

3-1-2015

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### Recommended Citation

Sharon Yamen and Yoel Goldfeder, *Equity Crowdfunding—A Wolf in Sheep's Clothing: The implications of crowdfunding legislation under the JOBS Act*, 11 *BYU Int'l L. & Mgmt. R.* 41 (2015).

Available at: <https://digitalcommons.law.byu.edu/ilmr/vol11/iss1/4>

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EQUITY CROWDFUNDING—A WOLF IN SHEEP’S  
CLOTHING:  
THE IMPLICATIONS OF CROWDFUNDING LEGISLATION  
UNDER THE JOBS ACT

Sharon Yamen\*  
Yoel Goldfeder<sup>†</sup>

I. INTRODUCTION

We all want our own slice of Americana, some variation of the American Dream<sup>1</sup> with our own house with a white picket fence, two children, an SUV in the driveway, economic freedom, and the ability to invest in a company from the ground up because we believe in it. But at what cost does this dream come, especially to the middle class?<sup>2</sup> The near crash of the banking system in 2008 happened, in part, because of the ramifications of this dream. As a country, we are still reeling from the aftermath of the economic crisis of 2008. Congress is now attempting to give back that slice of Americana by loosening investment regulations previously kept under tight control by the Securities and Exchange Commission (SEC).<sup>3</sup>

The Jumpstart Our Business Startups (JOBS) Act allows the middle class to invest in emerging growth businesses<sup>4</sup> through crowdfunding<sup>5</sup>

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Special thanks to our research assistant, Meredith Morey, whose contributions made this possible.

<sup>1</sup> See *American Dream*, DICTIONARY.COM, <http://dictionary.reference.com/browse/american+dream> (last visited Mar. 3, 2014) (“A phrase connoting hope for prosperity and happiness, symbolized particularly by having a house of one’s own. Possibly applied at first to the hopes of immigrants, the phrase now applies to all except the very rich and suggests a confident hope that one’s children’s economic and social condition will be better than one’s own”).

<sup>2</sup> There is no hard and fast definition to put to the “middle class,” so many have determined that the middle class is the term to describe the average American: the ones who consistently work and who believe that they are a part of the middle class. See Dan Horn, *Middle class a matter of income, attitude, USA*, TODAY (Apr. 14, 2013), <http://www.usatoday.com/story/money/business/2013/04/14/middle-class-hard-define/2080565/>.

<sup>3</sup> This is a governmental organization whose mission is to protect investors, maintain a fair and efficient market, and to facilitate the formation of new capital. See *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 4, 2014).

<sup>4</sup> See *Jumpstart Our Business Startups Act Frequently Asked Questions*, SECURITIES AND EXCHANGE COMMISSION (Apr. – Sept. 2012), <http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm> (last visited Mar. 4, 2014) (Defining an “emerging growth company” as “an issuer with ‘total annual gross revenues’ of less than \$1 billion during its most recently completed fiscal year”).

markets. Congress passed the law in hopes of stimulating the economy.<sup>6</sup> But is this the answer to our economic problems? While it is true that the JOBS Act opens the door to potentially lucrative ventures for the unaccredited middle class, it also opens a Pandora's Box of unknown dangers. Consequently, this new access may end up creating another economic bubble that will eventually burst, leaving the middle class devastated once again.

This article examines why Congress's efforts to encourage crowdfunding will likely do more harm than good and has violated the principles behind years of SEC investor protection. Section II looks at how financial regulations were created after various U.S. financial crises and also looks at the impact of opening finance opportunities to the average American. Section III addresses the difficulties small companies have had raising capital due to past legislation. Section IV discusses the nature of the JOBS Act and provides a description of the current rules regarding crowdfunding. Section V brings up the discrepancy between how the government has acted towards privatizing social security before the JOBS Act and after the JOBS Act was passed. Section VI considers several recent fraud cases in connection with multi-level marketing schemes and their similarities to crowdfunding. Finally, section VII concludes by looking at the implications of the JOBS Act and the pitfalls of crowdfunding.

## II. FINANCIAL REGULATION

Starting with the Great Depression, the U.S. Congress has enacted a new piece of reactionary legislation immediately following every major market crisis. And the SEC has spent increasingly more time and resources addressing each new piece of legislation passed by Congress; in spite of which, however, each subsequent crises were likely, at least partially, caused by Congress previously passing legislation without a full and complete understanding of the potential ramifications.

The Great Depression arose out of the Stock Market Crash of 1929,<sup>7</sup> where silver-tongued brokers convinced investors to purchase securities from companies issuing stocks "based on promises of large profits but with little disclosure of relevant information about the company."<sup>8</sup>

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<sup>5</sup> Crowdfunding is the idea in which a project or venture is funded by raising a sum from a large number of people, typically via the Internet. See Oxford University Press, *Crowdfunding*, OXFORD ENGLISH DICTIONARY, [http://www.oxforddictionaries.com/us/definition/american\\_english/crowdfunding](http://www.oxforddictionaries.com/us/definition/american_english/crowdfunding) (last visited Mar. 5, 2014).

<sup>6</sup> See THE WHITE HOUSE OFFICE OF THE PRESS SECRETARY, FACT SHEET: THE AMERICAN JOBS ACT (2011).

<sup>7</sup> See Deepa Sarkar, *Securities Law History*, CORNELL UNIVERSITY LAW SCHOOL, [http://www.law.cornell.edu/wex/securities\\_law\\_history](http://www.law.cornell.edu/wex/securities_law_history) (last visited Mar. 3, 2014) [hereinafter *Securities Law History*].

<sup>8</sup> *Id.* ("In many cases, the promises made by companies and brokers had little or no substantive basis, or were wholly fraudulent.").

Thousands of investors bought stocks with hopes of huge returns.<sup>9</sup> “The market was in a state of speculative frenzy that ended on October 29, 1929, when the market crashed as panicky investors sold off their investments en masse.”<sup>10</sup>

To ward off these “speculative frenzies” in the future, Congress enacted the Securities Act of 1933 (the Securities Act)<sup>11</sup> and the Securities Exchange Act of 1934 (the Exchange Act).<sup>12</sup> Both laws were written to ensure that investors would have sufficient access to both the information regarding securities and the companies putting forth those securities. These laws required a large amount of disclosure from the companies wishing to sell securities that limited the ability of many unqualified investors in the middle class to risk their capital. In short, Congress intended to ensure that public investors had complete access to balanced and honest information before investing money into a company.<sup>13</sup>

In recent history, we have seen the actions of management with respect to the burst of the Dot Com bubble, which was soon followed by the Enron,<sup>14</sup> Tyco International,<sup>15</sup> and Worldcom<sup>16</sup> debacles, in giving us the Sarbanes-Oxley Act of 2002.<sup>17</sup> The burst of the Dot Com bubble

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> The two objectives of the Securities Act of 1933 are (1) to require investors to “receive financial and other significant information concerning the securities being offered for public sale”, and (2) to “prohibit deceit, misrepresentations, and other fraud in the sale of securities.” See *The Laws That Govern the Securities Industry*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml> (last visited Mar. 5, 2014).

<sup>12</sup> This act created mandatory disclosure processes that forced companies to make public information that investors would find pertinent to making investment decisions. It also provides for “direct regulation of the markets on which securities are sold (the securities (stock) exchanges) and the participants in those markets (industry associations, brokers, and issuers).” See Deepa Sarkar, *Securities Exchange Act of 1934*, CORNELL UNIVERSITY LAW SCHOOL, [www.law.cornell.edu/wex/securities\\_exchange\\_act\\_of\\_1934](http://www.law.cornell.edu/wex/securities_exchange_act_of_1934) (last visited Mar. 5, 2014).

<sup>13</sup> See *Securities Law History*, *supra* note 8. Despite this initial concern with the protection of investors, in the proposed rules of JOBS, the SEC stated, in regards to ensuring companies acting in crowdfunding are legitimate, “We are not proposing to establish specific procedures for intermediaries to follow to reduce the risk of fraud beyond conducting the prescribed background and securities enforcement regulatory history checks.” See Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 70741, 78 Fed. Reg. 214 (Oct. 23, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf> [hereinafter Crowdfunding Securities Act Release No. 33-9470].

<sup>14</sup> Enron used deceptive accounting practices to hide serious debts the company had accrued, making it seem more successful than it actually was. See *Enron Scandal at-a-glance*, BBC NEWS (Aug. 22, 2002), <http://news.bbc.co.uk/2/hi/business/1780075.stm>.

<sup>15</sup> Tyco International CEO Dennis Kozlowski, SFO Mark Swartz, and general counsel Mark Belnick were convicted of stealing at least \$600 million from their company. *Three Tyco Execs Indicted for Fraud*, CNN.COM/BUSINESS (Sept. 12, 2002), <http://edition.cnn.com/2002/BUSINESS/asia/09/12/us.tyco>.

<sup>16</sup> From 1999 to 2002 WorldCom’s accountants used shady accounting tactics to hide the fact that its financial condition was declining, instead showing financial growth and profitability in order to increase the value of WorldCom’s stock. See *World-Class Scandal at WorldCom*, CBSNEWS (June 26, 2002), <http://www.cbsnews.com/news/world-class-scandal-at-worldcom/>.

<sup>17</sup> See Michael Lewis, *What is the JOBS Act (Jumpstart Our Business Startups)*, MONEY CRASHERS, <http://www.moneycrashers.com/jobs-act-business-startups/> (last visited Mar. 5, 2014) [hereinafter Lewis, *What is the JOBS Act*] (“Sarbanes-Oxley, enacted into law on July 29, 2002 following the failure of Enron, established strict standards for the accounting and reporting of

occurred, in part, because of lax oversight and loopholes in reporting requirements.<sup>18</sup> The Sarbanes-Oxley legislation was passed with the intent to require more fiscal accountability of companies and their boards of directors.<sup>19</sup> However, this legislation unintentionally dramatically increased the costs for publically traded companies and made it more difficult and expensive for those companies to raise investment capital.<sup>20</sup>

More recently, the Housing Crash, the financial crisis that threatened the collapse of both our banking system and our economy as we knew it, which led to Dodd-Frank.<sup>21</sup> The burst of the housing bubble triggered the Housing Crash,<sup>22</sup> where values of securities tied to U.S. real estate pricing plummeted<sup>23</sup> because of the overvaluation of bundled sub-prime mortgages.<sup>24</sup> Credit and loans of various types (mortgage “subprime” and adjustable rate (ARM), credit card, and auto) were easy to obtain and consumers created an unprecedented amount of debt.<sup>25</sup> Unable to keep on top of the mortgage payments, consumer default rates on these loans rose exponentially, resulting in evictions, foreclosures, and prolonged unemployment. This triggered defaults on collateralized debt obligation (CDO)<sup>26</sup> and instruments created to bundle these subprime mortgages, heavily impacting the banks holding these instruments.

The U.S. Senate’s Levin-Coburn Report<sup>27</sup> asserted that the crisis was the result of “[h]igh risk lending, regulatory failures, inflated credit

financial results of public companies, and extended criminal and civil liability to boards of directors, management, and public accounting firms for failure to comply with the regulations”).

<sup>18</sup> See *Public Law 107-204, 107th Congress* (July 30, 2002), <http://www.sec.gov/about/laws/soa2002.pdf>.

<sup>19</sup> *Id.* As stated in the opening sentence of the Act, its purpose is “To protect investors by improving the accuracy and reliability of corporate disclosures.”

<sup>20</sup> See Ken Tysiac, *SOX compliance costs rise for many companies, report finds*, J. OF ACCOUNTANCY (May 15, 2013), <http://www.journalofaccountancy.com/News/20137990>.

<sup>21</sup> See *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/dodd-frank.shtml>. Dodd-Frank was signed into law on July 21, 2010, by President Barak Obama. One of its components was the creation of the Consumer Financial Protection Bureau, which is responsible for preventing predatory practices by mortgage and credit card companies. See also *Dodd-Frank Wall Street Reform and Consumer Protection Act*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp> (last visited Mar. 5, 2014).

<sup>22</sup> See Justin Lahart, *Egg Cracks Differ in Housing, Financing Shells*, WALL ST. J. (Dec. 24, 2007), <http://online.wsj.com/article/SB119845906460548071.html>.

<sup>23</sup> Financial innovation such as Mortgage-backed securities (MBS) and collateralized debt obligations (CDO), given safe ratings by the credit rating agencies, enabled investors to invest in the U.S. housing market. See *World Economic Outlook (WEO): Crisis and Recovery*, INTERNATIONAL MONETARY FUND (Apr. 2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/exesum.pdf>.

<sup>24</sup> See Bob Ivry, *Paulson Seeks Mortgage Value That Eluded Bear, Lehman (Update 1)*, BLOOMBERG (Sept. 24, 2008), [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGT\\_xTYzbbQE](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGT_xTYzbbQE).

<sup>25</sup> See Chairman Ben S. Bernanke, *Four Questions About the Financial Crisis*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Apr. 14, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm>.

<sup>26</sup> A financial product that puts together different flow-generating assets and repackages them into tranches that can then be sold to investors. See *Collateralized Debt Obligation-CDO*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/cdo.asp> (last visited Mar. 3, 2014).

<sup>27</sup> This report is based on a two-year, bipartisan investigation by Senator Carl Levin, D-Mich., and Senator Tom Coburn M.D., R-Okla., on their inquiry into the key causes of the 2008 financial crisis. See Staff of S. Comm. On Homeland Security and Governmental Affairs, Subcomm. On

ratings, and Wall Street firms engaging in massive conflicts of interest.”<sup>28</sup> Subpoenaed documents from these financial firms revealed how these firms deliberately took advantage of the clients and investors who came to them for help. The documents also showed how these financial firms assigned AAA ratings<sup>29</sup> to securities that should have been labeled as high risk, and how regulators turned a blind eye to what was going on instead of ensuring a safe and trustworthy market for American citizens.<sup>30</sup>

Not only did the Senate release a report on the cause of the 2008 crisis, the Financial Crisis Inquiry Commission<sup>31</sup> also delivered its own determination of what caused the economy to collapse. In its report, the Commission found that the crisis was avoidable and that there were five main causes of the crisis.<sup>32</sup> First, there was failure in financial regulation, including the Federal Reserve’s failure to stop toxic mortgages.<sup>33</sup> Second, there was a breakdown in corporate governance. Too many financial firms acted recklessly and took unjustifiable risks, despite the regulations enacted pursuant to the Sarbanes-Oxley Act.<sup>34</sup> Third, there was an explosive mix of excessive borrowing and risk by both households and Wall Street.<sup>35</sup> Fourth, there was a lack of preparation for the crisis and a lack of understanding by key policy makers of the financial system they were supposed to oversee.<sup>36</sup> Finally, there were systemic breakdowns in accountability and ethics at every level of finance throughout the country.<sup>37</sup>

Many of the policies enacted under the Clinton administration contributed to the housing bubble and its subsequent burst.<sup>38</sup> In an

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Investigations, 112th Cong., *Wall Street and The Financial Crisis: Anatomy of a Financial Collapse* (Comm. Print 2011) (Apr. 13, 2011), available at [http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI\\_WallStreetCrisis\\_041311.pdf](http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf).

<sup>28</sup> Press Release, *U.S. Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis*, SENATE (Apr. 13, 2011), <http://www.levin.senate.gov/newsroom/press/release/us-senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis>.

<sup>29</sup> AAA rating is the highest rating possible for bonds of an issuer. Such a rating means that the issuer has exceptional creditworthiness and should be able to meet its financial commitments very easily. These bonds are considered to have little risk of default. See AAA, INVESTOPEDIA, <http://www.investopedia.com/terms/a/aaa.asp> (last visited Mar. 3, 2014).

<sup>30</sup> See Press Release, *U.S. Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis*, *supra* note 28.

<sup>31</sup> This commission was created in May 2009 for the sole purpose of discovering the cause of the Great Recession. See Rock Center for Corporate Governance, *About the Financial Crisis Inquiry Commission (FCIC) At Stanford Law School*, STANFORD LAW SCHOOL, <https://fcic.law.stanford.edu/about> (last visited Mar. 3, 2014).

<sup>32</sup> See *Financial Crisis Inquiry Commission Releases Report on the Causes of the Financial Crisis*, FINANCIAL CRISIS INQUIRY COMMISSION (Jan. 27, 2011), [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-news/2011-0127-fcic-releases-report.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-0127-fcic-releases-report.pdf).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> See *25 People to Blame for the Financial Crisis*, TIME.COM, [http://content.time.com/time/specials/packages/article/0,28804,1877351\\_1877350\\_1877322,00.html](http://content.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877322,00.html) (last visited Mar. 19, 2014).

attempt to fulfill the American Dream, the administration went to incredible lengths to increase the national homeownership rate. The goal of what was named “The National Homeownership Strategy” was to design financing strategies that would creatively reduce the two major financial barriers to homeownership. The first barrier was the lack of available cash required to make a down payment and the second was insufficient available income to make monthly mortgage payments.<sup>39</sup> These “creative strategies” turned into a system that promoted paper-thin down payments and pushed for ways to encourage lenders to offer mortgage loans to first-time buyers with unstable finances and incomes. In hindsight, “it’s clear now that the erosion of lending standards pushed prices up by increasing demand and later led to waves of defaults by people” who would have rightly been denied in previous years.<sup>40</sup>

While many are not familiar with the causes of the crisis, nearly everyone knows about the catastrophic consequences. The subprime mortgage defaults caused a stock market collapse in the fall of 2007, leading to a loss of trillions of dollars in shareholder value.<sup>41</sup> Additionally, several prominent banks failed and the federal government was forced to provide over a trillion dollars to many companies in distress.<sup>42</sup> The Dow Jones Industrial Average in 2011 revealed that the U.S. was still experiencing the repercussions in the stock market<sup>43</sup> Six years after the infamous Great Recession<sup>44</sup> Americans are still feeling the

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<sup>39</sup> See U.S. Dep’t of Hous. and Urban Dev., *The National Homeownership Strategy: Partners in the American Dream*, CONFOUNDED INTEREST BLOG (May 2, 1995), available at <http://confoundedinterest.files.wordpress.com/2013/01/nhsdream2.pdf>.

<sup>40</sup> Bill Clinton’s drive to increase homeownership went way too far. Peter Coy, *Bill Clinton’s Drive to Increase Homeownership Went Way Too Far*, BLOOMBERG BUSINESSWEEK (Feb. 27, 2008), [http://www.businessweek.com/the\\_thread/hotproperty/archives/2008/02/clintons\\_drive.html](http://www.businessweek.com/the_thread/hotproperty/archives/2008/02/clintons_drive.html).

<sup>41</sup> By September 2008, average U.S. housing had declined by over twenty percent from their mid-2006 peak. See *A Helping Hand to Homeowners*, THE ECONOMIST (Oct. 23, 2008), available at <http://www.economist.com/node/12470547> (chart in article). As prices declined, borrowers with ARMs could not refinance to avoid the higher payments associated with rising interest rates and began to default. During 2007, lenders began foreclosure proceedings on nearly 1.3 million properties, a seventy-nine percent increase over 2006. See Press Release, *U.S. Foreclosure Activity Increases 75 Percent in 2007*, REALTYTRAC (Jan. 30, 2008), <http://www.realtytrac.com/content/press-releases/us-foreclosure-activity-increases-75-percent-in-2007-3604?acct=64847>. This increased to 2.3 million in 2008, an eighty-one percent increase compared to 2007. See Press Release, *Foreclosure Activity Increases 81 Percent in 2008*, REALTYTRAC (Jan. 15, 2009), <http://www.realtytrac.com/content/press-releases/foreclosure-activity-increases-81-percent-in-2008-4551?acct=64847>. By August 2008, 9.2 percent of all U.S. mortgages outstanding were either delinquent or in foreclosure. See Press Release, *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey*, MORTGAGE BANKERS ASSOCIATION (Sept. 5, 2008), <http://www.mbaa.org/NewsandMedia/PressCenter/64769.htm>. By September 2009, this had increased to 14.4 percent. See Press Release, *Delinquencies Continue to Climb in Latest MBA National Delinquency Survey*, MORTGAGE BANKERS ASSOCIATION (Nov. 19, 2009), <http://www.mbaa.org/NewsandMedia/PressCenter/71112.htm>.

<sup>42</sup> *Financial Crimes Report to the Public*, FEDERAL BUREAU OF INVESTIGATION (Oct. 1, 2009–Sept. 30, 2011), available at <http://www.fbi.gov/stats-services/publications/financial-crimes-report-2010-2011>.

<sup>43</sup> See *id.* The recession’s impact on the U.S. Stock Market continued for years, dropping the Stock Market from “12,681 on July 22, 2011 to 10,655 on October 3, 2011.”

<sup>44</sup> This was the shrinking of the global economy from December 2007 until June 2009 and was so severe that it was compared to the Great Depression of the 1930s. See *The Great Recession*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/great-recession.asp> (last visited Mar. 5, 2014).

after-effects. Understandably, the Great Recession has been called the “worst financial crisis since the Great Depression.”<sup>45</sup>

To protect investors from the fraudulent schemes that brought on these economic disasters, with Dodd-Frank the SEC focused on transparency between the companies and hedge funds that invest in them. It did this by requiring the funds to make their investments less risky.<sup>46</sup> While this made it more difficult for companies to raise capital, the SEC felt the safety of the investors was more important than the convenience of the new businesses.

Aspects of the JOBS Act deviate from the historical policies and goals of the SEC: to provide investor fraud protection and to safeguard the integrity of the stock markets.<sup>47</sup> It is such a departure from the SEC’s previous policies and beliefs that it may have caused the SEC to delay the announcement of proposed rules to implement the crowdfunding aspects of the JOBS Act legislation. Two years after the Act was initially passed the final rules have yet to be implemented.

In response to the fiscal crisis caused by the mortgage debacle, the current administration, like other administrations before it, appears to be leading the markets down a dangerous path. While the ideal of a home for every family was laudable, the deregulation policies used to attain it were the start of a slippery slope that resulted in the subsequent banking crisis. Similarly, the Obama administration intended that its passage of the JOBS Act would be a catalyst to jumpstart the economy. However, the unintended consequences and potential ramifications to the middle class highlight how this policy may be setting the stage for consequences similar to those of the 2008 market crash.

### III. RAISING CAPITAL AND ISSUING SECURITIES

The JOBS Act was created to help companies raise capital. One of the biggest challenges to any business, be it a startup or a mature company, is raising enough capital to finance operations, growth, or expansion of the business.<sup>48</sup> Most startup companies receive their initial funding from the savings and investment of the founders of the business. However, this initial seed funding is often supplemented with additional capital before the business’s operations are self-sustaining. Even for those businesses with sufficient revenue, additional financing may be necessary to fund growth and expansion or to maintain a reserve for unexpected events.

Typically, a company raises capital through the offer and sale of its securities to investors. Both the federal and state governments have laws

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<sup>46</sup> See *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/dodd-frank.shtml> (last visited Sept. 30, 2014).

<sup>47</sup> See *Id.*

<sup>48</sup> See *Id.*

that govern the means by which a company can offer and sell its securities. The goal of these regulations is to balance the need of the company to raise funds for its business against the need to protect investors from potential loss of their savings.<sup>49</sup> If a company chooses to raise capital in this way, it will generally have to follow the SEC process of public offering and registration.

#### A. Public Offering and the Registration Process

As a general rule, under both federal and state securities laws, a company may sell securities to investors only if the securities are registered pursuant to a registration statement prepared and filed in accordance with the Securities Act of 1933<sup>50</sup> unless the sale meets an exception to the registration requirements.<sup>51</sup> The purpose of the registration process is to provide investors with enough information to make informed investment decisions.<sup>52</sup> Once a company's securities are registered, shareholders have a platform to liquidate their investment in the public markets. However, as will be shown, the filing of a registration statement with the SEC can be time consuming and costly.

The following is a brief summary of some of the information the SEC requires in a registration statement:

1. A brief overview of the business of the company and the key aspects of the securities being offered to investors<sup>53</sup>;
2. A detailed discussion of the risks that may affect the business operations of the company, the company's industry, the market for the company's securities, and what impact such risks may have on the company<sup>54</sup>;
3. A description of pending legal proceedings or proceedings being contemplated by a governmental authority, including the name of the court, the date the proceeding began, the parties involved, a description of the facts, and the relief sought<sup>55</sup>;
4. A discussion of the company's financial condition, any changes in financial condition, and results of operations for each of the last two fiscal years (or such shorter period as the company has been in business). This discussion should address the past and future financial condition and results of operation of the company, with particular emphasis on future prospects. The discussion should also address any qualitative and quantitative

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<sup>49</sup> See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 4, 2014).

<sup>50</sup> See 15 U.S.C. § 77e (2012).

<sup>51</sup> See 15 U.S.C. § 77d (2012).

<sup>52</sup> See SECURITIES AND EXCHANGE COMMISSION, *supra* note 49.

<sup>53</sup> 17 C.F.R. §§ 229.10, 229.202 (2013).

<sup>54</sup> 17 C.F.R. § 229.503 (2013).

<sup>55</sup> 17 C.F.R. § 229.103 (2013).

factors necessary to an understanding and evaluation of the company's financial condition<sup>56</sup>; and

5. An audited balance sheet, audited statements of income, cash flows, and changes in stockholders' equity.<sup>57</sup>

Once prepared and filed, the registration statement is filed with the SEC and goes through an extensive review process. The SEC can take up to 30 days for its initial review. The SEC will then give the company comments regarding which of the disclosures may require clarification and correction or what additional information is required in the registration statement. The SEC may occasionally inform a company that its registration statement will not be reviewed or will only receive a "limited" review. This generally does not happen unless the company is already reporting and the SEC has recently reviewed the company's filings.

Once the SEC provides the company with comments, the company must then respond to each of the comments with an explanation, file a response, and file an amended registration statement with the SEC. Once the amendment is filed, the SEC can make additional comments, seek further clarification, correction or additional information, or tell the company that it is satisfied. The SEC will keep issuing comments until the staff is satisfied with the company's disclosures in the registration statement. Once the SEC is satisfied, the company can ask that the registration statement be declared effective.

The foregoing preparation and review process for a registration as noted can be time-consuming and expensive. Typically, companies only go through the time and expense of the registration process if they intend to publicly trade their securities. Most small companies and businesses, while they have a need for capital, have no interest in being publicly listed and traded due to the time and expense involved. Accordingly, federal regulations have always had various exemptions so companies can raise smaller amounts of financing without the need for the full-registration process, such as intrastate offerings<sup>58</sup> and foreign offerings.<sup>59</sup> The most commonly utilized exemptions that we will examine are Section 4(2) of the 1933 Securities Act and the safe harbors afforded by Regulation D, which have also been modified pursuant to the JOBS Act.

#### B. Section 4(2): Private Offering Exemption

Section 4(2) of the Securities Act is deemed a "private offering exemption"<sup>60</sup> and provides the basic exemption for a company to offer its securities to investors in "transactions by an issuer not involving any

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<sup>56</sup> 17 C.F.R. § 229.303 (2013).

<sup>57</sup> *Id.*

<sup>58</sup> See 15 U.S.C. § 77c(a)(11).

<sup>59</sup> See 17 C.F.R. §§ 230.901-230.905 and Preliminary Notes.

<sup>60</sup> See U.S. Securities and Exchange Commission Release No. 33-4552 (Nov. 6, 1962).

public offering.”<sup>61</sup> If a transaction is considered a public offering, a company is required to go through the time and expense of preparing and filing a registration statement, such as a Form S-1, in connection with the offering. When it comes to large institutional investors, it is relatively easy to have a transaction that would meet the requirements for an exemption provided by Section 4(2). This is because a single institutional investor may be capable of providing a corporation with all of the financing it requires, which would not be considered a “public offering.” The problem many smaller companies face is that they may not have access to these institutional investors and therefore may need to obtain financing from multiple small investors.

The SEC has had difficulty defining a private offering that would not require the protections afforded by the registration process. The SEC provided the first real guidance in a letter by its general counsel published in a 1935 release.<sup>62</sup> It identified the following factors that should be considered when determining whether an offering is private and qualifies for an exemption under Section 4(2):

1. The number of offerees. The focus is not necessarily on the number of actual investors, but in the number of individuals the securities were offered to and their relationship to each other and the company<sup>63</sup>;
2. The number of shares being offered and size of the offering. The issuance of more shares indicates an intent to create a public market for the securities<sup>64</sup>; and
3. The method of conducting the offering. For example, whether the transaction negotiated individually or if there was advertising involved.<sup>65</sup>

This guidance stood until 1953, when the Supreme Court shifted the focus of the analysis and determination of a private offering. In *Securities and Exchange Commission v. Ralston Purina Co.*,<sup>66</sup> the SEC sought to enjoin an unregistered offering of stock by Ralston Purina to its employees. This offering was made to an estimated 500 employees located throughout the U.S. with various job titles and salary levels. For the first time, the U.S. Supreme Court looked at the protection of investors and determined that the securities registration process was designed to protect investors by providing disclosure of information. Therefore, the Court determined, “the applicability of Section 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An exemption should be for those who are shown

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<sup>61</sup> See 17 C.F.R. § 230.152.

<sup>62</sup> See Securities Act Release No. 33-285, 11 Fed. Reg. 10952 (Jan. 24, 1935).

<sup>63</sup> See *Id.*

<sup>64</sup> See *Id.*

<sup>65</sup> See *Id.*

<sup>66</sup> SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

to be *able to fend for themselves* in a transaction.”<sup>67</sup> This decision by the court moved the analysis of an offering away from a simple numeric focus to a required analysis of the qualifications of the offerees, their level of sophistication, and their access to information.

In a series of cases in the 1970s, the Fifth Circuit examined and refined the analysis provided by the Court in *Ralston*.<sup>68</sup> From this evolution emerged the interplay and focus on the following two factors:

1. The sophistication of the offerees. There is less of a concern when dealing with sophisticated investors because they are not viewed as requiring the protections afforded in registered public offerings and can properly ascertain the risk of their investment; and
2. The offerees’ access to information regarding the company normally disclosed by registration. Courts will often consider the information to which the investor had access with respect to the company that allowed for an evaluation of the offering.

Notwithstanding the various criteria provided by the courts, this exemption did not provide any concrete rules, and it remained difficult for small businesses to raise capital without going through the registration process. The SEC, in response to the various cases and congressional demands to ease the burden on small issuers, attempted to replace the criteria of the courts with a coherent set of guidelines by adopting Regulation D.

### C. Regulation D

Regulation D sets forth rules that provide a “safe harbor” exemption,<sup>69</sup> which allows companies to sell restricted securities to private investors, and therefore will not be considered a public offering, so long as certain conditions are met. Regulation D also establishes three exemptions from the registration requirements of the Securities Act under Rules 504,<sup>70</sup> 505,<sup>71</sup> and 506.<sup>72</sup> These three exemptions are only

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<sup>67</sup> *Id.* at 125 (emphasis added).

<sup>68</sup> See *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977) (finding an investor with a related, engineering degree, a net worth greater than a million dollars, and holdings in about 26 oil and gas properties purchasing a special participant interest in a limited partnership in an oil drilling operation to be a sophisticated investor who did not need the protections afforded by registration); *SEC v. Cont’l Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972) (finding an offering to thirty-eight prospective investors who were given information about the company, but did not provide all information available in a registration); *Hill York Corp. v. Am. Int’l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971) (finding an offering to sophisticated businessmen and attorneys with no prior relationship to the company a non-private offering since there was not a sufficient relationship to the issuer).

<sup>69</sup> See U.S. SEC Rule 506 of Regulation D available at <http://www.sec.gov/answers/rule506.htm> [hereinafter Rule 506].

<sup>70</sup> See U.S. SEC Rule 504 of Regulation D available at <http://www.sec.gov/answers/rule504.htm> [hereinafter Rule 504]. Rule 504 provides an exemption for certain offers and sales not exceeding an aggregate of \$1,000,000, in accordance with State law.

available to the company and not to its affiliates or others for resale of the company's securities.

In order to avail itself to the Regulation D exemptions, a company must meet the following general conditions:

1. **Integration.** All sales that are part of the same Regulation D offering must be integrated. The integration doctrine is intended to prevent a company from improperly avoiding registration by artificially dividing a single offering into multiple offerings. The exemption from registration appears to apply to the individual parts of the offering even though an exemption would not be available for the entire offering. Generally, all offers and sales that take place within six months of a Regulation D offering will not be deemed to be integrated with the offering so long as there are no offers and sales of the same securities within either of these six-month periods.<sup>73</sup>
2. **Information Requirement.** If a company sells securities under Rule 504 or only to accredited investors, then Regulation D does not mandate any specific disclosure. However, if securities are sold under Rule 505 or 506 to any non-accredited investors, then a company must meet certain disclosure requirements. The type of information to be furnished to prospective investors varies depending on the size of the offering and the nature of the company's business.<sup>74</sup>
3. **No Representations Other Than Those in the Financing Documents.** No representations contrary to the information set forth in the financing documents should be made, whether oral or written, by any person in connection with the potential transaction. If at any time any of the information or representations set forth in the financing documents are, or become, inaccurate, in any respect, the company should consult with their legal counsel to determine whether such changes justify supplementing the financing documents to allow investors to make an informed investment decision.<sup>75</sup>
4. **Investment Purpose; Limitation on Resale.**<sup>76</sup> Any securities sold must be purchased only for investment purposes and not for

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<sup>71</sup> See U.S. SEC Rule 505 of Regulation D available at <http://www.sec.gov/answers/rule505.htm> [hereinafter Rule 505]. Rule 505 provides an exemption from certain offers and sales not exceeding an aggregate of \$5,000,000, provided such offers and sales are made to no more than 35 investors, whether they are accredited or non-accredited investors.

<sup>72</sup> See U.S. SEC Rule 506, *supra* note 58. This rule exempts offers and sales to no more than 35 non-accredited investors or an unlimited number of accredited investors. Each purchaser who is a non-accredited investor, either alone or with his purchaser representative, is required to have such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment, or the company reasonably believes immediately prior to making any sale that such purchaser satisfies this description.

<sup>73</sup> 17 C.F.R. § 230.502(a) (2013).

<sup>74</sup> *Id.* § 230.502(b).

<sup>75</sup> See *id.* § 230.502.

<sup>76</sup> *Id.* § 230.502(d).

purposes of redistribution or transfer. Investors must be made aware that the securities being purchased have not been registered and, therefore, cannot be resold unless they are registered or an exemption from registration is available. To satisfy this requirement, the company is required to exercise reasonable care, which may be demonstrated by the following:

- (a) A reasonable inquiry to determine if the purchaser is acquiring the securities for himself or herself or for other persons;
- (b) A written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act and, therefore, cannot be resold unless they are registered under the Securities Act or unless an exemption from registration is available; and
- (c) A placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Securities Act and setting forth or referring to the restrictions on transferability and sale of the securities.

An accredited investor is either an individual with substantial financial means or a certain institution or company.<sup>77</sup> Generally, the SEC will consider a person, institution, or company to be an accredited investor if the person, institution, or company falls within any of the following categories at the time of the sale of the securities to that person, institution, or company:

1. A bank, insurance company, registered investment company, business development company, or small business investment company;
2. An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
3. A charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. A director, executive officer, or general partner of the company selling the securities;
5. A business in which all the equity owners are accredited investors;
6. A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of

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<sup>77</sup> 17 C.F.R. § 230.501(a) (2013). *See also* U.S. SEC, *Accredited Investors*, <http://www.sec.gov/answers/accred.htm> (last visited Mar. 19, 2014).

- the purchase, excluding the value of the primary residence of such person;
7. A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
  8. A trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.<sup>78</sup>

There is no limitation on the number of accredited investors who may invest in a company under federal law. However, to qualify for an exemption under State securities laws, the number of accredited investors may be limited.

Previously, no form of general solicitation, advertising, or distribution of information regarding the offering was permitted.<sup>79</sup> Put simply, any potential transaction could not be promoted by newspaper or magazine articles or notices, widespread mailings, television or radio broadcasts, or seminars. Information could only be conveyed to prospective investors by furnishing them with a copy of the financing documentation, which would be prepared by legal counsel and would be numbered. An individual would maintain a record of who has been provided such documentation. However, the SEC in accordance with the JOBS Act recently modified this. Under these recent modifications,<sup>80</sup> issuers may use general solicitation and advertising to offer securities, provided that the issuer takes reasonable steps to verify that all purchasers are “accredited investors.”<sup>81</sup>

As a result of the restrictive nature of these requirements, many have felt that numerous startups are kept from the market. These companies cannot afford the costs of filing, including hiring legal counsel, auditors, accountants, and many other professionals. In an effort to take some of the financial pressures off of these companies, Congress enacted the JOBS Act.<sup>82</sup>

#### IV. THE JOBS ACT - CROWDFUNDING

A turning point in startup history occurred on April 5, 2012, when President Barack Obama signed H.R. 3506, the JOBS Act, into law.<sup>83</sup> The JOBS Act was designed to lessen the restrictions and cost burdens associated with new and emerging-growth companies, to help those companies stimulate investment, grow their business, and create private

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<sup>78</sup> U.S. SEC, *supra* note 65.

<sup>79</sup> 17 C.F.R. § 230.502(c).

<sup>80</sup> 17 C.F.R. § 230.506(c) (2013).

<sup>81</sup> 17 C.F.R. §§ 230, 239, 242 (2013).

<sup>82</sup> See Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>83</sup> See U.S. SEC, *Jumpstart Our Business Startups (JOBS) Act*, available at <http://www.sec.gov/spotlight/jobs-act.shtml> (last visited Oct. 5, 2014).

sector jobs for Americans.<sup>84</sup> Simply put, its purpose is to “put more people back to work and put more money in the pockets of working Americans,” and to “do so without adding a dime to the deficit.”<sup>85</sup>

The JOBS Act has five key components:

1. Implementing tax cuts to help the United States’ small businesses hire and grow.<sup>86</sup>
2. Getting workers back on the job while rebuilding and modernizing America.
3. Creating pathways back to work for Americans looking for jobs.
4. Putting more money in the pockets of every American worker and family.
5. Remaining fully-funded as part of the President’s long-term deficit reduction plan.<sup>87</sup>

Consequently, the JOBS Act is intended to provide startups and small companies with access to a wider variety of investment capital than was previously available to them.<sup>88</sup> It reduces the “overly restrictive” requirements of security investing underneath the Exchange Act<sup>89</sup> and provides the chance for businesses with little capital available to them to access the crowdfunding market.<sup>90</sup> This allows businesses to work and put money back into the market. The JOBS Act effectively created an exemption to the Sarbanes-Oxley, Dodd Franck Acts, as well as the regulatory requirements created after the various financial crises of the 20<sup>th</sup> and 21<sup>st</sup> centuries.<sup>91</sup> Essentially, Congress created this Act to give a broader group of Americans, mainly the middle class, a wider selection of startups and small businesses in which to invest their money. Congress hoped this would result in diversifying the economy and strengthening personal nest eggs upon which Americans can draw for retirement.

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<sup>84</sup> See Lewis, *What is the JOBS Act*, *supra* note 18.

<sup>85</sup> Office of the Press Secretary, *Fact Sheet and Overview*, THE WHITE HOUSE (Sept. 8, 2011), <http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview>.

<sup>86</sup> This component is where the article will focus.

<sup>87</sup> Office of the Press Secretary, *Fact Sheet and Overview*, THE WHITE HOUSE (Sept. 8, 2011), <http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview>.

<sup>88</sup> See Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>89</sup> This act created mandatory disclosure processes that forced companies to make public information that investors would find pertinent to making investment decisions. It also provided for direct regulation of the markets on which securities are sold (the securities stock exchanges) and the participants in those markets (industry associations, brokers, and issuers). See Deepa Sarkar, *supra* note 13.

<sup>90</sup> Young adults are most likely to see new crowdfunding projects due to the fact it mainly occurs on the Internet and those funding projects will advertise via social media. In 2011, fifty-five percent of Facebook’s U.S. users were between 18 and 34. See Ken Burbary, *Facebook Demographics Revisited – 2011 Statistics*, SOCIAL MEDIA TODAY (Mar. 7, 2011), <http://ucsocialmediacourse.pbworks.com/f/Facebook%20Demographics%20Revisited%20%E2%80%93%202011%20Statistics.pdf>.

<sup>91</sup> *The Laws That Govern the Securities Industry*, SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml#jobs2012> (last visited March 4, 2014).

Congress utilized this bill to push the idea that every American can take part in making the dreams of other Americans a reality.<sup>92</sup> The law requires companies to disclose basic financial information and provides consumers with basic protections. This would happen in concurrence with streamlining the process for companies to put themselves into web portal sites where they can present their business ventures for waiting investors.<sup>93</sup> These portals would then become neutral broker-dealers<sup>94</sup> that simply provide a place for these new companies to go. However, the portals do not offer advice to those looking to invest. The idea was to make both creating a business and finding business ideas in which to invest easy and accommodating for both entrepreneurs and investors.<sup>95</sup>

For those unfamiliar with the term, crowdfunding can be defined as utilizing the communication capabilities of the Internet to raise small amounts of capital from a great number of people to fund a venture. Traditionally, in crowdfunding's short history, it has been of a charitable nature, but has more recently included business ventures.<sup>96</sup> One of the most prominent crowdfunding ventures of 2013 was producer Rob Thomas's campaign to raise \$2 million to turn the popular TV series *Veronica Mars* into a movie. Fans were so thrilled that it took only a few hours to reach the goal eventually raising a grand total of \$5.7 million.<sup>97</sup> Based on many campaigns' success, crowdfunding seems like an excellent way for people without access to large sums of money to create products that others can get excited about. It allows businesses to move forward with the assistance of an empowered middle class given the opportunity to aid projects they like rather than waiting on a relatively small group of accredited investors to push projects forward.

Companies that provide the public with access to various campaigns have been thriving with the hype of crowdfunding. As more and more campaigns begin, companies have started specializing in specific types of campaigns.<sup>98</sup> One such company is Kickstarter,<sup>99</sup> the website that enabled the *Veronica Mars* movie to become a reality. This is just one

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<sup>92</sup> See 158 Cong. Rec. 46, S1824-02 (daily ed. Mar. 20, 2012), available at <http://www.gpo.gov/fdsys/pkg/CREC-2012-03-20/pdf/CREC-2012-03-20-pt1-PgS1824-2.pdf>.

<sup>93</sup> See *id.*

<sup>94</sup> A firm in the business of buying and selling securities that sometimes acts as a broker, sometimes as a dealer, depending on the situation. See e.g. *About Broker-Dealers and Broker Dealer Agents*, CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT, [http://www.dbo.ca.gov/Licensees/Broker-Dealer\\_and\\_SEC\\_Investment\\_Advisers/about.asp](http://www.dbo.ca.gov/Licensees/Broker-Dealer_and_SEC_Investment_Advisers/about.asp) (last visited Sept. 16, 2014).

<sup>95</sup> See 158 Cong. Rec. 46, S1824-02 (daily ed. Mar. 20, 2012), available at <http://www.gpo.gov/fdsys/pkg/CREC-2012-03-20/pdf/CREC-2012-03-20-pt1-PgS1824-2.pdf>.

<sup>96</sup> See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10–18 (2012) (describing the history and types of crowdfunding).

<sup>97</sup> See Dave Itzkoff, *Veronica Mars' Fans Are Happy to Finance a Reunion*, N.Y. TIMES, Mar. 5, 2014, available at <http://www.nytimes.com/2014/03/09/movies/veronica-mars-fans-are-happy-to-finance-a-reunion.html> (last visited Sept. 16, 2014).

<sup>98</sup> See Chance Barnett, *Top 10 Crowdfunding Sites For Fundraising*, FORBES (May 8, 2013), <http://www.forbes.com/sites/chancebarnett/2013/05/08/top-10-crowdfunding-sites-for-fundraising/> (last visited Mar. 4, 2014).

<sup>99</sup> See generally KICKSTARTER, <https://www.kickstarter.com> (last visited Mar. 5, 2014).

example of the variety of sites on the market.<sup>100</sup> The majority of these sites are donation-based, meaning that people give their money without expecting any kind of return on that donation.

The JOBS Act has opened up a new market to those interested in utilizing crowdfunding to start businesses. This market will be doing equity-based crowdfunding, meaning that investors will be receiving securities in exchange for their money. Because of the great potential this opportunity presents, many websites have been created and are waiting for the JOBS Act to be implemented so they can open their virtual doors to the public.<sup>101</sup>

Until now, people have utilized crowdfunding for one of three primary reasons: (1) they care about the cause, individual, or idea; (2) they want products, perks, and amenities that are offered in exchange; or (3) they want to be included in society.<sup>102</sup>

It is “reasonable to believe that if you offer equity then a whole new wave of funders will come to market.”<sup>103</sup> However, the new investors will likely be the working and middle classes looking not to donate to a cause, but to earn a return on their investment. Saying that this new market of middle-class Americans will be “investing in” these companies rather than donating to them puts more emphasis on the crowdfunding portion of the JOBS Act. Congress and the Administration seem to be attempting to lure this crowd and its money into the economy.

Not only did Congress need to make the new equity market friendly to the middle-class American, it also needed to make it easier for the emerging-growth business. In order to enable more businesses to take advantage of the new equity-based crowdfunding, the disclosure requirements for new companies decreased substantially. The pre-JOBS Act requirements for selling securities to investors were extraordinarily detailed and inconvenient for those starting businesses. Because so few of these companies have access to the amount of money necessary to constantly check with the SEC that they have met the requirements, the new proposed rules have made it so the amount of financial disclosure required is dependent upon the amount of money requested from the crowd.<sup>104</sup> Besides the flexible financial conditions, other disclosure

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<sup>100</sup> Other sites include Indiegogo, GoFundMe, Crowdfunder, RocketHub, and many others. *See generally* INDIEGOGO, <http://www.indiegogo.com> (last visited Oct. 14, 2014); GOFUNDME, <http://gofundme.com> (last visited Oct. 14, 2014); CROWDFUNDER, <http://www.crowdfunder.com> (last visited Oct. 14, 2014); ROCKETHUB, <http://www.rockethub.com> (last visited Oct. 14, 2014).

<sup>101</sup> Some of these companies include Startupvalley, Wefunder, and Early Shares. A more complete list can be found at [crowdfundingwebsites.blogspot.com](http://crowdfundingwebsites.blogspot.com). *See* CROWDFUNDINGWEBSITES, <http://crowdfundingwebsites.blogspot.com/2013/07/equity-crowdfunding-sites.html> (last visited Oct. 14, 2014). *See generally* STARTUPVALLEY, <http://www.startupvalley.com> (last visited Oct. 14, 2014); WEFUNDER, <https://www.wefunder.me> (last visited Oct. 14, 2014); EARLY SHARES, <http://www.earlyshares.com> (last visited Mar. 5, 2014).

<sup>102</sup> Emily Chasin, *Crowd-Funding Industry Braces for Regulation*, WALL ST. J. (Apr. 5, 2012), <http://online.wsj.com/article/SB10001424052702303302504577326200304117034.html> (last visited Nov. 14, 2014).

<sup>103</sup> *Id.*

<sup>104</sup> Those asking \$100,000 or less must provide their most recent tax returns, if any, and certified financial statements. Those asking between \$100,000 and \$500,000 must provide financial

requirements have been reduced from detailed descriptions of the company and its financial situation<sup>105</sup> to the basic information of the company, namely, the business plan of the issuer, the intended use of the proceeds from the project, and the target offering.<sup>106</sup> These documents must be filed through a simple process with the SEC<sup>107</sup> before companies can enter the investment portals.<sup>108</sup>

While these provisions of the JOBS Act attempt to boost the economy by helping ease the regulations for emerging growth companies and create more jobs, there is concern that these companies may not actually provide a permanent solution to the current situation, and that the JOBS Act is setting the U.S. up for another disaster. The proposed rules set out investor limits of \$2,000, or 5 percent of the annual income or net worth (whichever is greater) for those whose net worth and annual income is less than \$100,000 and 10 percent of the annual income or net worth (whichever is greater) for those above the \$100,000 mark.<sup>109</sup> Although these limits are meant to protect investors, it may not be enough. Many “feel that the benefits are likely to come at the expense of private investors who have long-lasting, established protections provided under the Securities Act or the recent Sarbanes-Oxley Act.”<sup>110</sup> Because of the law’s decrease in regulations and transparency, many financial observers believe that the increased risks of fraud and scam to the public outweigh the small benefits the law provides a limited group of companies, investment managers, and broker-dealers.<sup>111</sup>

The most controversial provisions of the JOBS Act reduce regulatory oversight, allow public solicitation of investors, and encourage crowdfunding. The relaxed standards are an invitation to those seeking to defraud or scam the public, particularly those seeking to defraud the elderly who may lack the expertise necessary to properly evaluate the risk of private offerings. This could result in a nationwide scandal even worse than those surrounding Bernie Madoff<sup>112</sup> or Alan Stanford.<sup>113</sup>

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statements that are reviewed by a public accountant. Those asking more than \$500,000 must provide audited financial statements. *See* Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14, at 65.

<sup>105</sup> 17 C.F.R. § 229.503 (2013).

<sup>106</sup> *See* Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>107</sup> Before the JOBS Act, all documents had to be reviewed by the SEC before a company could ask for investors.

<sup>108</sup> These investment portals are the websites that the issuers will use to present their ideas. They will also act as the intermediaries between issuers and investors. *See* Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>109</sup> *See id.*

<sup>110</sup> *See* Lewis, *What is the JOBS Act*, *supra* note 18 (“With the passage of the JOBS Act, many of the protections afforded investors by Sarbanes-Oxley have been effectively removed. John Wasik, a regular contributor to Forbes magazine, contends that “crowdfunding could make the boiler room scams of the 1980s look like mere parking violations”).

<sup>111</sup> *See id.*

<sup>112</sup> Bernie Madoff was arrested in 2008 as part of a Ponzi scheme that lost \$50 billion in investor funds. *See Ex-Nasdaq Chair Arrested for Securities Fraud* (Dec. 12, 2008), [http://money.cnn.com/2008/12/11/markets/madoff\\_fraud/](http://money.cnn.com/2008/12/11/markets/madoff_fraud/) (last visited Sept. 16, 2014).

<sup>113</sup> Alan Stanford was convicted in early 2009 of selling fraudulent certificate from an off-shore bank account. *See* Jeanine Ibrahim, *Allen Stanford: Descent from Billionaire to Inmate # 35017-183*, CNBC (Oct. 5, 2012), <http://www.cnbc.com/id/49276842>.

Those affected by the Madoff and Stanford scandals were accredited investors<sup>114</sup> who hardly stood a chance when subjected to the sophisticated scamming of these men. How can one expect the average middle-class American, who does not have the awareness of risks as those with the accredited investor status, to fare better with less regulation?

The JOBS Act minimizes many regulations that have been built up to protect private investors since the passage of the Securities Act in the aftermath of the 1929 stock market crash. As the JOBS Act has become more prominent in business discussion, some market forecasters observe the potential for a return to the “boiler room” operations.<sup>115</sup> This is where high-pressure salesmen using sophisticated telephone banks, and with little concern that the regulators will become involved, manipulate unsuspecting, naïve people into losing their life savings.<sup>116</sup> Because the new crowdfunding projects will take place on the Internet, both pressure to invest and information about the projects will come from social media and various chat sites, all of which can be used to present information as fact and mislead the public. As the JOBS Act requires less of the companies asking for money, leaving them to do as they please upon entering a portal site, it will be easier for anyone with the desire to defraud the public to go unnoticed. New investors that lack the sophistication or financial stability of accredited investors are now asked to gamble in a market more risky than it has ever been.

#### V. PRIVATIZING SOCIAL SECURITY

A disconnect seems to exist between the federal government’s attitude towards American investors prior to the JOBS Act and after the JOBS Act was passed. This is most visible with regards to the debate over the increasingly precarious social security system. In 2005, concern over social security lead President George W. Bush to discuss whether to privatize social security or let Americans decide for themselves where to invest the money.<sup>117</sup> The idea of taking away social security from the government and giving it to the people was staunchly opposed by the Democratic Party, and died quickly.<sup>118</sup>

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<sup>114</sup> Those who were victims of Madoff and Stanford fall into the category of those who are considered financially sophisticated and should not have as much need for the protections of certain government filings. See *Accredited Investor*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/accreditedinvestor.asp> (last visited Mar. 6, 2014).

<sup>115</sup> See e.g. John Wasik, *JOBS Act Will Open Door to Investment Scams*, FORBES (Mar 14, 2012), available at <http://www.forbes.com/sites/johnwasik/2012/03/14/jobs-act-will-open-door-to-investment-scams> (last visited Sept. 16, 2014).

<sup>116</sup> See *Id.*

<sup>117</sup> See Brad Plumer, *Ryan Supported Social Security Privatization in 2005. What was That Again?*, WASH. POST (Oct. 12, 2012), available at <http://www.washingtonpost.com/blogs/wonkblog/wp/2012/10/12/ryan-supported-social-security-privatization-in-2005-what-was-that-again/> (last visited Sept. 16, 2014).

<sup>118</sup> See *id.*

One reason behind this can be explained by a report created by the SEC entitled, “The Facts on Saving and Investing in the United States.”<sup>119</sup> In this report, the SEC stated, “numerous studies and surveys show that many Americans—especially young adults—fail to comprehend the financial basics. Many do not understand how our securities markets work, how to evaluate the risks and rewards of investment products, and how to calculate what they need to save for retirement.”<sup>120</sup> After the frightening statistics released in this report became public knowledge—including that two out of every three savers in America have never prepared a financial plan, and that the vast majority of Americans do not believe they will have enough money to retire—it is no wonder that the legislature rejected the idea of giving Americans complete control over their retirement.

Talks of privatizing social security returned to the media spotlight again in the 2008 and 2012 presidential campaigns. In the 2008 campaign, Republican nominee Senator John McCain proposed privatization of social security,<sup>121</sup> and the Romney/Ryan ticket revived the idea for their 2012 campaign.<sup>122</sup> The Democratic Party remained vehemently against this notion. In 2008, then-Democrat Presidential nominee, Barack Obama, cautioned that a privatization of social security “would leave the retirement security of senior citizens at the whims of an erratic market.”<sup>123</sup> “I know Senator McCain is talking about a ‘casino culture’ on Wall Street, but the fact is, he’s the one who wants to gamble with your life savings and that is not going to happen when I’m President of the United States.”<sup>124</sup> His campaign continued with talk of how important it was to ensure that Americans had a stable source of income after they retired, saying “we must [fix social security] without putting at risk current retirees, the most vulnerable or people with disabilities, without slashing benefits for future generations and without subjecting American’s guaranteed retired income to the whims of the stock market.”<sup>125</sup>

The Democratic Party’s feeling towards retirement changed, however, upon the introduction of the JOBS Act. In the Senate debate

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<sup>119</sup> See Office of Investor Education and Assistance, *The Facts on Saving and Investing, SECURITIES AND EXCHANGE COMMISSION* (Apr. 1999), available at <http://www.sec.gov/pdf/report99.pdf>.

<sup>120</sup> *Id.*

<sup>121</sup> See *John McCain on Social Security*, ONTHEISSUES.ORG (Dec. 23, 2013), [http://www.ontheissues.org/economic/john\\_mccain\\_social\\_security.htm](http://www.ontheissues.org/economic/john_mccain_social_security.htm).

<sup>122</sup> Both had supported privatizing social security when President Bush announced it, and Ryan continued his support even after the 2008 financial collapse turned many Republicans away from the idea. See Benjamin Landy, *Mitt Romney and Paul Ryan Support Partial Privatization of Social Security*, THE CENTURY FOUNDATION (Aug. 28, 2012), <http://tcf.org/blog/detail/mitt-romney-and-paul-ryan-support-partial-privatization-of-social-security>.

<sup>123</sup> Sam Stein, *McCain Claimed “Privatization” Was Necessary For Social Security*, HUFFINGTON POST (Oct. 21, 2008), [http://www.huffingtonpost.com/2008/09/20/mccain-claimed-privatizat\\_n\\_127984.html](http://www.huffingtonpost.com/2008/09/20/mccain-claimed-privatizat_n_127984.html).

<sup>124</sup> *Id.*

<sup>125</sup> Stephen Ohlemacher, *Social Security Privatization Fight Revived By Dems To Attack Paul Ryan*, HUFFINGTON POST (Aug. 19, 2012), [http://www.huffingtonpost.com/2012/08/19/social-security-privatization-paul-ryan\\_n\\_1806309.html](http://www.huffingtonpost.com/2012/08/19/social-security-privatization-paul-ryan_n_1806309.html).

regarding the JOBS Act, Senator Jeff Merkley (D) from Oregon declared that, “in 2011, Americans had invested \$17 trillion in retirement funds. Imagine if 1 percent of those investments went into crowdfunding. The result would be \$170 billion of investment in our startups and small businesses.”<sup>126</sup> In this move, some of the officials who outwardly promised to not gamble with the life savings of citizens are now suddenly asking them to make that gamble.

Many of the Americans they expect to participate, however, will not have nearly enough money saved to be able to retire in the way they thought. Merely 4 out of every 100 people at retirement age will have saved enough capital to retire.<sup>127</sup> Additionally, while \$170 billion does seem to be a lot of money, Senator Merkley does not seem to make the crucial connection from the original SEC investment report to today’s society: the young adults from those surveys and studies who failed to comprehend financial basics are the same people who are currently beginning to invest in their retirement and who he hopes will invest in these startups and small businesses.

What took place from 1999-2011 that suddenly made the federal government feel confident about the ability of Americans to invest wisely? Why does the party that did not trust the American population with their retirement in 2005, 2008, or 2012 suddenly, in 2014, trust that the average American will know which crowdfunding investments are worthy of their retirement?

One quick answer to that question could be found in the SEC’s proposed investor caps. While two-thousand dollars a year may not seem like much to someone whose household income<sup>128</sup> is \$80,000, what about to someone whose household income is \$18,000?<sup>129</sup> These middle class investors may be helping to build these small businesses, but they sacrifice themselves in doing so. In the long run we believe it will do more damage to the American economy than its potential for good.

The author Ayn Rand explored the idea of a world in which people lived to support others in their ventures. In her pinnacle work, *Atlas Shrugged*, the main character, James Taggart, and his friends invest thousands of dollars to “save” the citizens of the People’s Republic of Mexico, to the detriment of their own needs. In the book Taggart says, “when considering an investment, we should, in my opinion, take a chance on human beings, rather on purely material factors.”<sup>130</sup> While on the surface this seems like a worthy and noble way to approach

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<sup>126</sup> 158 Cong. Rec. 46, *supra* note 81 (statement of Sen. Jeff Merkley).

<sup>127</sup> *Retirement Statistics*, Statistic Brain (Jan. 1, 2014), <http://www.statisticbrain.com/retirement-statistics/>.

<sup>128</sup> Household income is defined as “the combined gross income of all the members of a household 15 years old and older.” *Household Income*, INVESTOPEDIA, [http://www.investopedia.com/terms/h/household\\_income.asp](http://www.investopedia.com/terms/h/household_income.asp) (last visited Mar. 5, 2014).

<sup>129</sup> The median gross household income for the United States in 2012 was \$51,017, which would make the five percent the greater number at \$2,550.85. See Steve Hargreaves, *15% of Americans Living in Poverty*, CNN MONEY (Sept. 17, 2013), <http://money.cnn.com/2013/09/17/news/economy/poverty-income/>.

<sup>130</sup> See Ayn Rand, *ATLAS SHRUGGED* 54 (Penguin Group 35<sup>th</sup> ed. 1992).

investments, the consequences of this philosophy in the book lead to a collapse of the economy of the country.

While fiction is not reality, it can be a useful place to see what could happen when certain scenarios are presented in the world. Rand showed us some potential pitfalls of investing for the sake of being philanthropic, especially when the ramifications of the investment are not fully understood.

An investment implies a return of some sort,<sup>131</sup> whether it is in the form of a percentage of the sales or in the ability to sell the security at a higher rate at some later date. This makes sense when investing in large public companies because more often than not the investor will be able to see some form of return almost immediately. The same cannot be said for investing in these emerging growth companies. In fact, the SEC admits that seeing a return on one's investment may be fairly rare, saying that:

[I]t is unclear how securities offered and sold . . . would be transferred in the secondary market . . . and investors who purchased securities . . . and who seek to divest their securities would be unlikely to find a liquid market<sup>132</sup> . . . We expect that they would face additional challenges in addressing the impact of illiquidity, either in finding a suitable trading venue or negotiating with the issuer for an alternative retirement provision.<sup>133</sup>

In other words, many of these securities will be unable to be sold again once investors pass the required one-year restricted period,<sup>134</sup> leaving the investor without any means of recouping the loss of the investment.

Furthermore, a recent study of more than 2,000 companies that received at least \$1 million in venture funding from 2004–2010, found that almost three-quarters of these companies failed.<sup>135</sup> The SEC acknowledged that:

[T]hese failure rates are high, despite the involvement of sophisticated investors like venture capitalists<sup>136</sup> . . .

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<sup>131</sup> Investment is defined as “an outlay of money usually for income or profit.” See *Investment*, Merriam-Webster, <http://www.merriam-webster.com/dictionary/investment> (last visited Mar. 4, 2014).

<sup>132</sup> A liquid market is a market with many bid and ask offers, in which an investor can quickly trade and at a good price. *Liquid Market*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/liquidmarket.asp> (last visited Mar. 5, 2014).

<sup>133</sup> Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>134</sup> This period is the time after an investor purchases securities and is not allowed to resell them until after the one-year mark. See *id.*

<sup>135</sup> Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*, WALL ST. J. (Sept. 20, 2012), <http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190>.

<sup>136</sup> Venture capitalists are investors who provide capital to startup ventures or support to small companies that wish to expand. *Venture Capitalist*, INVESTOPEDIA, <http://www.investopedia.com/terms/v/venturecapitalist.asp> (last visited Mar. 5, 2014).

Because we expect that issuers that would engage in offerings made [through crowdfunding] would potentially be in an earlier stage of business development than the businesses included in the above studies, we believe that the issuers that engage in securities-based crowdfunding may have higher failure rates than those in the studies cited above.<sup>137</sup>

The SEC appears to have little confidence in the ability of investors to get any return on these investments. This means that those choosing to give money to these companies should not see their contributions as investments, but rather donations to the cause of business growth. They are putting the supposed needs of a society or another individual's business above their very own real needs. While the SEC sees the potential for a lack of return, those being targeted for investments will not be able to foresee such consequences.

Numerous skeptics doubt the usefulness of crowdfunding to develop businesses. "Many business experts believe that the failure rate of small business does not result from lack of capital, but from unrealistic expectations and poor management by the business owners. Easier access to capital encourages more unfounded startups by untrained entrepreneurs lacking basic management skills."<sup>138</sup> These untrained entrepreneurs do not seem to realize that running a business is very risky. The failure rate for technology startups is about three-times higher than that of all other businesses.<sup>139</sup> Even the businesses that receive funding from venture capitalists have an extraordinarily high rate of failure, with three-quarters of those that received at least \$1 million failing.<sup>140</sup> Most of these companies fail, not due to a lack of funding, but "due to lack of direction, poor planning, or poor leadership."<sup>141</sup>

Some people also suggest that the net effect of the JOBS Act will reduce capital and the formation of new companies. For instance, Jay Ritter, a finance professor at the University of Florida, testified before the Senate Committee on Banking, Housing and Urban Affairs that:

[B]y making it easier to raise money privately, creating some liquidity without being public, restricting

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<sup>137</sup> See Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>123</sup> Lewis, *What is the JOBS Act*, *supra* note 18.

<sup>139</sup> A study of new, technology businesses started in 2004 showed that only approximately sixty-eight percent remained in business by the end of 2008. Alicia Robb ET AL., *An Overview of the Kauffman Firm Survey: 2004-2008*, KAUFFMAN FOUNDATION (May 27, 2010), available at <http://www.kauffman.org/what-we-do/research/kauffman-firm-survey-series/an-overview-of-the-kauffman-firm-survey-20042008>.

<sup>140</sup> Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*, WALL ST. J. (Sept. 20, 2012), <http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190>.

<sup>126</sup> Kalen Smith, *The Real Reasons Why Companies & Business Startups Are Failing*, MONEY CRASHERS, <http://www.moneycrashers.com/reasons-business-failing-companies/> (last visited Mar. 4, 2014).

information that shareholders have access to, restricting the ability of public market shareholders to constrain managers after investors contribute capital and driving out capital, the net effect of these bills might be to reduce capital formation and/or the number of small IPOs.<sup>142</sup>

Ritter's sentiments were echoed in the same committee by John Coates, professor at Harvard Law School, who suggested that the new laws would "not only generate front-page scandals, but reduce the very thing they are being promoted to increase: job growth."<sup>143</sup> If Ritter and Coates are correct in their assessments, the JOBS Act will yield counterproductive and harmful results.

The SEC has suggested various ways in which it can protect investors by controlling both the issuers and the portals. Issuers have an aggregate project limit of \$1 million and can register on only one portal site.<sup>144</sup> This rule makes it simpler for potential investors to find out and share information regarding the project.<sup>145</sup> The SEC's theory is that by keeping the project in one portal, the portal will then be able to make sure that the conversation remains in the safe environment of a single portal. However, the SEC has also allowed issuers to post a basic link onto social media sites<sup>146</sup> in order to draw a crowd to the project. Allowing issuers to do this creates the multiple crowds that the SEC claimed to be trying to avoid because regulating conversations on social media sites is nearly impossible. Intermediaries, and other investors, will not be able to see the conversations being held on individual social media accounts, especially when privacy settings keep strangers from viewing posts.

In addition to the social media issue, there have already been apps and websites set up that provide off-site conversations of potential projects for investors.<sup>147</sup> These sites are designed to be a one-stop place for investors to find projects in which they might be interested, but these sites are not all interconnected. Multiple "crowds" already exist, and it is highly unlikely that information posted on one of these sites will get spread to every potential investor. Because of this, investors may invest in a fraudulent or other extremely risky venture without sufficient knowledge of the investment. As much as the proposed rules try to keep the issuers contained on one portal site, it seems impossible to regulate the spread of information. Third party sites can create a new type of

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<sup>142</sup> Lewis, *What is the JOBS Act*, *supra* note 18.

<sup>127</sup> *Id.*

<sup>144</sup> Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>145</sup> *See id.*

<sup>146</sup> *See id.*

<sup>147</sup> Such sites include Crowd Funding Forum, InvestorsHub, and Crowd Hub. *See generally* CROWD FUNDING FORUM, <http://www.crowdfundingforum.com> (last visited Mar. 5, 2014); INVESTORSHUB, <http://investorshub.advfn.com/> (last visited Mar. 5, 2014); CROWD HUB, <http://www.crowdhubapps.com> (last visited Mar. 5, 2014).

boiler room, with the pressure to invest coming entirely through Internet communication.

In order to alleviate worries that people will invest blindly and make bad business decisions, the SEC proposed a system to educate investors before they are allowed to put their money into a company.<sup>148</sup> This way they have an “opportunity” to learn before investing money and can then accept the risks associated with whatever investment they make. The JOBS Act seems to be doing almost the same thing that made Democrats skeptical of privatizing social security, but without the financial advisor to help. One of the criticisms made about privatizing social security was that “the administration [was] spinning the idea that any American individual with an Internet connection and an eager (and supposedly objective) financial advisor could do better on his or her own than either the social security system or the government.”<sup>149</sup>

The suggestions for possible education strategies with the portals, to replace actual paid financial advisors, include quizzes that will not let investors deposit money unless they answer a certain number of finance-related questions correctly.<sup>150</sup> The portals are also required to ensure that each investor answers questions demonstrating that they understand the risk involved and realize that “the investor should not invest any funds in a crowdfunding offering unless he or she can afford to lose the entire amount of his or her investment.”<sup>151</sup> While these all seem like great tools, answering quiz questions right before investing does not seem like an effective way to teach financial wisdom, and the risk statements sound a lot like the various “terms and conditions” documents that few people read before clicking “I have read and agree to these terms and conditions.”<sup>152</sup> On top of that, those taking the quizzes will be on a computer connected to the Internet, which means the answers are easily looked up and received without any financial knowledge actually sinking in. On paper, the SEC seems to be doing a lot to ensure the safety of the investors, but in this situation the SEC must consider what those participating will actually do, not what they should do.

The regulations seem to be based more on regulating the issuers and not on protecting the investors. The SEC’s proposed rules for issuers total over 500 pages with comments, while the extent of the discussion on investor regulation consists of a paragraph stating that “an investor

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<sup>148</sup> These educational materials are required to have “the process for the offer, . . . the risk associated with investing, . . . the types of securities that may be offered, . . . the restrictions on the resale of securities, . . . the types of information an issuer is required to provide, . . . the limitations on the amounts investors may invest, . . . the circumstances in which the issuer may cancel an investment, . . . the limitations on investor’s right to cancel, . . . the need for the investor to consider whether investing is appropriate, . . . and [whether there may be] an ongoing relationship between issuer and intermediary after the completion.” See Securities Act Release No. 33-9470, *supra* note 14.

<sup>149</sup> See Nomi Prins, *Privatizing Social Security: Who Wins?*, SOLIDARITY (Jan. 2005), <http://www.solidarity-us.org/site/node/1141>.

<sup>150</sup> Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>151</sup> *Id.*

<sup>152</sup> This statement appears at the bottom of every online purchase, every account setup, and every online music purchase and is often ignored, e.g., Amazon.com, Ebay.com, Apple.com.

seeking to invest in an offering . . . would need to open an account with an intermediary and provide consent to electronic delivery of materials.”<sup>153</sup> And, though the SEC has imposed investment limits to ensure that investors did not invest too much of their income, they state that, “an intermediary may rely on an investor’s representations concerning compliance with investment limitation requirements.”<sup>154</sup> While one always hopes that those registering on portal websites will be honest in the amount they have invested, it is incredibly easy for one to lie when typing in how much has been invested.

In an attempt to be less speculative and to discover how well these new sites will protect the investors, we created an account on a few of the new equity-based sites. The first few steps were pretty basic. The sites generally asked for a name, email address, password, phone, and date of birth. Once you declared your accreditation status—meaning whether or not you qualify as an accredited investor—it moved to a “qualification page.” On this page, new account holders first input how much they plan on investing and then check boxes before paragraphs of information about acknowledging the risks and understanding that the investment is made of the investors own accord and these sites cannot be held responsible for any information provided on their website. After that, the investor can browse the website and search for new investments wherever they are available. The process is streamlined and very user-friendly, but does little to confidently ensure that investors actually understand the risks and that they are protected against fraudulent projects.

While this may change with the implementation of the SEC rules, currently no consequences exist for the investor that spends over the prescribed limit, and neither the intermediary nor the issuer are responsible for ensuring that investors comply with the limits beyond reasonably trusting the representations of the investor. From this experience, we feel that protections for investors, as well as regulations ensuring that investors are complying with the laws, are not sufficiently strong and will not keep investors from falling into the hands of those determined to commit fraud.

## VI. FRAUD

The JOBS Act opens the door to unaccredited, middle-class fraud by loosening the disclosure requirements for expanding-growth companies and by failing to regulate investors.<sup>155</sup> If the transparency of businesses is reduced, the opportunities to scam unsuspecting Americans will

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<sup>153</sup> See Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

<sup>154</sup> *See id.*

<sup>155</sup> The elements of proving fraudulent activity are 1) A false statement of a material fact, 2) Knowledge on the part of the defendant that the statement is untrue, 3) Intent to deceive the victim, 4) Justifiable reliance by the victim on the statement, and 5. Injury to the alleged victim as a result of the reliance. *Fraud*, LEGALDICTIONARY.COM, <http://legal-dictionary.thefreedictionary.com/fraud> (last visited Mar. 6, 2014).

inevitably increase. History has proven that where there is a chance to make money, there is a risk of fraud. Time after time, trusted individuals have swindled people out of large amounts of money due to disastrous reliance on fraudulent schemes. Two popular methods of fraudulent schemes are market manipulation schemes<sup>156</sup> and multi-level marketing schemes.

Multi-level marketing is a system of sales involving a company with a marketable product and salespeople who buy and then resell the product to the public.<sup>157</sup> The key to these schemes is the large amount of people involved. Those involved often recruit people to work under them, thus promoting the scheme and pushing it to greater lengths. Multi-level marketing is similar to a Ponzi/pyramid scheme<sup>158</sup> but can be differentiated from a Ponzi/pyramid scheme because multi-level marketing systems offer a legitimate product. Multi-level marketing schemes thrive off of the idea that having more people involved will result in more success for everyone. Members use word-of-mouth advertising to draw in other investors and perpetuate the system. The success of multi-level marketing is almost entirely based on the connections one has and her ability to persuade others to join in the venture under the pretense of guaranteed success.

Multi-level marketing schemes and crowdfunded projects gather investors in a very similar way. In both cases, those wishing to bring investors to their projects often reach out to their family, friends, and acquaintances. They often reach out to their religious congregations, to their social media “friends” and connections, and to others with whom they come into contact. They often utilize a position of trust to persuade potential investors into investing out of loyalty, with the understanding that the investment opportunity is brought with the friend’s best interest at heart. While this can be a great way to get people involved in investing in new projects and emerging-growth businesses, it also significantly increases the potential for fraud.

For example, the SEC has uncovered companies with incomes based entirely on the funds from new investors rather than a legitimate business

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<sup>156</sup> These involve getting investors to buy securities in an effort to raise their price. They use low-priced stock and target unsophisticated investors, trusting that these investors will try to “play safe” and buy low. The conspirators then dump their own stock at a profit before it collapses. Occasionally, these schemes bring in brokers to further pressure and persuade investors into purchasing the stock, which results in more damaging fraud. *See 2011 Report of the Cost of Fraud in the United States*, COMPUTER EVIDENCE SPECIALISTS, LLC (Jan. 10, 2012), <http://cesnb.com/index.php/2012/01/10/fraud-in-the-united-states-2/>.

<sup>157</sup> Some of the most prominent multi-level marketing companies in the United States today include Mary Kay, which sells make-up products; The Pampered Chef, whose products are all designed to help with anything in the kitchen; and MonaVie, which markets health drinks. *See generally* MARY KAY, <http://www.marykay.com/> (last visited Mar. 6, 2014); THE PAMPERED CHEF, <http://www.pamperedchef.com/> (last visited Mar. 6, 2014); MONAVIE, <http://www.monavie.com/> (last visited Mar. 6, 2014).

<sup>158</sup> These are investing scams that promise high returns with little to no risk. They are built on the idea that the more people you bring underneath you, the higher up the “pyramid” you go and the more money you make. These schemes almost always collapse on themselves and cause devastating financial loss. *See Ponzi Scheme*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/ponzischeme.asp> (last visited Mar. 6, 2014).

venture. In October 2013, the SEC charged Cyber Kids Best Education Limited (CKB) and froze their assets. CKB was a scheme that sold education courses to both the U.S. and various Asian countries. Investigations performed by the SEC discovered that CKB only received revenue from each new investor rather than any other significant source.<sup>159</sup> Investors recruited to help “sell” education materials were in fact consumers—the CKB executives did not have any intent to sell any legitimate products.

In August 2012, the SEC uncovered another fraudulent scheme. A company called ZeekRewards offered customers several ways to earn money, including the purchase of securities in the form of investment contracts.<sup>160</sup> ZeekRewards promised members up to fifty percent of the company’s net profits through its profit share system and then offered members bonus points for recruiting others to the projects. The SEC determined that the income was not based on legitimate revenue but instead on the funds from recruiting new members.<sup>161</sup>

People can take advantage of their connections in a myriad of ways. For example, the fraud rate in the state of Utah is extremely high due, in part, to the strong presence of The Church of Jesus Christ of Latter-day Saints (the LDS church).<sup>162</sup> The interconnectedness of the LDS church congregations provides the prime opportunity for fraud.<sup>163</sup> Often leaders of individual congregations, or bishops, are in a position of influence and trust. There have been cases in which LDS bishops have successfully used their position to lead people to invest large amounts in fraudulent schemes, all because the leader of this “crowd” seems reliable. In 2010, a former LDS bishop, Bill Hammons, was charged with defrauding tens of millions of dollars out of people within his church.<sup>164</sup> He treated his calling in the church as validation of his trustworthiness, and many members believed him, causing devastating losses once the scheme was revealed.<sup>165</sup>

This is not a problem that is unique to the LDS church; such fraud can be found in religious congregations throughout the country. As soon as a person puts him or herself into a position of trust over another, especially in a religious atmosphere, he or she is positioned to persuade others to do any number of things. For example, in 2012, Ephren Taylor,

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<sup>159</sup> See *SEC Halts Pyramid Scheme Targeting Asian-American Community*, SECURITIES AND EXCHANGE COMMISSION (Oct. 17, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539880547#.UxGKdPldWVM>.

<sup>160</sup> *SEC Shuts Down \$600 Million Online Pyramid and Ponzi Scheme*, SECURITIES AND EXCHANGE COMMISSION (Aug. 17, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483920#.UxI8yfIdWVM>.

<sup>161</sup> See *id.*

<sup>162</sup> Members of this church, founded in New York State in 1830, are often referred to as “Mormons.” *Frequently Asked Questions*, THE CHURCH OF JESUS CHRIST OF LATTER-DAY SAINTS, <http://mormon.org/faq/topic/about-mormons/question/the-mormons> (last visited Mar. 10, 2014).

<sup>163</sup> See Tom Harvey, *Preying on the Faithful: Though Mormons Often Victims, LDS Church Skips Fraud-Prevention Event*, THE DENVER POST (May 1, 2010), [http://www.denverpost.com/faith/ci\\_14993866?source](http://www.denverpost.com/faith/ci_14993866?source).

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

the infamous presenter of the “Wealth Tour Live” seminars, was discovered to have swindled millions of dollars out of Americans.<sup>166</sup> He often declared that he chose potential investments based on the divine inspiration from God and could therefore guarantee extraordinary returns to all investors.<sup>167</sup> The key to his success, and the success of the leaders of the Ponzi schemes in Utah, is the solid social connections they had with their audiences. They manipulated these relationships until group members felt comfortable and confident in giving up their wallets.<sup>168</sup>

One of the most profound things to consider about the previously discussed examples is that they occurred even when the SEC demanded that the investors be accredited. All those affected and financially devastated were expected to be wise investors. With reductions in investor protections, the ability for scam artists to reach investors and take advantage of the public is only exacerbated.

#### A. Recent Fraud Cases

Many examples of fraud can be found throughout the history of big investments. The majority of those involved were accredited investors, meaning they were supposed to be able to discern which schemes were “legitimate” and which were likely fraudulent.

The JOBS Act maintains that financial disclosures will act as a protection for investors. However, these disclosures can be manipulated. In March 2012, the SEC reported that it had charged an investment adviser, James Michael Murray, with defrauding investors. Murray raised more than \$4.5 million dollars from investors. He gave these investors a bogus audit report—using an accounting firm that he made up (called Jones, Moore & Associates) and manipulated the numbers to make it seem like his fund was in better shape than it actually was. He exaggerated the fund’s investment gains of the fund by ninety percent, its income by thirty-five percent, its member capital by 18 percent, and its total assets by approximately ten percent.<sup>169</sup> The implications of this case to our post-JOBS Act life are astronomical. The SEC stressed multiple times throughout its proposed rules that they would require larger amounts of disclosure depending on how much money the issuer requests.<sup>170</sup> However, after looking at this case, it is obvious that financial disclosures can be faked and used to dupe even sophisticated investors.

Less than a month later in April 2012, a similar case was reported. George Elia, an investment manager in Florida, fabricated statements

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<sup>166</sup> *Fleeing the Flock*, THE ECONOMIST (Jan. 28, 2012), available at <http://www.economist.com/node/21543526>.

<sup>167</sup> *Id.*

<sup>168</sup> *See Id.*

<sup>169</sup> *SEC Charges Bay Area Investment Adviser for Defrauding Investors With Bogus Audit Report*, SECURITIES AND EXCHANGE COMMISSION (Mar. 15, 2012), [http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487806#UwwgY\\_ldWVM](http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487806#UwwgY_ldWVM).

<sup>170</sup> *See* Crowdfunding, Securities Act Release No. 33-9470, *supra* note 14.

about his investment track record. He provided investors with fake account statements that demonstrated false profits. Elia was able to acquire \$11 million from his investors, most of which came through word-of-mouth referrals from friends and relatives.<sup>171</sup> Not only does this case illustrate how easy it is to forge financial documents, but it also demonstrates the risks associated with word-of-mouth references. With the SEC suggesting that issuers can post blurbs about their investment opportunities on social media sites, these issuers will be mainly advertising to their families and friends, who then pass it on out of loyalty rather than out of knowledge that the investment is safe.

Not only is advertising via social media dangerous because of the potential for bad word-of-mouth referrals, it is also dangerous because those interested in scamming the public can easily adapt to the ways of social media. In January 2012, the SEC charged Anthony Fields with fraud for selling more than \$500 billion in fictitious securities through social media sites, including LinkedIn. He provided fake information about the assets of his company to both the investors and to the SEC in his various filings.<sup>172</sup> The most frightening thing about this case is that Fields navigated around the SEC at a time when the SEC was much more strict in its disclosure policies. Now, with the SEC and the intermediary companies able to “rely on the representations of the issuer” in whether or not the information in the required documentation is correct, it will be even easier to slide past the intermediaries and provide false information.

## VII. CONCLUSION

During the Congressional debates surrounding the implementation of the JOBS Act, Senator Carl Levin is quoted with these insightful words, “[w]hen I use a word, it means just what I choose it to mean.”<sup>173</sup> Congress decided to change the word used to describe crowdfunding from donation-based platforms to investment-based tools. The former is used to empower the public to spread goodwill and support causes in which they believe, the latter is used by companies and their intermediaries to raise capital. This changes the connotation of the process and the expectation of society. When crowdfunding is seen as donation-based, the money is given without any expectation of a return. However, now that crowdfunding will be utilized as an investment-based tool, those who put money into a project expect a return on their investment.

This idea of investment will not appeal to those looking for an altruistic platform for a simple donation. But, the change in wording will

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<sup>171</sup> See *SEC Charges South Florida Man in Investment Fraud Scheme*, SECURITIES AND EXCHANGE COMMISSION (Apr. 6, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171488112#.Uwwm0vldWVM>.

<sup>172</sup> *Id.*

<sup>173</sup> 158 Cong. Rec. 46, *supra* note 81 (Senator Carl Levin quoting Lewis Carroll, *Through the Looking Glass*, available at <http://www.literature.org/authors/carroll-lewis/through-the-looking-glass/chapter-06.html> (last visited Mar. 10, 2014)).

draw a broader market of self-interested investors. It will also attract the group that the SEC has been trying to keep from investors since its inception: silver-tongued brokers like who caused the Stock-Market Crash of 1929. However, now these brokers will have a more widespread presence on the Internet, invading social media and reaching potential investors on individual smart phones, tablets, etc. Up until now, fraud has been committed against those who are deemed “accredited investors.” Going forward, we have now opened the door to take advantage of those without the wherewithal or financial means to overcome the financial loss, whether from fraud or the simple failure of their investment strategy.

Has Congress really created a means to help the economy, infused capital into the marketplace, and created jobs, or has it led us down a primrose path, which will create a bubble that will inevitably hurt those whom Congress aims to please? While humanitarian-based policies are laudable, putting such policies ahead of proven business strategies can quickly snowball into economic devastation. Congress likely has good intentions with the crowdfunding aspect of the JOBS Act; however, the long-term consequences may not be as beneficial as the government likely wishes them to be.