 24, 2013).

132. Plus, a written confirmation from the investor claiming that he or she expects to make the same income in the upcoming year. *Id.* at 44,781.

133. *Id.* at 44,781.

134. *Id.* at 44,781-82.

135. *Id.* at 44,781.

136. *Id.* at 44,782.

137. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,782 (Jul. 24, 2013) (to be codified at 17 C.F.R. Pts. 230, 239, 242).

discussed below, a similar problem is presented by income or net worth information provided by crowdfunding investors to intermediaries. Concerns regarding a flexible, market-based approach, and other possibilities for compliance with the single-issuer and aggregate investment limits, are discussed *infra* in Part V.

II. LEGISLATIVE HISTORY OF THE CROWDFUND ACT.

A. Congressional Willingness to Capitalize on a Recent Crowdfunding Phenomenon Led to a Brief Legislative History.

Crowdfunding has been characterized as “a recent phenomenon,” with the “term crowdfunding first appear[ing] in 2006.”¹³⁸ The first crowdfunding website, Kiva, started in 2005,¹³⁹ and its use has generally increased such that crowdfunding is now being employed to fund efforts for everything from filmmaking and music to health care and information technology. The first crowdfunding bill was introduced in the House of Representatives in September of 2011 by Republican Representative Patrick McHenry of North Carolina.¹⁴⁰ After passing in the House in November of 2011,¹⁴¹ Congressman McHenry’s crowdfunding bill was incorporated into the Jumpstart Our Business Startups (“JOBS”) Act with only minor changes and passed in March 2012.¹⁴² However, the Senate replaced the House version of the crowdfunding exemption with a new Senate provision attached to the JOBS Act,¹⁴³ which was the version ultimately signed into law by President Obama on April 5, 2012.¹⁴⁴ The President had announced his support for crowdfunding only seven months prior to signing it into law.¹⁴⁵ Between the first bill’s introduction in the House and the signing of the JOBS Act by the

138. Bradford, *Promise Unfulfilled*, *supra* note 17, at 196.

139. *Id.*

140. Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2(a) (2011).

141. Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2(a) (as passed and amended by the House on Nov. 3, 2011).

142. Jumpstart Our Business Startups Act, H.R. 3606 112th Cong., §§ 301-303, Title III, Entrepreneur Access to Capital Act; *see* 158 CONG. REC. H1288 (Mar. 8, 2012).

143. Senate Amendment 1884, 112th Cong. (2012).

144. President Obama’s Remarks on Signing the JOBS Act, 2012 DAILY COMP. PRES. DOC. 1-2 (Apr. 5, 2012), *reprinted in* 2012 U.S.C.C.A.N. S4.

145. Executive Office of the President, Statement of Administration Policy (Nov. 2, 2011),

http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr2930r_20111102.pdf (“The Administration supports House passage of H.R. 2930.”).

President, there were several Congressional hearings mentioning crowdfunding.¹⁴⁶

B. Bipartisan Passage of the JOBS Act Amid Vociferous Dissent.

Although the JOBS Act passed the Senate with seventy-three votes and received bipartisan support,¹⁴⁷ the crowdfunding exemption was not without its critics. Senator Carl Levin (D-MI) took to the Senate floor in opposition to the JOBS Act, saying, “[w]e are about to embark upon the most sweeping deregulatory effort and assault on investor protection in decades.”¹⁴⁸ After eviscerating the rest of the Act, Senator Levin conceded that the amendment offered by Senator Jeff Merkley (D-OR) made modest improvements to reduce crowdfunding risks, but he still implored: “[w]e should not fool ourselves. These improvements, if adopted, though welcome, are far from sufficient. . . . If we pass this bill, it will allow new opportunities for fraud and abuse in capital markets.”¹⁴⁹

Similar criticisms of crowdfunding emerged as different proposals wound their way through Congress.¹⁵⁰ Securities expert, Professor John Coffee of Columbia, for instance, mockingly called Senator Brown’s initial crowdfunding bill, S. 1791, *The Boiler Room Legalization Act of 2011* because of broker registration exemptions.¹⁵¹ Professor Coffee observed:

146. A search of “crowdfunding” in the Congressional Record yields several results prior to April 2012. *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing before the S. Comm. on Banking, Housing and Urban Affairs*, 112th Cong. (2011); *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing before the Subcomm. On Capital Mkts. and Gov’t Sponsored Enters., H. Comm. on Fin. Svcs.*, 112th Cong. (2011); *Crowdfunding: Connecting Investors And Job Creators: Hearing before the Subcomm. on TARP, Fin. Svcs. and Bailouts of Public and Private Programs Subcomm. on TARP, Fin. Svcs. and Bailouts of Public and Private Programs Oversight and Gov’t Reform Committee*, 112th Cong. (2011). Since the passage of the JOBS Act, however, there have been other hearings in Congress. *JOBS Act in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC, Subcomm. on TARP, Fin. Svcs. and Bailouts of Public and Private Programs, H. Comm. on Oversight and Gov’t Reform*, 112th Cong. (2012).

147. 158 CONG. REC. S1977 (Mar. 22, 2012) (detailing Roll Call Vote #55 on passage of H.R. 3606 with 25 Democrats and 48 Republicans voting in favor).

148. 158 CONG. REC. S1963 (Mar. 22, 2012) (statement of Sen. Carl Levin).

149. *Id.* at S1964. It is unclear, however, whether Sen. Levin is referring here to the CROWDFUND Act.

150. See *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 112th Cong. 62-66 (2011) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Univ. Law School).

151. *Id.* at 61,64 (stating that the broker registration exemption presented “unparalleled opportunities for the traditional boiler room operation to reemerge”).

Because the maximum aggregate amount that may be raised in any 12-month period is \$1 million, this exemption is likely to be used primarily by early stage issuers that do not yet have an operating history or, possibly, even financial statements. Such issuers are in effect flying on a 'wing and a prayer,' selling hope more than substance. Precisely because of this profile, however, such offerings are uniquely subject to fraud, and some issuers will simply be phantom companies without any assets, business model, or real world existence.¹⁵²

The Senate responded by adopting an amendment sponsored by Senators Merkley, Bennet (D-CO), and Brown (R-MA) which included key investor protection measures, such as investment limits.¹⁵³ Senator Merkley explained following passage of the CROWDFUND Act that the individual investment cap is "an important investor protection" provision and that aggregate caps serve as a stopgap against an investor "unintentionally wiping out their entire savings."¹⁵⁴ The director of investor protection at the Consumer Federation of America was still skeptical, warning that crowdfunding should occupy "precisely the same place in the average person's investment portfolio that lottery tickets do . . . If you have a little spare cash that you think it would be fun to gamble with, that's fine, but don't consider it part of a well-thought-out investment strategy."¹⁵⁵ The president of the North American Securities Administrators Association has also expressed concerns, indicating "[s]tates are concerned that the fraud and scammers will come out of the closets now and start using social networking sites to rip off investors."¹⁵⁶ Professor Steven C. Bradford of the University of Nebraska, who has comprehensively addressed crowdfunding in law review articles and testified before two congressional committees on the subject,¹⁵⁷ expressed disappointment in the final bill, saying Congress

152. *Id.* at 64.

153. Senate Amendment 1884, 112th Cong. (2012) replaced a House version and was passed 64-35. 158 CONG. REC. S1976-1977 (Mar. 22, 2012); *see also* Mari Serebrov, *The Senate Adds Investor Protection for Crowdfunding to JOBS Act*, BIO WORLD TODAY (Mar. 26, 2012), <http://www.bioworld.com/content/senate-adds-investor-protection-crowd-funding-jobs-act-0>.

154. 158 CONG. REC. S5476 (July 26, 2012).

155. Margaret Collins, *Will Crowdfunding Beget Crowdfunding?*, BUSINESSWEEK (Apr. 26, 2012), <http://www.businessweek.com/articles/2012-04-26/will-crowdfunding-beget-crowdfunding>.

156. *Id.*

157. Bradford, *Crowdfunding*, *supra* note 50, at 94 (stating "Senator Merkley's [crowdfunding] bill also incorporates several of the policy recommendations made in this article."); Financial Services and Bailouts of Public and Private Programs, Hearing on The JOBS Act Before the Subcomm. on TARP, 112th Cong. (2012) (testimony of C.

“threw together a poorly drafted regulatory bundle of old ideas that is complicated, expensive, and unlikely to have much of an effect on the small business capital gap.”¹⁵⁸

III. THE POTENTIAL BOON FOR HEALTH STARTUPS.

A. Where Venture Capitalists See High Risk in Life Sciences, Crowdfunding Investors May See Opportunity for a Cure.

1. Hindrances to Venture Capitalist Investment in Biotech May Not Apply to Crowdfunding.

The economics of the biotechnology and pharmaceutical sectors (“biopharma”) are distinguishable from other sectors such as information technology, in that returns on investment may take much longer, investors can expect to hold illiquid assets for a long period of time, biopharma endeavors can be capital intensive in the short term, and the chances that drugs will actually make it to market are slim.¹⁵⁹ Compared to other startups, venture capitalists investing in biopharma enterprises “need to take on more risk, hold illiquid investments, and wait longer for a return.”¹⁶⁰ Therefore, such equity investments cost more to the issuer. This could be used as a rationale for pessimism regarding the potential impact of the crowdfunding legislation on biopharma capital formation.¹⁶¹ The failure rate among startups receiving venture capital investments is high. Senator

Steven Bradford), <http://oversight.house.gov/wp-content/uploads/2012/06/6-26-12-TARP-Bradford.pdf>.

158. Bradford, *Promise Unfulfilled*, *supra* note 17, at 222.

159. IAN COCKBURN & JOSH LERNER, THE COST OF CAPITAL FOR EARLY-STAGE BIOTECHNOLOGY VENTURES, NATIONAL VENTURE CAPITAL ASSOCIATION 6 (Jul. 10, 2009) (identifying several challenging features unique to biotech ventures: long marketing timelines, illiquid assets, high levels of risk, and capital-intensive technology costs).

160. *Id.* Put differently, the high risk of a life sciences investment for a small amount of venture capitalists drives up the cost of capital formation for the startup; *see also Biggest Biotech Trends of 2012*, GENETIC ENGINEERING & BIOTECHNOLOGY NEWS, (Dec. 31, 2012), <http://www.genengnews.com/insight-and-intelligence/biggest-biotech-trends-of-2012/77899744/>. (stating that investors blame the decline in venture capital investment in biotechnology in 2012, in part, on “biopharma startups’ greater risk than other techs”).

161. Stephanie Baum, *The JOBS Act, crowdfunding and what it will mean for healthcare startups*, MEDCITY NEWS (Apr. 5, 2012), <http://medcitynews.com/2012/04/the-jobs-act-and-what-crowdfunding-will-mean-for-healthcare-startups/>. (“With President Barack Obama signing the Jumpstart Our Business Startups Bill into law today, the crowdfunding provision could mark a new era for startups and make it easier to raise money with more investment from new investors who fuel early and later-stage healthcare companies.”).

Merkley has described the expectations of venture capitalist this way: “Angel and venture capital funds, whose mission is to invest in the start-up sector, tend to invest in perhaps one out of one hundred opportunities presented and assume that ninety-five percent of investments will fail entirely. Their profits commonly emerge out of only a handful of big winners.”¹⁶² However, the fact that fewer than 1% of new drugs make it to market may worry a small sliver of wealthy venture capitalists more than it does a “crowd” of investors attracted to an idea through social media.¹⁶³ In other words, a venture capital firm, which assumes a large amount of downside risk on all of its endeavors, may be far more concerned about the statistical probabilities of the success of a new drug treatment than will a group of low-dollar investors, representing an array of individual interests, attracted through social media to that specific idea for a variety reasons.¹⁶⁴

2. Decline in Biotechnology Venture Capital Investment May Reflect a Funding Gap.

Recent trends further demonstrate that there is a venture capital funding gap for biotechnology firms, particularly in the startup phase. The quarterly MoneyTree Report measuring nationwide venture capital activity, published by PricewaterhouseCoopers and the National Venture Capital Association, shows a 13% decline in overall biotechnology venture capital funding from \$4.8 billion in 2011 to \$4.2 billion in the 2012.¹⁶⁵ The number of venture capital-funded biotech deals has been steady over that time, with 472 deals in 2011 and 480 in 2012.¹⁶⁶

There are limitations to using this data as a measure of the potential for crowdfunding, as it includes the investment activity primarily of professional venture capital (“VC”) funds and venture subsidiaries of

162. 158 CONG. REC. S5476 (Jul. 26, 2012) (Stmt. Of Sen. Merkley (OR)).

163. COCKBURN & LERNER, *supra* note 119 (Jun. 29, 2006) (noting that “fewer than 1% of drug candidates will make it to market”).

164. *See, e.g., infra* Part III.A.3 (discussing the motivations of crowdfunding investors as distinguished from primarily profit-seeking venture capitalists).

165. PRICEWATERHOUSECOOPERS/VENTURE CAPITAL ASS'N, MONEYTREE REPORT: BIOTECHNOLOGY INDUSTRY HISTORICAL TREND DATA, <https://www.pwcmoneytree.com/MTPublic/ns/nav.jsp?page=historical> [hereinafter MONEYTREE REPORT]. Data is provided by Thomson Reuters. The MoneyTree Report is described by its collaborators as “the only industry-endorsed research of its kind,” the “definitive source of information on emerging companies that receive financing and the venture capital firms that provide it,” and “a staple of the financial community, entrepreneurs, government policymakers and the business press worldwide.”

166. *Id.*

investment banks, as opposed to data from all private placements.¹⁶⁷ However, the data provides some useful guidance on financing trends. Particularly pertinent to the crowdfunding discussion is the critical funding gap in the biotechnology startup phase.

Venture capital investment in the biotechnology “startup/seed” funding stage decreased from \$339 million in 2011 to \$288 million in 2012, representing a 15% drop, with a corresponding 18% decrease in the number of VC-funded deals.¹⁶⁸ These figures compare with \$731 million invested in 140 deals in 2008 (averaging \$5.2 million per deal), \$735 million in 125 deals in 2009 (averaging \$5.9 million), and \$599 million in 110 deals for 2010 (\$5.5 million).¹⁶⁹ Notably, the average investment deal in the startup/seed phase of biotechnology funding decreased from \$5.9 million in 2009 to \$4.3 million in 2013.¹⁷⁰ In addition to a notable decrease in the average investment, this range suggests that the \$1 million annual cap on crowdfunding offerings¹⁷¹ may not be a significant hindrance to capital formation in biotechnology, at least for the startup phase.¹⁷²

3. The Promise of Life Science Companies Concern Matters of the Heart, Which May Attract Low Dollar Crowdfunding Investors.

Where a venture capitalist may avoid a life sciences startup, such as Jimmy Lin’s Rare Genomics Institute, as a far-fetched and capital-intensive genome sequencing project,¹⁷³ large amounts of small investors may be less risk averse, more attracted to the hopeful idea of the endeavor, and less

167. *Id.*, Report Definitions and Methodology, available at <https://www.pwcmoneytree.com/MTPublic/ns/nav.jsp?page=definitions#stage>.

168. Venture capital funded deals in biotech decreased from 80 deals in 2011 to 66 deals in 2012. MONEYTREE REPORT, *supra* note 165 (defining parameters by “Biotechnology” Industry and “Startup/Seed” Stage).

169. *Id.* Some of these figures have shifted over time with updates in the data, but the downward trends have remained unaffected.

170. *Id.* (reflecting \$176 million in only 41 over first three quarters of 2013). The average investment per biotechnology deal, taken annually, for the other years are: \$4.24 million in 2011 (\$339 million in 08 startup/seed deals), \$5.5 million in 2010 (\$599 million in 110 deals), and \$5.7 million in 2008 (\$721 million in 127 deals). *Id.*

171. The JOBS Act exempts “transactions involving the offer or sale of securities by an issuer . . . provided that,” *inter alia* “the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000.” Securities Act of 1933 § 4(6)(A), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 15 U.S.C. § 77d(a)(6)(A) (2012).

172. *But see supra* notes 119-23 and accompanying text.

173. Solomont, *Rare Genomics*, *supra* note 4.

concerned with an immediate return on their investments.¹⁷⁴ Low dollar investors may be more patient than “angel investors”¹⁷⁵ or venture capitalists, and more willing to provide seed money to such projects.¹⁷⁶

For instance, consider the economics of capital formation for a Seattle-based biotechnology firm, Kineta.¹⁷⁷ Though Kineta has not employed crowdfunding, it has accumulated a diverse set of investors that include a charitable foundation and a “string of small financing deals.”¹⁷⁸ Kineta, a multi-million dollar federal contract awardee,¹⁷⁹ raised \$11 million from individual investors, the Iacocca Family Foundation, MPI Research, and a group of 30 pharmaceutical executives, according to a company representative.¹⁸⁰ The Iacocca Family Foundation is run by a Chrysler executive who lost his wife to diabetes, and he is particularly interested in the work Kineta is doing to combat autoimmune disease, including type 1

174. *Id.*

175. For a discussion of the differences between an angel investor and a venture capitalist, see Michael B. Farrell, *Angel Investors Flood The Tech Start-Up Scene*, BOS. GLOBE, (Mar. 17, 2013), <http://www.bostonglobe.com/business/2013/03/16/rise-angel-investors/mjt8DYNxWj0bcShK4ElwhN/story.html>.

176. Sara Hanks, Crowdfunder, *Webinar: Crowdfunding for Entrepreneurs*, RESEARCH COMMERCIALIZATION AND SBIR CENTER (June 20, 2012), http://center.ncet2.org/index.php?option=com_content&view=article&id=500&Itemid=87 (discussing advantages of crowdfunding over conventional funding options, such as crowdfunding investors are likely to be more patient, there is flexibility to tailor financing needs [debt v. equity], and geographic boundaries and social connections become less determinative of access to capital).

177. *See About Us*, KINETA, <http://www.kineta.bio.com/aboutus.html>.

178. Luke Timmerman, *Playing for Bunt Singles, Builds a Biotech Company Without VC Bucks*, XCONOMY.COM (June 6, 2012), <http://www.xconomy.com/seattle/2012/06/06/kineta-playing-for-bunt-singles-builds-a-biotech-company-without-vc-bucks/>.

179. Luke Timmerman, *Seattle's Kineta Rakes in Half of \$13M Federal Contract to UW For Vaccine Boosters*, XCONOMY.COM (Nov. 10, 2009), <http://www.xconomy.com/seattle/2009/11/10/seattles-kineta-rakes-in-half-of-13m-federal-contract-to-uw-for-vaccine-boosters/>.

180. Press Release, Kineta, Inc., NIH-Funded Project to Develop Vaccine Immune Boosters University of Washington (Nov. 10, 2009), <http://www.reuters.com/article/2009/11/10/idUS105167+10-Nov-2009+BW20091110>; Luke Timmerman, *Kineta, Playing for Bunt Singles, Builds a Biotech Company Without VC Bucks*, XCONOMY.COM (June 6, 2012), <http://www.xconomy.com/seattle/2012/06/06/kineta-playing-for-bunt-singles-builds-a-biotech-company-without-vc-bucks/>; *see also*, NAT'L INST. HEALTH, DEVELOPMENT OF KV1.3 CHANNEL BLOCKER SHK-186 AS A THERAPY FOR MULTIPLE SCLEROSIS, http://projectreporter.nih.gov/project_info_description.cfm?aid=8053763&icde=14775174.

diabetes.¹⁸¹ “The heart, it turns out, is a strong motivator,” and the non-profit’s investment was reported to represent “an example of how foundations are recasting the model of philanthropy” by making an equity investment in promising companies in the hopes of advancing biotech solutions, with “the potential for a double payoff if the company succeeds.”¹⁸²

This exemplifies the sort of endeavor that is likely to find crowdfunding beneficial because, where matters of the heart are concerned, crowdfunding investors, like charitable foundations, are more likely to carry the requisite “patience to support lengthy clinical trials to determine whether” a given drug works in humans.¹⁸³ Thus, crowdfunding, where multiple low-dollar investors undertake a cost-benefit investment calculus that is quite different than that of risk-averse professional investors, has the capacity to fundamentally alter the sometimes grim underlying economic dynamics of capital formation for early stage life science endeavors. The dreaded “Valley of Death”¹⁸⁴ is easier to overcome with more time, patience, and less risk aversion.

IV. THE POTENTIAL FOR HEIGHTENED FRAUD AMONG HEALTH CARE ISSUERS.

A. Unique Risks for Small Cap Fraud Reminiscent of Penny Stock Scandals.

Many crowdfunding observers have warned of the heightened risk involved in low-dollar investments of unsophisticated parties in small businesses. The proposition has been described as “very risky” because small businesses are usually illiquid, more likely to fail, and “[I]osses due to

181. Kristi Heim, *Seattle Biotech Kineta Wins Over Heartfelt Funding*, SEATTLE TIMES, http://seattletimes.com/html/business/technology/2012042365_kineta07.html, (last updated June 7, 2010, 11:30am) (“The Iacocca Family Foundation is investing in Kineta to spur its efforts to develop the new drug, called ShK-186.”).

182. *Id.*

183. *Id.*

184. The “Valley of Death” refers to the capital-intensive nature of the initial stage of development for a startup company, which often includes extensive research and development expenses, prior to the transition to marketing its products. See Evan Mills and Jonathan Livingston, *Traversing The Valley Of Death*, FORBES (Nov. 17, 2005, 4:00 PM) http://www.forbes.com/2005/11/17/utilities-emerging-tech-cz_1117energy_programs.html. In biotechnology, these early stage expenses can make venture capitalists especially squeamish. See Deanna Pogoreic, *The Biotech Valley Of Death Has Become The Uncrossable Canyon*, MEDCITY NEWS (Sept. 21, 2012, 10:42 AM), <http://medcitynews.com/2012/09/the-biotech-valley-of-death-has-become-the-uncrossable-canyon-heres-one-innovative-approach-to-funding/>.

fraud and self-dealing are also much more likely.”¹⁸⁵ This is the lesson, it is argued, to be learned from the devastating outbreak of penny stock securities fraud during the 1980s.¹⁸⁶ Professor Bradford made this observation:

The abuses in the penny stock market in the 1980s “typify the securities fraud potential associated with direct marketing of microcap securities to individual investors.” The SEC’s experience when it eased the requirements of the Rule 504 small offering exemption in the 1990s also illustrates the potential fraud associated with unregulated small offerings. The changes freed Rule 504 offerings from federal mandatory disclosure requirements even when those offerings were not registered at the state level. In New York, which has no state registration requirement, “Rule 504 was being used by nefarious promoters to distribute up to \$1 million of securities in New York to a select favored group, followed promptly by boiler-room promotions that artificially drove up the secondary market price until such time as the initial purchasers could sell their shares at a handsome profit, leaving the gullible crop of new investors with suddenly deflated shares and irrecoverable losses.”¹⁸⁷

Thomas Lee Hazen, a professor of law at the University of North Carolina at Chapel Hill, expresses similar apprehension:

Exposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals to the perceived need to lower the disclosure barriers for small businesses and crowdfunding techniques. The Internet and social networking offer fertile ground for scammers. Scammers and securities fraudsters have for nearly a century found ways to adapt their scams to new technologies. Consider, for example, high-pressure boiler room sales operations or the promotion of fictitious or worthless securities to build Ponzi schemes. The Internet has also proven to be fertile ground for pump and dump schemes. Boiler room tactics have adapted to new technologies. For example, telephonic cold calling has been supplemented or superseded by spam emails. In other words, the benefits of technology necessarily offer scammers new opportunities. The Internet as a forum for crowdfunding thus does not by itself warrant a special exemption. It is to be expected that absent compliance with the crowdfunding exemption, the SEC will

185. Bradford, *Crowdfunding*, *supra* note 50, at 105-06.

186. *Id.*

187. *Id.*

vigorously pursue crowdfunding efforts without 1933 Act registration.¹⁸⁸

Senator Merkley warned in 2011:

[T]here are real risks of investment losses at a rate far beyond ordinary investing. Crowdfunding, if done without proper oversight, provides significant opportunity for fraud. Indeed, it was not too long ago that our financial regulators were doing daily battle with scam artists pitching huge returns on fraudulent schemes through small, unregistered securities.¹⁸⁹

B. Health Care Startups May Attract Bad Actors.

Some crowdfunding industry advocates downplay questions the JOBS Act presents regarding the potential for fraud.¹⁹⁰ This overlooks legitimate concerns that the hopeful cyber atmosphere developing in the crowdfunding community could combine with factors unique to health care to increase investor risk exposure. Issuers selling securities over the internet based on the promise of curing a rare disease, for instance, may attract a more vulnerable subset of unsophisticated investors who are more willing to part with their money for a good cause.¹⁹¹ The factors contributing to the success of donation-based crowdfunding endeavors in health care may exacerbate the risk of fraud in this sector for the equity-based crowdfunding model.

It is debatable whether the risk is higher for seniors, who are regarded as an already-at-risk population by regulators and consumer groups.¹⁹² Seniors

188. Hazen, *supra* note 28, at 1767-68 (2012).

189. 157 Cong. Rec. S8458 (Dec. 8, 2011) (statement of Sen. Merkley).

190. See, e.g., Jason Best & Sherwood Neiss, *Crowdfunding Delayed Again, Blasted As A "Top Danger"*, VENTUREBEAT (Aug. 22, 2012, 5:10 PM), <http://venturebeat.com/2012/08/22/crowdfunding-delayed-again-blasted-as-a-top-danger/> (claiming that “no cases of successful fraud have been discovered” in the United Kingdom and Australia since crowdfunding was legalized there, and that, in donation-based crowdfunding in the U.S., “fraud has been caught rapidly, and always before funds are distributed, as social network uncover the truth” thanks in part to “sophisticated algorithms to detect fraud”).

191. Chuck Jaffe, *JOBS Act Benefits Financial Criminals*, MARKETWATCH.COM, (Mar. 29, 2012), <http://www.marketwatch.com/story/jobs-act-benefits-financial-criminals-2012-03-29?pagenumber=2> (“The most promising startup in this new environment might be a boiler-room pump-and-dump operation. . . . investors who are too trusting in this environment will be the next legion of victims in financial frauds.”).

192. Edward Wyatt, *Senate Delays Vote on Start-Ups Bill for 2 Amendments*, N.Y. TIMES (Mar. 21, 2012), <http://www.nytimes.com/2012/03/22/business/senate-delays-vote-on-start-ups-bill-for-2-amendments.html> (“Some Democrats, who made up all the opposing votes to the bill, and consumer-advocacy organizations were less optimistic about the effect of a law that rolls back regulations on corporate financial disclosure.

are often the target of scam artists,¹⁹³ but their engagement with crowdfunding portals online through social media may be somewhat limited. However, web use among senior citizens is increasing,¹⁹⁴ and Internet-based fraud can now combine with investment schemes, another pre-existing vulnerability, to compound the concern.¹⁹⁵

V. INVESTMENT LIMITS POSE COMPLIANCE AND ENFORCEMENT PROBLEMS.

A. Investment Limits Are Among Investor Protection Measures.

Two key investor protection measures¹⁹⁶ were included in the CROWDFUND Act: (1) an individual limit on the amount an investor may invest in any single crowdfunding venture (“single-issuer investment limit”),¹⁹⁷ and (2) a requirement that intermediaries ensure that such investor not exceed his investment limits in the aggregate among all crowdfunding ventures (“aggregate investment limit”).¹⁹⁸

Pension funds, lobbying organizations like AARP and the chairwoman of the S.E.C. have also opposed the bill.”).

193. *Consumer Alert, Scammers Out to Profit on U.S. Supreme Court's Ruling on the Affordable Care Act*, FED. TRADE COMM'N (July 2012), <http://www.ftc.gov/bcp/edu/pubs/consumer/alerts/alt047.shtm>; *see also Consumer Alert, Health Care Scams Targeting Elderly*, OFFICE OF THE ATTORNEY GENERAL (July 13, 2012) (“Federal and state authorities believe scammers will increasingly exploit news about the recent health care ruling to target seniors, confuse and rip them off.”).

194. *Fraud Target: Senior Citizens*, FEDERAL BUREAU OF INVESTIGATION, <http://www.fbi.gov/scams-safety/fraud/seniors> (last visited Dec. 20, 2013) (“As web use among senior citizens increases, so does their chances to fall victim to Internet fraud.”); *Facebook and YouTube Help the Edlerly Keep Their Brains Active and Reduce Stress and Depression*, DAILY MAIL REPORTER (Apr. 13, 2011) (“Facebook and YouTube help the elderly keep their brains active and stave off memory loss, according to scientists. . . ‘Over the past few years the number of pensioners going online and using social networks has increased by 80 per cent,’[Marco Trabucchi, chairman of the Italian Association of Psychogeriatrics] added.”).

195. *Top 10 Scams Targeting Seniors*, NAT'L COUNCIL ON AGING, <http://www.ncoa.org/enhance-economic-security/economic-security-Initiative/savvy-saving-seniors/top-10-scams-targeting.html> (listing Healthcare/Medicare/Health Insurance Fraud, Internet Fraud, and Investment Schemes as three of the top ten scams targeting seniors),

196. While other measures exist, such as the issuer disclosure and investor education requirements, this Comment argues that the statutory investment limits constitute the real bright-line backstop designed to protect unwitting investors from squandering their money over the Internet.

197. The Securities Act of 1933 § 4(6)(B)(i)-(ii), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d(6)(B)(i)-(ii)).

198. JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. § 4A(a)(8), 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. § 77d-1(a)(8)).

Originally, Republicans in Congress drafted bills in the House which “failed to contain any meaningful investor protections” for crowdfunding.¹⁹⁹ These “bare bones” bills,²⁰⁰ one of which passed by a bipartisan and overwhelming majority in the House with the support of the White House,²⁰¹ would have allowed *any* individual to invest, and lose, up to \$10,000 or 10% of his income, whichever was less.²⁰² A \$10,000 total investment cap would have been inappropriately high.²⁰³ The version passing the House also stated that “an issuer or intermediary may rely on certifications as to annual income provided by the person to whom the securities are sold to verify the investor’s income.”²⁰⁴ As is outlined in Part V.B below, this standard prevailed with the SEC Staff in its Proposed Crowdfunding Rule, but at the time of the bill’s drafting, the Senate removed this self-verification language from the House version.²⁰⁵

199. Hazen, *supra* note 28 at 1750; Robb Mandelbaum, *Which Crowdfunding Bill Will It Be?* N.Y. TIMES, (Mar. 27, 2012), <http://boss.blogs.nytimes.com/2012/03/27/which-crowdfunding-bill-will-it-be/> (observing that “[o]pportunities to defraud unsuspecting investors . . . may be vast if the House version of the bill survives.”).

200. Hazen, *supra* note 28 at 1750 (2012).

201. Press Release, Office of the Press Secretary, The White House, The American Jobs Act (Sept. 8 2011), <http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview> (“The administration also supports establishing a “crowdfunding” exemption from SEC registration requirements for firms raising less than \$1 million (with individual investments limited to \$10,000 or 10% of investors’ annual income.)”).

202. Entrepreneur Access to Capital Act, H.R. 2930 112th Cong. § 2(a) (2011), (as amended and passed by the House, Nov. 3, 2011) (House lawmakers voting 407-17 to add a new exception, § 4(6), to the Securities Act of 1933, provided that “(B) the aggregate amount sold to any investor in reliance on this exemption within the previous 12-month period does not exceed the lesser of (i) \$10,000 . . . [or] “(ii) 10 percent of such investor’s income”), <http://www.gpo.gov/fdsys/pkg/BILLS-112hr2930eh/pdf/BILLS-112hr2930eh.pdf>; *see also* Jumpstart Our Business Startups Act, H.R. 3606 112th Cong. § 301 (2012) (as passed by House, Mar. 8, 2012); *see also* Mandelbaum, *supra* note 199 (“Under the terms of the House bill . . . [e]ach investor would be limited to \$10,000 or 10 percent of annual income, whichever is less.”).

203. Bradford, *Crowdfunding*, *supra* note 50, at 130 (“The \$10,000 individual limit in some of the proposals seems excessive; it is doubtful whether most investors could afford an annual loss of that magnitude.”).

204. The JOBS Act, H.R. 3606 112th Cong. § 301(b)(2012) (as amended and passed by the House, March 2012), <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eh/pdf/BILLS-112hr3606eh.pdf>; *see* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2(b)(2011) (as Introduced in House) (proposing to add §4A(c) to the Securities Act of 1933).

205. 158 CONG. REC. S1884 (Mar. 21, 2012) (proposing amendment to H.R. 3606, the Jumpstart Our Business Startups Act); *see also* 158 CONG. REC. S1806 (Mar. 19, 2012) (proposing SA 1884 ”striking title III” of H.R. 3606 and inserting new text).

The Senate sensibly responded by adopting a lower single-issuer investment limit,²⁰⁶ and by adding a provision requiring intermediaries to make efforts to ensure that investors not exceed these same investment limits on the aggregate among all crowdfunding ventures.²⁰⁷ As adopted, the CROWDFUND Act limits any individual investor with an annual income or net worth below \$100,000 to a maximum investment of the greater of \$2,000 per year or 5% of annual income or net worth.²⁰⁸ Investors with an income or net worth over \$100,000 could invest up to 10% of their annual income or net worth, up to a maximum of \$100,000.²⁰⁹ The Proposed Crowdfunding Rule resolves the ambiguity presented in the statutory language under circumstances where an investor's net worth is below \$100,000 but annual income is above \$100,000 (or vice versa).²¹⁰

For investors with an income or net worth above \$100,000, the investor is limited to an investment of 10 percent of her income or net worth over a 12-month period, not to exceed \$100,000.²¹¹ Because the above limits could subject an investor with a net worth above \$100,000 but an income of less than \$100,000 (or vice versa) to technically two investment limits, the SEC Staff resolved that the greater limit would apply.²¹² Thus, an investor with an annual income of \$150,000 but a net worth of \$60,000 would be able to invest up to \$15,000 (10% of his income) in crowdfunding ventures in a 12-month period. This has been referred to as the "single-issuer investment limit."²¹³ On the morning of the Commission vote on the proposed rule, SEC Commissioner Stein expressed concern about permitting the greater investment amount, commenting that "even with primary residences excluded from the calculation, I remain concerned that taking the 'greater than' approach may expose seniors or others to risks and losses they cannot afford."²¹⁴

206. Securities Act of 1933 § 4(6)(B)(i)-(ii), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (codified at 15 U.S.C. Section 77d(6)(B)(i)-(ii)).

207. Securities Act of 1933 § 4A(a)(8), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 316 (codified at 15 U.S.C. §77d(a)(8) (2012)).

208. *Id.*

209. *Id.*

210. 78 Fed Reg. at 66,433 ("If either annual income or net worth exceeds \$100,000, then a limit of 10 percent of annual income or net worth, whichever is greater, but not to exceed \$100,000, would apply.").

211. Securities Act of 1933 § 4A(a)(6)(B), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. §77d(6)(B)).

212. 78 Fed Reg. at 66,433.

213. Bradford, *Promise Unfulfilled*, *supra* note 17, at 200.

214. SEC Comm'r Kara Stein, Statement Regarding the Proposing Release on Crowdfunding (Oct. 23, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370540008723#.Ur4WeBZU1G4/>.

Indeed, these two provisions, the single-issuer investment limit and aggregate investment limits, now enshrined in the federal securities laws as 15 U.S.C. §§ 77d(a)(6)(B) and 77d-1(a)(8), respectively, deserve significantly more attention than the SEC gave them in its proposed rule.²¹⁵ For instance, although the limits are related, there is a key distinction between them and how they impact the exemption. “An investor’s violation of th[e] *aggregate limit* would affect the exemption differently than an investor’s violation of the *single-issuer limit*.”²¹⁶ Since the availability of a section 4(6) exemption is based on the condition that an issuer not sell shares to an investor in excess of the investor’s limit *for that issuer* (i.e. the single-issuer limit), if any one investor exceeds his investment threshold for that single issuer then the exemption is lost for that issuer.²¹⁷ However, the exemption is not conditioned on all investors staying below their overall aggregate limit, but only on the statutory mandate that an intermediary take such steps to ensure that investors not exceed that aggregate limit.²¹⁸ Thus, if an investor did in fact exceed his investment limits by having invested too much with multiple issuers, the exemption is not lost for all of those issuers, so long as the relevant intermediaries satisfied their burdens to ensure that the investor had not exceed his aggregate limits.²¹⁹

Thus, of particular regulatory concern is the intermediary burden to “ensure” compliance with the aggregate investment limit.²²⁰ Section 4A(a) of Title III states that intermediaries must “make such efforts as the Commission determines appropriate, by rule, to *ensure* that no investor in a 12-month period has purchased securities offered pursuant to section 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in section 4(6)(B).”²²¹ This places an affirmative duty on the funding portals/intermediaries to “ensure that no investor” exceeds the statutory limits on his annual crowdfunding investments, but it was unclear at the time of the statute’s passage precisely what would be expected of intermediaries

215. The Proposed Crowdfunding Rule is brief in its rationale discussing self-verification of investor income and aggregate investments, taking up less than a page of the Federal Register. 78 Fed. Reg. at 66,469-70.

216. Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 (emphasis added).

217. *Id.* (“If an issuer sells more to an investor than the single-issuer limit allows, the exemption would be lost; section 4(6)(B) conditions the exemption on the amount sold to the investor not exceeding the limit.”).

218. Securities Act of 1933 § 4A(a)(8), 126 Stat. 306, 316 (2012) (codified as 15 U.S.C. § 77d-1(a)(8)).

219. Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 (emphasis added).

220. *Id.* at 201-02.

221. Securities Act of 1933 § 4A(a)(8), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(a)(8)) (emphasis added).

to carry out this obligation.²²² The following two sections explore the Proposed Crowdfunding Rule's recommended resolution to this compliance issue, investor self-verification, and its advantages and disadvantages.

B. SEC Crowdfunding Rule Proposal Details Liability of Intermediaries and Their Duty to "Ensure" Investment Limits.

1. Intermediaries May Rely on Investors, and Issuers May Rely on Intermediaries.

Since the passage of the statute, legal experts and commenters have suspected that enforcing the aggregate investment limits would prove difficult.²²³ Section 4A(a) of the CROWDFUND Act requires intermediaries to "make such efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to section 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in in section 4(6)(B)."²²⁴ Of course, as already detailed, Section 4(6)(B) sets forth the single-issuer investment limits.²²⁵ Thus, since Section 4(6)(B)(i) limits the investments of individuals earning less than \$100,000 per year to the greater of \$2,000 or 5% of investor net worth or income,²²⁶ the aggregate investment limit found in Section 4A(a)(8) is identical to the single-issuer investment cap.

To enforce compliance with these two provisions, the Proposed Crowdfunding Rule allows intermediaries to rely on an investor's representations concerning his annual income, net worth, and his aggregate amount invested through other crowdfunding-exempt intermediaries.²²⁷ To this end, the SEC proposed "Regulation Crowdfunding," which would, in part, create 17 C.F.R. §§ 227.100(a)(2)²²⁸ & 227.303(b). Section 227.100(a)(2) memorializes in the Code of Federal Regulations the statutory

222. Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 ("It is unclear what the SEC will require intermediaries to do to enforce this aggregate limit.").

223. *See, e.g.*, 158 CONG. REC. S5476 (Jul. 26, 2012) (remarks by Sen. Merkley) ("Some have expressed concern about how to implement the aggregate amounts across platforms."); *see also* Hazen, *supra* note 28 (observing that aggregate investment limits "could be difficult to enforce if the investor uses multiple crowdfunding sites."); Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 ("It is unclear what the SEC will require intermediaries to do to enforce this aggregate limit.").

224. Securities Act of 1933 § 4A(a)(8), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. § 77d-1(a)(8)).

225. *See supra* notes 197 and 213 and accompanying text.

226. Securities Act of 1933 § 4(6)(B)(i), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d(a)(6)(B)(i)).

227. 78 Fed. Reg. at 66,470.

228. *Id.* at 66,551.

§ 4(a)(6) single-issuer investment limits, while § 227.303(b) implements § 4A(a)(8) of the Securities Act of 1933.

The SEC noted in Instruction 3 to paragraph §227.100(a)(2) that issuers may rely on the efforts of intermediaries:

An issuer offering and selling securities in reliance on Section 4(a)(6) . . . may rely on the efforts an intermediary is required to undertake pursuant to § 227.303(b) to ensure that the aggregate amount of securities purchased by an investor in offerings pursuant to Section 4(a)(6) of the Securities Act will not cause the investor to exceed the limit set forth in Section 4(a)(6) of the Securities Act and § 227.100(a)(2), provided that the issuer does not know that the investor had exceeded the investor limits or would exceed the investor limits as a result of purchasing securities in the issuer's offering.²²⁹

This presumably would allow an issuer to retain the crowdfunding exemption under circumstances where an investor in actuality exceeds his limits but where the intermediary complies with proposed § 227.303(b), unless the issuer otherwise knows that the investor is unqualified to make the investment. Section 227.303(b) is the key provision implementing the Staff's self-certification standard, because it requires only that an intermediary "have a reasonable basis for believing that the investor satisfies the investment limitations" established by § 4(a)(6)(B) of the 1933 Act, and that, crucially, the intermediary can establish such reasonable basis belief by relying on the investor's representations.²³⁰ These two provisions combined, then, allow for an issuer to rely on the assurances that its investors provide to the intermediary in order to retain the exemption, even if the investor misleads the intermediary and exceeds his income-based or aggregate investment limitations.

One reason the SEC Staff found persuasive in reaching its conclusion that a self-verification standard is the most appropriate is that, "it would be difficult for intermediaries to monitor or independently verify whether each investor remains within his or her investment limits for each particular offering in which he or she intends to participate."²³¹ The Staff pointed to three comment letters complaining about this issue.²³² One letter said that "unless the SEC offers some sort of very simple clearinghouse for tracking

229. *Id.* at 66,551.

230. *Id.* at 66,557.

231. *Id.* at 66,470.

232. *Id.* at 66,469 (citing Cera Technology Comment Letter, *infra* note 233; Crowdfunding Offerings Comment Letter, *infra* note 238; and Schwartz Comment Letter, *infra* note 234).

investors nationwide, I think a portal can't be expected to track investments made on other, competing portals."²³³ However, another source, University of Colorado Professor Schwartz's comment letter, described the CROWDFUND Act's annual investment cap as a bedrock statutory protection for crowdfunding investors,²³⁴ arguing that:

It may not be enough, for instance, for intermediaries to simply ask investors whether they have reached their annual limit and leave it at that, as crowdfunding investors might not remember or keep records of their past investments. Nor can intermediaries rely solely on their own internal records, as the cap is an aggregate one for all crowdfunding securities purchased on any platform and from any issuer. How exactly to regulate intermediaries' policing of the annual cap is a difficult and complex matter that deserves careful attention by the SEC. Modern information technology may make it possible to enforce the cap at very low cost, even across different crowdfunding platforms. But even if the cost of effectively enforcing this cap turns out to be a bit high, it is probably worth it, because the whole statutory scheme depends on it.²³⁵

Given these observations, it may come as a surprise to the Professor that the main takeaway the SEC drew from his comment letter was that, because "it will be difficult" for intermediaries to track investor activity with various other portals, a self-certification standard is therefore the best option.²³⁶ Indeed, he seemed to argue the opposite.²³⁷ The third source wrote: "For all the brokers and funding portals to know this [aggregate investment] information, the Commission would have to collect this data and maintain it, on a real-time basis, for electronic access and search by brokers and funding portals."²³⁸

233. Letter from Michael Mace, CEO of Cera Technology to SEC and Comment on SEC Regulatory Initiatives Under JOBS Act: Title III, at 2 (Apr. 13, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-10.pdf>.

234. Letter from Andrew A. Schwartz, Associate Professor of Law at University of Colorado, to SEC and Comment on Regulatory Initiatives Under JOBS Act: Title III (Jun. 13, 2013), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-240.pdf> (excerpting his own law review article as a response: *Keep it Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. 43 (2013)).

235. *Id.*

236. 78 Fed. Reg. at 66,469.

237. Schwartz, *Keep it Light*, *supra* note 234, at 59.

238. Letter from Marshall Neel, Esq., Co-Founder of Crowdfunding Offerings, Ltd., to SEC and Comment on Regulatory Initiatives Under JOBS Act: Title III, (May 11, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-60.htm>.

The SEC concedes that relying on a centralized database could “help provide an intermediary with a reasonable basis for a conclusion” that an investor is qualified, but notes that no such database currently exists.²³⁹ Instead, the Staff seems to envision a “check the box” system where intermediaries create the functionality on their websites prompting investors to disclose their annual income, net worth, and their total investments in other intermediary platforms over the past 12 months.²⁴⁰ Unless the intermediary had information within its control, like for instance, that particular investor’s investment levels in another issuer on the platform, the intermediary will have satisfied its statutory burden by relying on the assurances of investors.

2. Intermediaries May Be Liable for Fraud Committed by Issuers.

The SEC took a significant position on the issue of intermediary liability under the CROWDFUND Act that is worth noting. Section 4A(c)(3) of the Securities Act of 1933 now defines, for purposes of liability under Section 4A generally, an issuer as any “person who offers or sells the security in such offering.”²⁴¹ Section 4A(c)(1)(A) permits an investor to bring an action against “an issuer” to recover consideration paid for a crowdfunding-exempt security or for damages if the issuer make an untrue statement of material fact or omitted a material fact required in order to make the statements not misleading.²⁴² The SEC staff found that, on the basis of the definition found in section 4A(c)(3), “it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of this liability provision.”²⁴³ Thus, the SEC Staff seems to suggest that if a startup company provides an intermediary/funding portal with materially false offering documents and then disappears with investors’ money, then the investor could bring an action against the other “issuer” involved—the intermediary.²⁴⁴ The Staff hints that liability for making an untrue statement of material fact would be implicated only if the portal failed to conduct an adequate review of the offering documents to uncover the fraud, but it is unclear if the mere posting of fraudulent documents would alone implicate the liability section.

239. 78 Fed. Reg. at 66, 470.

240. *Id.*

241. Securities Act of 1933 §4A(c)(3), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 319 (2012) (codified at 15 U.S.C. § 77d-1(c)(3)).

242. Securities Act of 1933 §§4A(c)(1)(A) & 4A(c)(2)(A), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 318-19 (2012) (codified at 15 U.S.C. §§ 77d-1(c)(1)(A) & 77d-1(c)(2)(A)).

243. 78 Fed. Reg. at 66,499 (Nov. 5, 2013).

244. *Id.*

C. Self-Verification: Advantages and Disadvantages of Relying on Investor Assurances.

The Commission took a hands-off approach to both the single-issuer investment limits found in section 4(6) and the aggregate investment limits compelled by section 4A(a)(8), as it did in the August 2012 Proposed Rule lifting the general solicitation ban. The SEC proposes that issuers and intermediaries can depend on the voluntary disclosure by the investors of their income and net worth and aggregate investment levels.²⁴⁵ This result was likely a relief to intermediaries who may have feared the prospect of having to independently verify the total purchases of a given investor through other funding portals.²⁴⁶ However, since issuers are relying on the methods of intermediaries, who are in turn relying on the assurances of investors, it is worth considering whether this “trust me” structure satisfies the Congressional intent of the investment limitations, and whether the risks of self-certification are too high or uncertain.

1. Does Self-Certification Satisfy Congressional Intent?

A self-certification method to satisfy the aggregate investment levels, where an intermediary trusts the word of the investors regarding their investments with other funding portals, arguably does not capture the spirit of Congress’s inclusion of the word “ensure.”²⁴⁷ Senator Merkley outlined clearly that individual and aggregate caps serve as key investor protection measures in the CROWDFUND Act.²⁴⁸ He said in July 2012: “Without aggregate caps, someone could in theory max out a per-company investment in a single company and then repeat that bet ten, a hundred, or a thousand times, perhaps unintentionally wiping out their entire savings.”²⁴⁹ Sen. Merkley referred to the single-issuer investment limit as “an important investor protection” for low-income earners, and warned against adopting a “checking a box” method in order to “protect less sophisticated investors from opting into the higher limits accidentally or due to potentially misleading promptings from a less scrupulous intermediary.”²⁵⁰

245. 78 Fed. Reg. at 66,551 (proposing 17 C.F.R. 227.100).

246. *See, e.g.*, Crowdfunding Offerings Comment Letter, *supra* note 238 (noting the difficulty of crowdfunding portals to track the activity of investors using multiple intermediaries).

247. Securities Act of 1933 § 4A(a)(8), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 316 (2012) (codified at 15 U.S.C. § 77d-1(a)(8)).

248. 158 Cong. Record S5476 (Jul. 26, 2012).

249. *Id.*

250. *Id.*

In fact, statutory provisions that were part of the original House versions of the crowdfunding exemption allowing for an issuer or intermediary to rely on investor certifications as to annual income²⁵¹ were removed from the Senate versions. The House bills stated: “For purposes of section 4(6), an issuer or intermediary may rely on certifications as to annual income provided by the person to whom the securities are sold to verify the investor’s income.”²⁵² Since the House bill contained no aggregate caps,²⁵³ there was no corresponding language permitting an intermediary to rely on an investor’s assurances regarding crowdfunding investments through other portals.

On March 21, 2012, Majority Leader Senator Harry Reid (D-NV) agreed to allow an amendment to replace the House crowdfunding bill contained in the JOBS ACT, saying:

This amendment will ensure that watchdogs are in place to protect the small investors and their money from fraudulent companies and abuse of the system. People are lurking out there waiting for ways to cheat. I am sorry, but it is true. These are people who are either amoral or immoral, looking for opportunities to make money. . . . It is an important amendment, and it is so important to improving this bill.²⁵⁴

The next day, when the JOBS Act came to the floor of the U.S. Senate, Senators Merkley, Brown, and Bennet introduced Senate Amendment 1884²⁵⁵ to replace Congressman McHenry’s crowdfunding language,²⁵⁶ the latter of which allowed for self-verification. Sen. Merkley did not list the self-certification language as one of the seven key distinctions that he outlined between his amendment and the House bill.²⁵⁷ However, the Senator did note that the House version contained “no aggregate caps,” meaning that “a person could lose their entire life savings in one fell

251. The JOBS Act, H.R. 3606 112th Cong. § 301(b) (2012) (as amended and passed by the House in March 2012), at 31:24-32:3, available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eh/pdf/BILLS-112hr3606eh.pdf>; Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2(b) (2011) (as Introduced in House) (proposing to add §4A(c) to the Securities Act of 1933).

252. *Id.*

253. *See infra* notes 257-63 and accompanying text.

254. 158 CONG. REC. S1884 (Mar. 21, 2012).

255. Senate Amendment 1884, 112th Cong. (2012); *see also* 158 CONG. REC. S1884 (Mar. 21, 2012).

256. 158 CONG. REC. S1884 (Mar. 21, 2012) (proposing amendment to H.R. 3606, the Jumpstart Our Business Startups Act); *see also* 158 Cong. Rec. S1806 (Mar. 19, 2012) (proposing SA 1884’ strik[ing] title III” of H.R. 3606 and inserting new text).

257. 158 CONG. REC. S1886-S1888 (Mar. 21, 2012).

swoop.”²⁵⁸ He said the Senate version set aggregate caps “so we don’t end up with folks who are on public services because they were swindled out of everything they had.”²⁵⁹ The day of the vote, Sen. Merkley described the House bill as “a pathway to predatory scams” because of lack of issuer transparency and it “allows companies to hire people to pump the stocks.”²⁶⁰ Senate Amendment 1884 passed 64-35.²⁶¹ Thus, the House crowdfunding bill’s self-certification language was explicitly omitted in the final Senate bill that was signed into law.

Although the self-verification standard for annual income was not discussed at length on the Senate floor, Sen. Merkley certainly did not seem to contemplate self-verification as an option. In addition to discouraging a “check-the-box” approach to the single-issuer investment cap for those seeking to make larger investments, citing investor protection,²⁶² Sen. Merkley stated:

Some have expressed concern about how to implement the aggregate amounts across platforms. A data sharing regime is one way to do that, but the SEC might also consider whether to pair it with a presumption that ordinary investors that remain within an amount below the default aggregate, for example \$500, on any one platform are also presumed compliant across other unaffiliated platforms. This streamlining may be particularly useful for those seeking to make small investments and for those that want to engage in community-based crowdfunding.²⁶³

It seems fair to say that any sort of “data sharing regime” among the intermediaries resembles something more like a centralized database, or at the very least is clearly distinct from the permitting of investors to self-certify as the SEC staff has proposed. The Senator envisioned some degree of a heightened duty on behalf of the intermediaries, beyond the mere assurances of investors.

Further, consider the similarities between Title II and Title III of the JOBS Act. As stated previously, Title II of the JOBS Act requires issuers to “take reasonable steps to verify” that purchasers are accredited investors,²⁶⁴ while Title III requires that intermediaries “make such efforts as the Commission determines appropriate, by rule, to ensure” that investors do not exceed their

258. 158 CONG. REC S1887 (Mar. 21, 2012).

259. *Id.*

260. 158 CONG. REC. S1976 (Mar. 22, 2012) (introducing Senate Amendment 1884).

261. 158 CONG. REC S1976 (Mar. 22, 2012).

262. 158 Cong. Rec. S5476 (Jul. 26, 2012).

263. 158 Cong. Rec. S5476 (Jul. 26, 2012).

264. JOBS Act § 201(a)(1).

limits.²⁶⁵ The requirement that intermediaries “ensure” that aggregate investment limits are not exceeded is analogous to the burden on issuers taking advantage of the general solicitation rule to take reasonable steps to ensure that purchasers are accredited.²⁶⁶ One wonders why the SEC had not considered the statutory burdens—one on issuers to “verify” that purchasers are accredited for the sake of the new general solicitation exemption, and the other on intermediaries to “ensure” investor qualification for the crowdfunding exemption—to be essentially the same.

2. *Investor Risk.*

It is simple to overstate the worries of self-certification. After all, investors are their own best advocates, and are responsible for their own decisions with their money. However, at the very least the SEC should craft a rule that minimizes intermediary uncertainty and investor risk. The hands-off approach to intermediary enforcement is understandable, but it carries risks that the financial incentives of self-verification harms, if not erases, the intent of the investment limitations as a meaningful investor protection measure. The worry is that there could be a cascade of misrepresentations by investors, intentional or not, that could tarnish the marketplace with stories of low-income earners losing more than they should have had invested.

It seems that self-certification could carry with it a predictable unchecked chain of incentives that has produced undesirable market outcomes in similar contexts.²⁶⁷ Consider, for example, the role that the mortgage servicing industry played in the housing bubble precipitating the 2008-2009 financial crisis, where economic incentives and information gaps in the securitization market facilitated collusion among loan officers and fraud

265. JOBS Act §302(b) (codified as 15 U.S.C. § 77d-1(a)(8)).

266. See Sara Hanks, *JOBS Act Crowdfunding Provisions Await Clarification by SEC*, 44 SEC. REG. & L. REP. (BNA) 37, 1712 (Sept. 17, 2012) (positing that the SEC’s August 2012 general solicitation proposal may be indicative of SEC rulemaking on crowdfunding intermediary’s compliance with investment limits); but see Freeman White, *SEC Gives Hints on Equity Crowdfunding*, LAUNCHT BLOG (June 21, 2012), <http://www.launcht.com/blog/2012/06/21/sec-gives-hints-on-equity-crowdfunding/> (explaining that “the SEC was leaning towards the use of a central database for verifying aggregate annual investment amounts instead of taking the investor’s word for it” at a June 2012 rulemaking meeting).

267. See FIN. CRISIS INQUIRY COMM’N REPORT, NAT’L COMM’N ON THE CAUSES OF THE FIN. & ECON. CRISIS IN THE US, FIN. CRISIS INQUIRY COMM’N 161 (2011), <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [hereinafter FCIC REPORT] (describing “[l]ax or practically non-existent government oversight” in the housing mortgage servicing industry creating what criminologists label “‘crime-facilitative environments,’ where crime could thrive.”).

among homeowners.²⁶⁸ Here, optimistic crowdfunding investors may attempt to maximize their investment and expected return by misrepresenting their income and/or crowdfunding aggregate investment levels with other funding portals to a third party validator,²⁶⁹ just as unqualified aspiring homeowners did during the housing bubble.²⁷⁰ Meanwhile, intermediaries could insulate themselves from liability by arguing that they fulfilled their obligation by reasonably relying on third party validators, which presumably would earn fees for their services, to “ensure” that aggregate investor limits were being followed. Similarly, a lender (i.e. the third party validator) who originates a mortgage earns a commission for each sale but lacks a long-term stake in whether the mortgage is paid, “beyond the lender’s own business reputation,” and the firm packaging the mortgages into mortgage-backed securities (i.e. the intermediary) also lacks the financial stake of the purchaser (the issuer).²⁷¹ Everyone seems to win—the loan applicant gets a home, the crowdfunding investor a stake in the issuer’s company—but, if both were unqualified from the start, the result is a foreclosed home or a broke investor (and potentially lost crowdfunding exemption for the issuer, if the single-issuer limit is breached).²⁷²

3. Market Uncertainty.

Although self-verification is a more workable standard for intermediaries, it arguably comes at the cost of not only increased investor risk but also market uncertainty. For instance, some have argued that self-supplied income information could “be intentionally or unintentionally incorrect.”²⁷³ Could investors have a claim against intermediaries for not failing to “ensure” compliance with investment limit overall, even if the investor misrepresented his income or net worth? The SEC staff does not

268. *Id.* at 160-65.

269. Professor Bradford observed, when criticizing the original House Bill 2930 and its single issuer income-based investment standard, that “[i]nvestors who want to invest more would quickly learn to exaggerate their income.” Bradford, *Crowdfunding*, *supra* note 50, at 128.

270. FCIC REPORT, *supra* note 267, at 160 (citing the role of “a borrower’s lying or intentionally omitting information on a loan application” in rampant housing fraud).

271. FCIC REPORT, *supra* note 267, at 165 (giving example of economically destructive incentives, where “the lender who originated the mortgage for sale, earning a commission . . . had no long-term stake in whether the mortgage was paid, beyond the lender’s own business reputation. The securitizer who packaged mortgages into mortgage-backed securities, similarly, was less likely to retain a stake in those securities.”).

272. See *supra* notes 216-22 and accompanying text.

273. Bradford, *Promise Unfulfilled*, *supra* note 17, at Part III.c.ii.

forthrightly address the potential for investor misrepresentation in the Proposed Crowdfunding Rule,²⁷⁴ but stated that “[t]he intermediary could not rely on an investor’s representations if the intermediary had reason to question the reliability of the representation.”²⁷⁵ In other words, if an investor had already purchased Section 4(a)(6)-exempt crowdfunding securities through that intermediary, then it would not be reasonable for the intermediary to fail to track or otherwise ignore that amount purchased for purposes of other crowdfunding investments; the intermediaries are expected to reasonably track investor activity on their own internal systems.²⁷⁶ Regardless, courts and the Enforcement Division of the SEC is unlikely to be sympathetic to actions by investors against intermediaries for damages or rescission where the investors made misrepresentations. Analogous circumstances exist where investors have claimed to have been accredited at the time of transactions but subsequently disavowed those assurances in order to sue under the federal securities laws, and federal courts have been unsympathetic.²⁷⁷

Additionally, an issuer loses the crowdfunding exemption for the entire equity or debt offering in the event that an intermediary fails to adequately ensure that a lone investor stays within his aggregate investment limit. In that case, is there liability of the intermediary to the issuer?

It is unclear, but the chief concern is not necessarily the issue of liability for fraud, but rather that investor misrepresentations of their qualifications could pervade the business. Lack of adequate enforcement of investor qualifications could undermine the statute’s purpose by deteriorating investor confidence in small issuers. Some have noted that “a self-certified income standard is essentially the same as no standard at all,” and the same logic can be applied to aggregate investment levels.²⁷⁸

In any case, there is certainly the potential that the SEC Staff may reconsider its proposed rules in light of responses it receives throughout the comment period. As discussed above, the SEC originally had proposed a similarly hands-off approach to its first general solicitation proposal with respect to an investor’s status as an accredited investor.²⁷⁹ The usefulness of

274. 78 Fed. Reg. 66,470 (Nov. 5, 2013).

275. *Id.*

276. *Id.*

277. See 77 Fed. Reg. at 54,464 (citing *Wright v. Nat’l Warranty Co.*, 953 F.2d 256 (6th Cir. 1991), *Goodwin Props., LLC v. Acadia Group, Inc.*, 2001 U.S. Dist. LEXIS 9975 (D. Me. 2001), and *Faye L. Roth Revocable Trust v. UBS Painewebber Inc.*, 323 F. Supp. 2d 1279 (S.D. Fla. 2004)).

278. Bradford, *Crowdfunding*, *supra* note 50, at 128.

279. Sara Hanks, *Crowdcheck.com Memo, New Rule 506(c): General Solicitation in Regulation D Offerings*, (Sept. 5, 2012) (“The SEC declined to specify even a non-

a facts and circumstances approach was questioned by some securities law practitioners as an ambiguous standard and too vague to be effective,²⁸⁰ so the SEC responded with a non-exclusive list of verification methods in its final rule. Hopefully the Staff will respond to similar concerns of misrepresentations by crowdfunding investors in its final rule by suggesting that: the questions asked of investors by intermediaries about net worth, income, and aggregate investments be sufficiently detailed; that investor responses be accompanied by a sworn pledge of truthfulness; and that intermediaries disclose the potential for investor liability for untruthfulness (in, for instance, an administrative action by the SEC).

D. SEC Rejects Calls for a Centralized Database, Which Would Be Safest, But Potentially Cost-Prohibitive Option to Enforce Aggregate Investment Limit.

At the end of the day, the only way for an intermediary truly to “ensure” investor compliance would be to create a “central recordkeeping system” that all intermediaries could share.²⁸¹ Such a centralized system could ideally be created and staffed by either the Commission itself²⁸² or some (sole) third party verification service with the blessing of the SEC. This was the path recommended by the Massachusetts state-level securities regulator²⁸³ and others. Before the passage of the JOBS Act, one commenter outlined his vision for an SEC-run crowdfunding regime this way:

Under such a setup, the SEC would own the central database of crowdfunding offerers, investors, and transactions. The SEC would therefore have the identities, financial account info, digital signatures, etc. of all market participants, and would initiate all movements of funds through its own system. This would grant the SEC full knowledge of and control over this market, allowing it to program red flags, investigate abuses, and shut down transactions

exclusive list of such methods” that the SEC would consider “reasonable steps to verify” that the purchasers are accredited).

280. See *supra* notes 129-30 and accompanying text.

281. Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 (stating that the “only totally effective solution would be to establish a central recordkeeping system”).

282. See Letter from Paul Spinrad to SEC and Comment on Regulatory Initiative Under JOBS Act: Title III (Jul. 26, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-114.pdf>.

283. Letter from William Francis Galvin, Sec’y of Commonwealth of Mass. to SEC and Comment on SEC Regulatory Initiatives Under JOBS Act: Title III, at 3 (Aug. 8, 2012), http://www.sec.state.ma.us/sct/sctpdf/JOBS_Act0001.pdf (stating that “the Commission should require intermediaries to share information about who has invested in these offerings and the amounts of their investments”).

and users as needed, without approvals or cooperation from any other entity.²⁸⁴

A centralized system would benefit intermediaries because a single, integrated database could contain both verifiable proof of investor income and net worth (i.e. federal tax returns) and investor investment status with other intermediaries in a form accessible to the multitude²⁸⁵ of intermediaries.²⁸⁶ In 2012, there were indications that the SEC was “leaning towards the use of a central database for verifying aggregate annual investment amounts instead of taking the investor’s word for it,”²⁸⁷ so perhaps the debate is still alive among the Staff.

Given the other options, a non-profit, government-run clearinghouse could eliminate the risks of various market participants competing for customers and information. The existence of various unknown verification services across the spectrum of crowdfunding²⁸⁸ could serve as a deterrent to investor participation because of a lack of trust. From an investor’s perspective, if all that is known about an issuer is that which can only be read in cyberspace on an intermediary’s social media platform, providing a new third party sensitive documents demonstrating proof of income or about their crowdfunding investments may pose a risk outweighing potential investment returns. The Commission should aim to make crowdfunding easier and less risky for investors, not riskier and unpredictable. A central database, for income verification at least, may be more efficient anyway. If federal tax

284. Letter from Paul Spinrad, to SEC and Comment on Rulemaking File No. 4-605 (Aug. 26, 2010), <http://www.sec.gov/comments/4-605/4605-16.pdf>; see also Jenny Kassan, Sustainable Econ. L. Cent., *Request for Rulemaking to Exempt Securities Offerings up to \$100 from Registration Under Section 5 of The Securities Act of 1933* (Jul. 1, 2010), <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>.

285. See *id.* at 2 (discussing the likelihood of a “large number of crowdfunding offerings” creating enforcement difficulties for regulators).

286. See Bradford, *Promise Unfulfilled*, *supra* note 17, at 202 (calling “central recordkeeping system” for intermediaries to rely on for §4A(a) aggregate limit compliance as “[t]he only totally effective solution”).

287. White, *supra* note 266 (suggesting “the SEC was leaning towards the use of a central database for verifying aggregate annual investment amounts instead of taking the investor’s word for it” at a June 2012 rulemaking meeting).

288. Consider that CFIRA has already expressed concern over the tracking of as-yet unknown intermediaries, recommending that FINRA create a system similar to the existing regime for investment brokers. See Letter from CFIRA to Marcia E. Smith, Office of the Corporate Sec’y, FINRA, FINRA Regulatory Notice 12-34: Request for Comment on Proposed Regulation of Crowdfunding Activities, at 1-2 (Aug. 30, 2012), <http://www.scribd.com/doc/105135058/Crowdfunding-Intermediary-Regulatory-Advocates-Comments-Notice-12-34> (recommending that FINRA create “a registered Portal-Check to list all intermediaries registered to conduct Crowdfunding similar to the Broker-Check system currently maintained by FINRA.”).

returns were used to verify income levels, for example, a federal agency is likely to have an easier time partnering with the Internal Revenue Service to retrieve such information.²⁸⁹ Consider, for instance, that the Department of Education partners with the Internal Revenue Service to offer the upload of federal tax information to streamline the Free Application for Federal Student Aid (“FAFSA”).²⁹⁰

It may be true, however, that a centralized database—at least a taxpayer-funded one—is likely cost prohibitive.²⁹¹ Consider that, when asked whether it possessed a list of accredited investors in the U.S., the SEC told the Government Accountability Office (“GAO”) that it did not because, in the words of the GAO, “maintaining such a list would be impractical because there are so many accredited investors and could raise privacy concerns.”²⁹² Further, even if “maintaining such a list were possible, the costs of doing so would likely outweigh the benefits.”²⁹³ Surely a list of retail investors would be much larger than one of accredited investors, suggesting that there is little hope for a centralized database to track investor information.

Regardless, as stated above, the SEC Staff has thus far been unwilling to publicly entertain the idea of creating an in-house system, and has rejected calls for creating such a centralized database.²⁹⁴ The SEC Staff said in the Proposed Crowdfunding Rule that “[w]hile the proposed rules would permit reliance on a centralized database providing information about particular

289. White, *supra* note 266 (suggesting “the SEC was leaning towards the use of a central database for verifying aggregate annual investment amounts instead of taking the investor’s word for it” at a June 2012 rulemaking meeting). Freeman White is CEO of Launcht, a crowd-funding website for “socially responsible startups.”)

290. FED. STUDENT AID, OFFICE OF THE U.S. DEP’T OF EDUC., search results for “IRS,” *IRS Data Retrieval Tool*, <http://www.fafsa.ed.gov/help/irshlp9.htm> (stating that “[t]he IRS Data Retrieval Tool allows students and parents to access the IRS tax return information . . . and transfer the data directly into their FAFSA from the IRS Web site”).

291. See Bradford, *Promise Unfulfilled*, 40 SEC. REG. L. J. at 202 (2012) (describing “a central recordkeeping system” for aggregate investment enforcement as cost prohibitive).

292. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-640, ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED 17 (July 2013), available at <http://www.gao.gov/assets/660/655963.pdf>.

293. *Id.*

294. 78 Fed. Reg. 66,470 (Nov. 5, 2013) (citing “Spinrad Letter 1” which argued that “[a] centralized database approach would make such aggregate checks very simple. . . . [S]uch an approach could be self-funding . . . through the SEC’s taking a small fee from each transaction.”); see also Letter from Paul Spinrad to SEC and Comment on Regulatory Initiative Under JOBS Act: Title III (Jul. 26, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobtitleiii-114.pdf>.

investors, if it could help provide an intermediary with a reasonable basis for a conclusion, we understand that none currently exists.”²⁹⁵

Perhaps another option for a central database would be a quasi-governmental organization funded in part by fees from intermediaries and issuers. It is true that this would only further burden the nascent industry with higher costs, so perhaps some sort of public-private partnership or coordination with FINRA could be a viable option.

E. Multiple Verification Services Could Introduce Economic Competitiveness, But May Complicate Information-Sharing.

Under another scenario, numerous third-party participants could compete in a sub-market for the business of intermediaries seeking investment information for potential crowdfunding investors. This could decrease costs in the short-term. However, competitors would need to cooperate and share very specific investment volume information (i.e. which investor is using which intermediary website and how much each person is investing).²⁹⁶ When similar asymmetric relationships exist in a market, a single market player often emerges. Consider economic developments in other Internet-based markets where there existed a structural vacuum, such as PayPal’s role in the development of eBay or Verisign’s role in domain name registration.

Verisign, for instance, is the world’s largest Internet domain name registry service and is also a publicly-traded company working in a partnership with the federal government.²⁹⁷ Verisign retains the right to control and charge fees for the ubiquitous “.com” website suffix under an agreement with the Department of Commerce.²⁹⁸ The advantages are that the government hands over technical implementation to the market, while the integrity of the registration process is streamlined and functional. Verisign is required by federal regulators to obtain permission before raising prices to cover its security and stability costs.²⁹⁹ However, an antitrust case involving Verisign

295. 78 Fed. Reg. at 66,470 (Nov. 5, 2013).

296. At least one state securities regulator has acknowledged the necessity of information-sharing. Galvin Comment Letter to SEC, *supra* note 283, at 3 (recommending that intermediaries be *required* to share information in order to “allow other intermediaries to check compliance with this [crowdfunding investment] limit.”).

297. Fitzgerald, Drew, Chaudhuri, Saabira, *VeriSign Limited in Raising Domain Prices*, WALL ST. J. (Nov. 30, 2012), <http://online.wsj.com/article/SB10001424127887324705104578151071332357666.html>.

298. *Id.*

299. Ted Bridis, *VeriSign Is Allowed to Keep ‘.Com’ but Gives Up ‘.Org.’* WALL ST. J. (Mar. 1, 2001), <http://online.wsj.com/article/SB986229873245168534.html> (full text available also at Proquest) (stating that “[u]nder a 1999 agreement with the Clinton administration, VeriSign retained long-term management control over the Internet’s

outlines the disadvantages of this model: that overwhelming market dominance by a single player could lead to the undesirable externalities of monopolies, such as anti-competitiveness and monopolization charges by customers, even with the approval of a federal executive agency.³⁰⁰ In any case, this is only to suggest that perhaps the SEC should not be so dismissive of some sort of other model before accepting a self-certification standard for crowdfunding.

F. Summary of Investment Limit Enforcement Options.

Four basic options for enforcing the aggregate investment limits were proposed above: (1) investor self-certification, which is the current standard in the Proposed Crowdfunding Rule, (2) a government-conceived, taxpayer-funded centralized database, (3) a private solution with multiple players, or (4) a private solution with one dominant provider with the blessing of the Commission. Ideally, an SEC-run centralized database containing investor limits and income levels would solve the regulatory problem. Intermediaries would be protected from risk by having the security of relying on the same clearing house, and the verification process itself could be more efficient if investors were entrusting their information with one party, the SEC, in a partnership with the IRS to retrieve federal tax returns of investors. The obvious impediment is the cost to taxpayers.

VII. CONCLUSION.

Case law and SEC rulemakings have demonstrated time and again since the passage of the Securities Act of 1933 that the primary goal of federal

master list of addresses only if it split the company by May 10. That condition was fueled by concerns by regulators and rivals that VeriSign held unfair advantage by managing the master directory and also selling Web addresses.”).

300. *See, e.g.,* Coal. for ICANN Transparency, Inc. v. VeriSign, Inc., 611 F.3d 495 (9th Cir. 2010). The 9th Circuit, in 2010, found that an organization of website owners, the Coalition for ICANN Transparency, Inc. (“CFIT”), challenging the pricing and implementation of the Internet domain name system (“DNS”) by the Internet Corporation for Assigned Names and Numbers (“ICANN”) and Verisign, Inc. had stated a valid claim of conspiracy in restraint of trade and attempted monopolization under §§ 1 and 2 of the Sherman Act. ICANN is the non-profit oversight body which oversees the DNS on behalf of the Department of Commerce. *Id.* at 499. In overturning a lower court’s Fed. Rules Civ. Proc. Rule 12(b)(6) dismissal for failure to state a claim, Circuit Judge Schroeder stated that CFIT had validly alleged “that VeriSign’s predatory litigation activity was aimed at coercing ICANN to perpetuate VeriSign’s role as exclusive regulator of the .com domain name market by awarding VeriSign the 2006 .com Agreement without any competitive bidding, and by agreeing to the terms that favored VeriSign.” *Id.* at 506.

securities laws has been investor protection. Congress and the Commission have struggled over the years to balance reasonable access to the financial markets and capital formation with this vital need to protect unsophisticated investors from fraud. Congress articulated laudable goals with its passage of the CROWDFUND Act: an alternative source of capital formation for entrepreneurs and increased access to the equity markets for ordinary Americans. The President downplayed “laws that are eight decades old,” which he said prevent ordinary Americans from participating in capital markets, calling the bill a “game changer.”³⁰¹

The Comment has mapped out how there are useful small issuer exemptions already on the books, but that crowdfunding does have the potential to transform the manner in which startups form capital, especially in the biotechnology industry, chiefly because of the personal stake investors will have in seeking out medical solutions through social media. However, crowdfunding efforts by life sciences and biotechnology startups may produce a toxic combination of bad actors and particularly hopeful unsophisticated investors. So, did Congress and the SEC ignore decades of evidence that fraud pervades the securities marketplace, and will the new crowdfunding exemption usher in a new wave of boiler room schemes and pump-and-dump penny stock scandals?

Perhaps. Congress specifically enacted measures to mitigate against these very real risks. The potential extension of liability to intermediaries for materially false representations made by underlying issuers may serve as a meaningful backstop against fraud. However, such liability still presumes that investors possess the means, willingness, and capacity to file civil actions against scam artists. The chief investor protection measures in the CROWDFUND Act are the single-issuer and aggregate investment limits. As Senator Merkley articulated, these are the provisions that prevent an elderly American on a fixed income from losing his whole life savings by “investing” in some charlatan’s false Internet promise.

According to the Proposed Crowdfunding Rule, the SEC staff considers self-certification by investors to be the most realistic option for compliance with these requirements, in part because it would be just too difficult for various intermediaries to track aggregate investment activity on multiple other funding portals nationwide. However, mere reliance on investors undermines the Congressional intent of the aggregate investment limits. The versions of the JOBS Act that contained self-verification, which originated in the House of Representatives, were rejected by the Senate. The SEC thus far has failed to note this fact. Reliance on investors may come at a high

301. President Obama’s Remarks on Signing the JOBS Act, 2012 DAILY COMP. PRES. DOC. 1-2 (Apr. 5, 2012), 2012 U.S.C.C.A.N. S4.

cost of market uncertainty and increased risk that crowdfunding as a capital formation strategy may not come to fruition. Both of these possibilities should be taken more seriously.

A third-party verification regime overseen by the SEC or FINRA would provide the safest protection from fraudsters and reduce risks of liability for funding portals. It could also provide a stable and trusted set of custodians for investors' financial information. The SEC's Proposed Crowdfunding Rule fails to adequately contemplate the establishment of a centralized clearing house to verify investor qualifications or even some sort of role for third party verification services. The lack of imagination and discussion in the proposed rule release is not surprising, given that the SEC staff is likely eagerly awaiting critical feedback from the crowdfunding and investing communities to incorporate more data and further develop the final rule.

However, the fact remains that self-verification will likely result in inadequate compliance with the statutory limits. Self-certification does not align with the Congressional intent behind the statutory limits, and is likely to behave as essentially a non-standard. This may dash the hopes that young biotechnology startups have for equity crowdfunding as a meaningful capital formation tool moving forward. Entrepreneurs, funding portals, and potential crowdfunding investors should request that the SEC explain more fully how unfeasible it would be to, at minimum, require that intermediaries verify investor income or net worth when investors try to invest above a certain threshold. Further, absent establishing its own central database, creating one at FINRA, or developing a registration system for third party verification services, the SEC should at least require intermediaries to share aggregate investment information with each other in order to facilitate meaningful compliance with intermediaries' statutory mandate to "ensure" aggregate limits.³⁰²

302. Like, for instance, in the same manner in which Secretary Galvin advocates that intermediaries should be "required" to share information. Galvin Comment Letter to SEC, *supra* note 283 (recommending that intermediaries be required to share information).