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SEC Preventative Measures Against Securities Violations and Fraud Post-JOBS Act

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I. INTRODUCTION

The purpose of the Securities Act and the Exchange Act is to supply investors with disclosure by granting them access to all necessary information to make informed decisions regarding an entity’s offerings with a few exemptions.\(^1\) When Congress passed the Sarbanes-Oxley Act, they were responding to corporate and accounting scandals, which caused them to increase reporting standards, which also increased the cost of compliance.\(^2\) After this change to the securities laws, Congress expanded market regulations further by passing the Dodd-Frank Act in response to the 2010 financial crisis.\(^3\)

After the 2010 financial crisis, the economic downturn devastated the economy leaving many without jobs.\(^4\) Small businesses struggled raising money before and especially after the economy collapsed, because most lending institutions, venture capitalists, and angel investors


\(^3\) Id.

\(^4\) See Derman, Does the SEC Rule the Job Creation Roost? Squaring SEC Rulemaking with the JOBS Act’s Relaxation of the Prohibition Against General Solicitation and Advertising, 47 SUFFOLK U. L. REV. 139, 139 (2014) (illustrating how the economy was stagnant: 12.5 million Americans were unemployed by 2012).
prefer larger investments.\textsuperscript{5} In response to this economic downturn, President Obama signed the Jumpstart Our Business Startups Act (JOBS Act) into law in 2012.\textsuperscript{6} This Act changed some securities regulations for small businesses in the hopes of stimulating “job creation and economic growth by improving access to the public capital markets for emerging growth companies.”\textsuperscript{7} In order to accomplish this goal, the JOBS Act in effect deregulates certain securities laws by expanding existing exemptions or adding to them.\textsuperscript{8} These changes allow a small business more

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\textsuperscript{6} Derman, supra note 4, at 160.
\textsuperscript{7} Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012); see Benjamin P. Siegel, Note, Title III of the Jobs Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters’ Bank Accounts?, 41 Hofstra L. Rev. 777, 779 (2013) (explaining the purpose of the JOBS Act as stimulating the economy, creating jobs, and increasing business funding); see also Robert B. Thompson & Donald C. Langevoort, Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising, 98 Cornell L. Rev. 1573, 1574 (2013) (noting that the JOBS Act’s purpose is to generate job creation); see also Derman, supra note 4, at 139–40 (describing how the recession played a part in passing the JOBS Act by focusing Congress on small-business job creation).
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access to capital by reducing the reporting requirements for certain entities and increasing access to shareholders. As a result, a small start-up like Mark’s Toy Company may save money and increase its capital by taking advantage of these new changes the JOBS Act generated.

However, many think that deregulation of the securities market for small businesses under the JOBS Act has the potential to generate investor fraud by trading investor protection for capital formation and job growth. Two years after this Act was passed, a small number of fraud cases

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9 Id. at 135–36.

10 Mark’s Toy Company is a hypothetical startup business creating innovative toys. The owner, Mr. Markos, needs to raise $5 million in capital to get his prototype toys into the marketplace.

11 Before the JOBS Act, a startup like Mark’s Toy Company was required to comply with costly SEC reporting requirements making an offering too expensive and impracticable for raising capital. See Birdthistle & Henderson, supra note 1, at 26–27 (explaining how federal securities laws imposed a heavy burden of disclosure on issuers).

12 See Thompson & Langevoort, supra note 7, at 1574 (describing how changes to securities laws affect the market in ways “dimly understood” creating a potential for investor fraud and inefficiency within the market); see also Derman, supra note 4, at 140 (stating that with the deregulation of the securities market under the JOBS Act, there are benefits and costs involved: job creation versus defrauding investors). Compare with John Tozzi, In the SEC’s JOBS Act Lawsuit, a Message to Critics, BLOOMBERG BUSINESSWEEK: SMALL BUS. (Apr. 26, 2013) available at http://www.businessweek.com/articles/2013-04-26/in-secs-jobs-act-lawsuit-a-message-to-critics (citing USA Real Estate Fund 1, Inc., Fed. Sec. L. Rep (CCH) P98,012) (alluding that the SEC is stalling the release of the finalized versions of the crowdfunding exemption which were due for release earlier this year, because it fears investor fraud); with
have surfaced that utilized the JOBS Act changes, illustrating how bad actors can hide themselves from the U.S. Securities and Exchange Commission’s (SEC) view and use the JOBS Act changes to defraud investors.\textsuperscript{13} The problem with passing judgment based on these cases is that the SEC has not finalized the rules regarding a significant section of this Act: Title III related to the crowdfunding\textsuperscript{14} exemption.\textsuperscript{15} Because the SEC has not released those changes, investor fraud cases could increase.\textsuperscript{16}

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\textsuperscript{14} See Joan MacLeod Heminway & Shelden Ryan Hoffman, \textit{Proceed at Your Peril: Crowdfunding and the Securities Act of 1933}, 78 TENN. L. REV. 879, 881 (2011) (explaining crowdfunding as a web-based business model which pursues and obtains venture funds through a website that connects businesses with potential investors); see also Thomas Lee Hazen, \textit{Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must be conditioned on Meaningful Disclosure}, 90 N.C. L. REV. 1735, 1736 (2012) (noting how crowdfunding is the fundraising equivalent to crowdsourcing, because crowdfunding entails collaborative efforts of a large amount of people through the use of the Internet in order to reach a larger audience of potential investors).
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II. OVERVIEW OF THE JOBS ACT: CHANGES TO SECURITIES LAW

A. New category of issuer: Emerging Growth Company

In an effort to urge small businesses to go public, the JOBS Act created a new type of issuer called the emerging growth company (EGC). The JOBS Act “defines an EGC as an

15 See Todd Blakeley Skelton, 2013 JOBS Act Review & Analysis of Emerging Growth Company IPOs, 15 TRANSACTIONS TENN. J. BUS. L. 455, 475 (2013) (asserting that the JOBS Act requires the SEC to implement the new crowdfunding exemption as it is not self-effectuating); see also Derman, supra note 4, at 140 (citing Jumpstart Our Business Startups Act § 201(a)) (explaining the SEC’s role in implementing the changes created by the JOBS Act).

16 See Tozzi, supra note 11 (discussing how the SEC has delayed finalizing the rules for the crowdfunding exemption of the JOBS Act due to the fear of investor related fraud).

issuer that has total gross revenues of less than $1 billion during its most recently completed fiscal year.”

This definition is a broad description incorporating any entity that meets this total gross revenue restriction. However, this status is meant to be temporary as an issuer will lose this status if either of three events occur: “(1) the last day of the issuer’s fiscal year during which it had total annual gross revenues of at least $1 billion; (2) the last day of the issuer’s fiscal year following the fifth anniversary of its initial public offering of equity securities pursuant to the Securities Act of 1933, as amended [. . .]; or (3) the date on which the issuer is deemed to be a ‘large accelerated filer’ as defined under the Securities Exchange Act of 1934, as amended.”

While this category of issuer is temporary, it allows entities to increase its communications with a reduction in filing standards, thereby reducing the cost of filing with the SEC while increasing access to potential investors. For instance, EGC issuers must file two

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18 *VENTURE CAPITAL* § 15.02(4) (2007).

19 *Fargnoli, supra* note 8, at 135–36 (citing Jumpstart Our Business Startups Act, § 101(a)).

20 *VENTURE CAPITAL* § 15.03(4); see *Edge et al., supra* note 16 (describing how the EGC definition applies retroactively to an issuer who meets the requirements providing its initial public offering (IPO) transpired after December 8, 2011).

21 *See Fargnoli, supra* note 8, at 135–36 (describing how the JOBS Act creates an exemption for small businesses for “emerging growth companies,” which reduces the reporting requirements under the Exchange Act and the Sarbanes-Oxley Act); *see also* *Edge et al., supra* note 16 (noting how EGCs have a reduced requirements under the securities laws as compared to public companies who cannot meet this definition). *Compare with* Tom Wentzell, Comment, *The JOBS Act: Effects on Capital Market Competition in Both Public and Private Markets*, 10 U. St.
years of audited financial statements rather than the traditional three in the initial public offering (IPO).\textsuperscript{22} Also, the JOBS Act does not require these issuers to file an auditor’s attestation report under Section 404 of the Sarbanes-Oxley Act or a compensation disclosure under the Dodd-Frank Act.\textsuperscript{23} In addition to this reduction in reporting requirements, an EGC may approach and proposition certain investors before filing a registration statement allowing the EGC to determine investor interest if it makes an offering pursuant to specific exemptions: Rule 144A\textsuperscript{24} or Rule 506 of Regulation D.\textsuperscript{25}

While a business can save money by reducing its filing standards and increase investor capital when it qualifies as an EGC, most do not use it as the savings do not outweigh the

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  \item Thomas L.J. 892, 905 (2013) (noting how the creation of the EGC category of issuer blurred the line between private and public offerings).
  \item Edge et al., supra note 16.
  \item See Edge et al., supra note 16 (describing how an EGC is exempt from many rules under the Dodd-Frank Act: no requirement to provide compensation disclosures; rules regarding shareholder votes on executive compensation arrangements do not apply during the qualification period plus three years).
  \item See Skelton, supra note 14, at 465–66 (stating that Rule 144A is a commonly used private transaction and a “safe harbor” exemption from SEC registration requirements regarding the resale of restricted securities to specific buyers—qualified institutional buyers); see also Edge et al., supra note 16 (explaining a limitation of making a private offering under Rule 144A: the issuer may only sell the security to qualified institutional buyers).
  \item See Fargnoli, supra note 8, at 136 (noting that if an EGC prefers, it may confidentially file a draft registration statement with the SEC before approaching investors).
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negative investor perception that the security is of lower value.\textsuperscript{26} Additionally, these entities must determine what the future cost will be, because the reporting requirements increase once the EGC period expires driving up the cost of complying.\textsuperscript{27} For example, Mark’s Toy Company creates an inventive new line of toys and wishes to market directly to consumers but needs capital. The owner Mr. Markos estimates a need of $5 million to get his prototype off the ground and in the marketplace. Because his total gross revenue is less than a billion, he may wish to go public using the EGC standard, but he must make enough to cover the cost of compliance—this status allows him to ease the company into total SEC filing compliance during the EGC qualifying period.\textsuperscript{28} However, many small startups do not have the funds to use this tool, and Mark’s Toy Company is no exception.\textsuperscript{29} Without having the funds to comply, choosing to

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\item \textit{Id.} at 148.
\item \textit{See Wentzell, supra} note 20, at 904 (asserting that once the small business no longer qualifies as an emerging growth company, the expenses increase as a result of more costly reporting requirements implying that these businesses must account for this increase before making the selection).
\item \textit{See BLOOMENTHAL \& WOLFF, supra} note 16, at § 5.50 (quoting Senator Toomey (R-PA)) (illustrating how the EGC option provides small companies with the ability to go public while transitioning into SEC compliance during the EGC qualifying period).
\item \textit{See Wentzell, supra} note 20, at 904 (describing how the cost of compliance with Section 404 of Sarbanes-Oxley for a large firm consists of “an average of $7.3 million in year one, while smaller public firms spen[t] an average of $1.6 million in year one”).
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qualify as an EGC may cost the company more money in the end unless the projected growth is large enough to cover the costs of SEC compliance.\textsuperscript{30}

\textbf{B. Changes to Regulations D and A}

A company making an offering is required to register with the SEC when it sells a security to investors unless it meets an exemption under the Securities regulations.\textsuperscript{31} Most small businesses who raise money through small offerings choose between a few exemptions: Regulation D, Regulation A, or Rule 144A.\textsuperscript{32} The revised Regulation D exemptions resemble previous versions in that Rules 504 and 505 of Regulation D now apply to offerings of “no more than $1 million and $5 million, respectively, in a twelve-month period” while Rule 506 now operates as “a ‘safe harbor’ for the private offering exemption of Section 4(2)” with an unlimited

\textsuperscript{30} See id. (discussing how many startups avoid using the EGC standard to go public, because the cost of complying with the SEC increase significantly within a five year period regardless of the entity’s size).

\textsuperscript{31} David Mashburn, Comment, \textit{The Anti-Crowd Pleaser: Fixing the Crowdfund Act’s Hidden Risks and Inadequate Remedies}, 63 EMORY L.J. 127, 142 (2013); SEC: \textit{REGULATION D OFFERINGS} (Nov. 26, 2014 2:15 PM) available at http://www.sec.gov/answers/regd.htm; see Siegel, \textit{supra} note 7, at 783–84 (noting how Rules 504, 505, and 506 of Regulation D increase a business’s access to capital by sacrificing some investor protections).

\textsuperscript{32} But see Bradford, \textit{supra} note 5, at 44 (citing Stuart R. Cohn & Gregory C. Yadles, \textit{Capital Offense: the SEC’s Continuing Failure to Address Small Business Financing Concerns}, 4 N.Y.U. J. L. & BUS. 1, 35 (2007)) (observing that most exemptions are not helpful when choosing crowdfunding due to timing, financing, and marketing issues).
total offering size.\(^{33}\) For instance, if Markos decided to raise the needed $5 million for Mark’s Toy Company using a Regulation D exemption, he would choose either a Rule 505 or 506 offering.\(^{34}\) However, a business may not use these exemptions without restrictions.\(^{35}\) For instance, sales of the offering are limited thirty-five (35) unaccredited investors\(^{36}\) for Rule 505

\(^{33}\) Mashburn, \textit{supra} note 30, at 142. The older version of Rule 504 was originally amended as a result of fraud. \textit{See} Sherief Morsy, Note, \textit{JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs}, 79 \textit{Brook. L. Rev.} 1373, 1380–81 (2014) (describing how the older version of Rule 504 permitted non-reporting issuers to sell and offer securities to investors regardless of their sophistication and without supplying sufficient information); \textit{see also} John S. Wroldsen, \textit{The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd}, 15 \textit{Vand. J. Ent. & Tech. L.} 513, 604 (2013) (explaining lessons learned of the Rule 504 experiment resulting in the “pump and dump” schemes in the 1990s, which abused this exemption).

\(^{34}\) \textit{See} Mashburn, \textit{supra} note 30, at 142 (noting that an offering of more than $1 million would preclude the issuer from using the exemption under Rule 504 of Regulation D).

\(^{35}\) \textit{See} Siegel, \textit{supra} note 7, at 783–84 (noting how Rules 505 and 506 limit the pool of investors to those who qualify as accredited which reduces fraud; explaining that while Rule 504 does not limit offerings to accredited investors, it is limited to state regulation rules generally requiring investors to meet the accredited investor definition).

\(^{36}\) Unaccredited investors are those that do not fit the definition under 15 U.S.C. § 77b(a)(15) which defines the “accredited investor” as an entity or individual with “financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management [. . .].” 15 U.S.C § 77b(a)(15) (2012); Siegel, \textit{supra} note 7, at 777–80 n. 27–28;
and 506 offerings, but unlimited for offering made under Rule 504; secondary offerings are not permitted under Regulation D. Consequently, Markos would be restricted from allowing more than thirty-five (35) unaccredited investors to invest in the offering. Another limitation restricts issuers from using general solicitation and advertising when issuing an offering under Regulation D unless the offering is made pursuant to Rule 506.

The problem with the new version of Rule 506 is that it allows issuers to use means previously prohibited by securities laws to reach potential investors—public advertising and general solicitation. While Regulation D previously barred businesses from using general solicitations when making a securities offering due to fraud concerns, the JOBS Act allows these

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37 Skelton, supra note 14, at 465.

38 Because the Markos is trying to raise $5 million in capital for his toy startup, the business is precluded from using the Rule 504 exemption allowing unlimited unaccredited investors. Id.

39 See Bloomental & Wolff, supra note 16, at § 9.33.10 (stating that the JOBS Act allows issuers under Rule 506 of Regulation D and Rule 144A to generally solicit and advertise to investors).

40 Fargnoli, supra note 8, at 136 (2013).
previously prohibited practices in order create a new opportunity for raising funds as a means for meeting the JOBS Act’s goal.\footnote{Michael D. Guttentag, Protection from What? Investor Protection and the JOBS Act, 13 U.C. DAVIS BUS. L.J. 207, 244 (2013). But see SMALL BUS. AND THE SEC: A GUIDE FOR SMALL BUS. ON RAISING CAPITAL AND COMPLYING WITH THE FED. SEC. LAWS, REG. D—RULES 504, 505, AND 506 (Feb. 27, 2014) available at http://www.sec.gov/info/smallbus/qasbsec.htm#regd (noting that while the issuer may be exempt from securities registration under Regulation D, antifraud protections still apply requiring the issuer to disclose certain information to investors); but see Mashburn, supra note 30, at 142 (asserting that each state’s general solicitation and advertising rules limit Rule 506).} This change would allow Mark’s toy startup to publically advertise and solicit investors by placing the information on its website if it chose to use this exemption making it easier to reach investors.\footnote{See Cary Martin, One Step Forward for Hedge Fund Investors: The Removal of the Solicitation Ban and the Challenges that Lie Ahead, 16 U. PA. J. BUS. L. 1143, 1147 (2014) (noting how issuers may use their websites as a form of advertisement in order to reach a larger audience of investors).}

Despite this benefit to the issuer, a potential problem with Rule 506 exists concerning broker-dealers, which affects Mark’s Toy Company.\footnote{See David W. Blass, Chief Counsel, Div. of Trading and Markets, SEC, Speech at ABA, Trading and Markets Subcomm., Wash., D.C.: A Few Observations in the Private Fund Space (April 5, 2013) available at http://www.sec.gov/News/Speech/Detail/Speech/1365171515178#P41_11951 (observing that to determine whether one must register as a broker-dealer is a fact intensive question); see also} Specifically, Rule 506 provides an
exemption from registration as a broker-dealer when making an offering pursuant to the exemption, but the broker-dealer must comply with certain requirements and may not receive compensation.\footnote{Speech, David W. Blass, \textit{supra} note 42, at n. 10 (citing Exchange Act of 1934 § 3a4–1).} For instance, these unregistered broker-dealers must limit the offering by selling only to other broker-dealers or specified financial institutions; they must perform a substantial amount of other tasks for the issuer besides those associated with the securities transaction; they cannot have worked with another broker-dealer within 12-months; or they must limit communications to written means.\footnote{\textit{Id.} (citing Exchange Act of 1934 § 3a4–1).} However, most private fund advisors do not comply with this exemption committing a possible SEC violation placing the issuer at substantial risk of losing the exemption.\footnote{See John Jennings & Katherine Gutierrez, \textit{Main Street Goes Wall Street: The Risks of Unregistered Sales Agents in Small Business Capital Raising}, 24 S.C. LAW. 33, 33–34 (2012) (describing an intermediary’s substantial duties in order to comply with securities laws).} Although Markos may wish for SEC compliance regarding the Rule 506 exemption, he may find himself in a predicament: most registered broker-dealers are uninterested in small transactions while most unregistered broker-dealer requires payment for their services.\footnote{Jennings & Gutierrez, \textit{supra} note 45, at 33.}
Consequently, Markos may need to look elsewhere for a helpful exemption if he cannot find a reputable broker-dealer for his toy startup.\textsuperscript{48}

While Regulation A eased many burdens that Regulation D imposed pre-JOBS Act, the expenses related to choosing Regulation A were too costly for most crowdfunders.\textsuperscript{49} As a result, the JOBS Act improved Regulation A by adding Regulation A+.\textsuperscript{50} Regulation A+ increases the maximum aggregate unregistered offering amount from $5 million within a twelve-month period to $50 million.\textsuperscript{51} Even without this change, Markos could have used this exemption for Mark’s Toy Company, as his maximum aggregate unregistered offering is $5 million for the startup.\textsuperscript{52}

One benefit of this new addition is that it preempts state regulation unlike Rule 506 of Regulation D, making compliance easier.\textsuperscript{53} While Regulation A+ and Rule 506 allow issuers to solicit and advertise, Regulation A+ allows unlimited sales to unaccredited investors and permits

\textsuperscript{48} See Speech, David W. Blass, \textit{supra} note 42 (asserting that the unregistered status imply misconduct).

\textsuperscript{49} See Heminway & Hoffman, \textit{supra} note 13, at 921 n. 216 (illustrating how the average cost of choosing a Regulation A offering may outweigh the amount of capital the small business wants to raise).

\textsuperscript{50} Skelton, \textit{supra} note 14, at 484–85.

\textsuperscript{51} Id.

\textsuperscript{52} Id.

\textsuperscript{53} Jonathan Guest, \textit{Sussing Out Regulations A and D of the JOBS Act}, LAW360, May 08, 2012; see Fargnoli, \textit{supra} note 8, at 137 (stating that issuers can rely on general solicitations while supplying investors with simplified versions of the offering circular and the financial statements under Regulation A).
resale without restrictions.\textsuperscript{54} Also, it permits secondary offerings with some limitations.\textsuperscript{55} Consequently, some companies may find this offering attractive, because they can test the market for investor interest using solicitation materials before making the offering.\textsuperscript{56} If Markos tested the market and found more investor interest including those of unaccredited investors, Regulation A+ would be an attractive alternative to Rule 506 of Regulation D.\textsuperscript{57}

\textbf{C. Crowdfunding}

Another alteration to existing securities laws includes a new exemption for unregistered offerings through the crowdfunding platform previously disallowed.\textsuperscript{58} In order to make an

\footnotesize{\textsuperscript{54} Fargnoli, \textit{supra} note 8, at 137.}

\footnotesize{\textsuperscript{55} \textit{Id.}}

\footnotesize{\textsuperscript{56} \textit{See} Skelton, \textit{supra} note 14, at 486 (describing how an issuer under Regulation A+ may use certain solicitation materials in order to test the market before making an offering); \textit{see also} Guest, \textit{supra} note 52, at 137–38 (noting that entities who qualify under Regulation A can reduce their expenses, because they are not full-fledged SEC reporting companies who have greater reporting requirements).}

\footnotesize{\textsuperscript{57} Because Mark’s Toy Company would still have the benefit of general solicitation and advertising like Rule 506, it could widen its reach to either kind of investor. Fargnoli, \textit{supra} note 8, at 137.}

offering under this exemption, the issuer must use an intermediary.\textsuperscript{59} For a crowdfunding site to qualify as an intermediary, it must register with the SEC as a broker-dealer\textsuperscript{60} or a funding portal,\textsuperscript{61} and it must provide investors with educational materials notifying investors of any

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U.C. DAVIS BUS. L.J. 259, 263 (2013) (stating how the SEC may only regulate those transactions which involve securities—offerings involving “an equity stake to the people providing the money”).
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\textsuperscript{59} Skelton, \textit{supra} note 14, at 476 (citing 17 C.F.R. § 227.100(a)(3)); \textit{see also} BLOOMENTHAL \& WOLFF, \textit{supra} note 16, at § 9.52 (asserting that an issuer may only use one intermediary per offering and when the issuer makes concurrent offerings); \textit{see generally} Alan R. Palmiter, \textit{Pricing Disclosure: Crowdfunding’s Curious Conundrum}, 7 ENTREPREN. BUS. L.J. 373, 374 (2012) (noting that the purpose of requiring a crowdfunder to use an intermediary is to prevent investor fraud).

\textsuperscript{60} \textit{See} 15 U.S.C. § 78c(a)(4) (2012) (defining a broker as any person that participates in a securities transaction for another); \textit{see also} 15 U.S.C. § 78c(a)(5) (2012) (explaining a dealer as a person involved in buying and selling securities for another through a broker or otherwise); \textit{see also} BLACK’S LAW DICTIONARY, BROKER (noting how most broker-dealers are registered with the SEC before doing business).

\textsuperscript{61} \textit{See} 15 U.S.C. § 78c(a)(81) (2012) (describing a funding portal as any person participating as an intermediary involving a transaction regarding the offer or sale of a security for another pursuant to the Securities Act Section 4(a)(6)). \textit{Compare with} BLOOMENTHAL \& WOLFF, \textit{supra} note 16, at § 9.61 (asserting that broker-dealers enjoy more flexibility, because funding portals are restricted to a specific range of activities); \textit{with} Lougran et al., \textit{supra} note 57 (describing funding portals as a lighter version of broker-dealers); \textit{with} Palmiter, \textit{supra} note 58, at 421
risks. Six models for Internet crowdfunding exist: “(1) the donation model, (2) the reward model, (3) the pre-purchase model, (4) the peer-to-peer lending model, and (5) the equity model. Not all crowdfunding involves a security—donation, reward, pre-purchase, and some peer-to-peer lending types do not qualify as security offerings. When an entity uses

(declaring that while the Financial Industry Regulatory Authority (FINRA) requires broker-dealers to employ due diligence in suggesting a security, crowdfunding portals are forbidden from giving any such advice).


See C. Bradford, supra note 5, at 15 (defining the donation model as one in which a donation is given with no return on the amount contributed).

See id. at 16 (stating that the reward model offers a tangible to the investor in return for a contribution).

See id. (asserting that the pre-purchase model is the most common type in which the investor receives the entrepreneur’s product in return for the contribution).

See id. at 20–24 (describing the lending model type as one where potential lenders may browse a collection of loan requests).

Wroldsen, supra note 32, at 588 (quoting C. Steven Bradford, Crowdfunding and the Federal Securities Laws, 2012 COLUM. BUS. L. REV. 1, 14 (2012)); see Bradford, supra note 5, at 24 (asserting that the equity crowdfunding model is one that involves an exchange of securities: the investor receives a return on the amount contributed).

An offering made using the equity crowdfunding model is generally a security, because “investors receive ordinary corporate stock in exchange for their contributions.” See Bradford, supra note 5, at 31–33 (noting that the lending model involves a security only when interest is
crowdfunding to offer a security, the offering is subject to securities regulations and laws, unless it meets the requirements under an exemption.69

While the purpose of the crowdfunding exemption is to provide small businesses with an easier and less expensive alternative to raise capital, other limitations exist in order to prevent securities scams and protect investors.70 To benefit from this crowdfunding exemption, the issuer is limited to an aggregate amount of securities that it may sell to all investors: no more

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69 See Bradford, supra note 5, at 44 (stating that those selling securities through crowdfunding sites may avoid certain registration requirements if an exemption exists).

70 See Skelton, supra note 14, at 473–75 (asserting that crowdfunding expands a small business’s pool of investors); see also Hazen, supra note 13, at 1736–37 (noting how crowdfunding is designed to reach a large audience of potential investors); but cf. Palmiter, supra note 58, at 374 (declaring that the JOBS Act lowers the negligence threshold regarding antifraud liability for the issuer and the intermediary). Compare with Bloomenthal & Wolff, supra note 16, at § 9.61 (citing Securities Act, § 4A(c)(2)(B)) (noting that investors may bring a private action against issuers using the crowdfunding exemption, but the issuer may use the defense that “it did not know and in the exercise of reasonable care could not have known the untruth or omission”).
than $1 million within a twelve-month period. As a result, Markos would not be able to use this tool for his toy startup, because the offering exceeds the limit within a twelve-month period. In addition to issuer limitations, the crowdfunding provision restricts the amount individual investors may invest through these crowdfunding sites:

(B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—(i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.

The burden falls on the intermediary and not the issuer to ensure the investor purchases an amount in compliance with this limitation.

Some benefits to this new crowdfunding provision involve amendments to Sections 12(g) and 15(d) of the Exchange Act, which increase the threshold of company assets and shareholders. When the issuer meets this new threshold, it must register with the SEC:


72 If Markos could spread out the offering for his toy startup company over a five-year period without surpassing the limitations, he could use the crowdfunding exemption. See id. (noting how crowdfunding is used for small offerings)


74 See BLOOMENTHAL & WOLFF, supra note 16, at § 9.51 (explaining that if the issuer knows the investor exceeds its contribution limits, the issuer cannot rely on the intermediary for compliance).

75 Fargnoli, supra note 8, at 137.
company assets of more than $10 million, and over 2,000 persons or 500 unaccredited
investors. Under this new threshold, the “maximum aggregate amount of securities an issuer
may sell [. . .] is $1 million in a twelve-month period . . . [while the] aggregate amount of
securities an issuer may sell to any investor in reliance on Section 4(a)(6) is also capped.”

V. WHAT IS THE SEC DOING TO PREVENT FRAUD UNDER THE JOBS ACT?

A. SEC Increased Enforcement of Unregistered Broker-Dealers

Broker-dealers and funding portals are a necessary part of the crowdfunding exemption,
because they serve as “gatekeepers.” For instance, intermediaries have several
responsibilities. They must reasonably believe that an issuer looking to sell a security under
the crowdfunding provision complies with securities laws and that those issuers will keep

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76 See Skelton, supra note 14, at 463 n. 63 (citing JOBS Act § 501 and 15 U.S.C. §§ 78l(g),
78b(a)(9) (2013)) (defining a person as “a natural person, company government, or political
subdivision, agency or instrumentality of a government’’). Some shareholders are not included
in the threshold number under Section 12(g): those who received securities under an employee
compensation plan. Id. Also, the threshold for banks and bank holding companies have
increased to 2,000 persons while the deregistration limit increased to 1,200 persons. Id.

77 Id. at 475–76 (2013) (citing 17 C.F.R. § 227.100(a)(1) and Securities Act § 4(a)(6)). Compare
with Palmiter, supra note 58, at 375 (stating that in reality, the Crowdfunding provision caps
each offering at $500,000 due to the audit requirements).

78 BLOOMENTHAL & WOLFF, supra note 16, at § 9.61; Fargnoli, supra note 8, at 137.

(observing that intermediaries must reasonably believe the issuer is making an offering which
does not exceed the aggregate amount under the Securities Act Section 4(a)(6)(B)).
accurate records of holders.\textsuperscript{80} In addition to this duty, intermediaries must complete a regulatory check on each issuer and its officers to ensure they are not disqualified issuers.\textsuperscript{81} Consequently, intermediaries have a heavy burden to ensure the issuers and investors comply with the crowdfunding exemption.\textsuperscript{82}

In addition to the crowdfunding provision, broker-dealers work with issuers making other offerings such as those under Rule 506\textsuperscript{83} of Regulation D.\textsuperscript{84} However, when making a small offering, many businesses prefer to use unregistered broker-dealers known as “finders” in order to locate interested investors, because most banks and registered broker-dealers are uninterested in small transactions.\textsuperscript{85} The problem with using “finders” is that they act as broker-dealers in the

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\textsuperscript{80} Id. at § 9.61 (citing 15 U.S.C.A. § 77d–1(b)).

\textsuperscript{81} Id. (citing 15 U.S.C. 78c(a)(39)).

\textsuperscript{82} See id. (listing several more duties an intermediary is required to perform in order to comply with securities regulations).

\textsuperscript{83} Although an exemption from registration as a broker-dealer exists when making an offering pursuant to Rule 506 of Regulation D, the broker-dealer must comply with certain requirements and may not receive compensation likely resulting in non-compliance, as most prefer payment. Speech, David W. Blass, \textit{supra} note 42, at n. 10.

\textsuperscript{84} See Hamilton, \textit{supra} note 42 (observing that since the creation of Rule 506 of Regulation D, many unregistered broker-dealers appeared marketing themselves as capital raisers despite no registration with the SEC).

\textsuperscript{85} See Jennings & Gutierrez, \textit{supra} note 45 at 33 (defining finders as unregistered broker-dealers who locate investors for a fee). \textit{Compare with} Speech, David W. Blass, \textit{supra} note 42 (stating that the unregistered status of a finder indicates misconduct).
securities transaction violating securities laws as a result of their unregistered status and creating
problems for the issuer.86 For instance, if the business made the offering pursuant to Rule 506,
the exemption could be lost.87 Also, any future efforts to raise capital could fail or be delayed.88
As a result, the issuer bears a large risk when using an unregistered broker-dealer.89

Because these finders often engage in broker activity but remain unregistered, the SEC
has increased enforcement of the securities laws regarding these violations.90 One reason the
SEC has intensified its enforcement on this issue could be related to deregulation of some
securities laws under the JOBS Act such as allowing general solicitations and advertising for
some exemptions.91 Also, a filing requirement includes identifying payments to any broker-

86 Jennings & Gutierrez, supra note 45, at 33 (stating that the consequences for a finder consist
of nonpayment of contracted price, and criminal and civil liability). Compare with Brad R.
Jacobsen & Fred Pena, Securities Finders—More Confusing Than Ever Before, 27 UTAH BAR J.
38, 38 (2014) (noting that registration with the SEC should be simple for Private Placement
Broker-Dealers, but registration is confusing).

87 Jennings & Gutierrez, supra note 45, at 34.

88 Id.

89 See id. at 33–34 (describing several possible consequences an issuer may face as a result of
using an unregistered broker-dealer).

90 Watts, supra note 11, at 3.

91 See Hamilton, supra note 42 (forecasting a rise in SEC enforcement of broker-dealer
registration securities laws post-JOBS act as a result of allowing general solicitations and
advertising for some offerings).
dealers or “finders” notifying the SEC of these types of violations.\textsuperscript{92} One recent case of SEC enforcement involves the \textit{Ranieri Partners}\textsuperscript{93} where the SEC brought actions against the finder and the private equity fund’s managing partner and investment manager due to the finder’s broker-dealer activity.\textsuperscript{94} In an address to the American Bar Association (ABA), the SEC warned that more cases like \textit{Ranieri Partners} could be expected where both parties, the finder and the issuer, are sanctioned.\textsuperscript{95} As a result of an increase in unregistered broker-dealer enforcement, when businesses or other unregistered persons solicit investor capital, they must ensure they are in compliance with securities laws or face substantial risks.\textsuperscript{96} As the SEC releases more rules regarding the JOBS Act changes, such enforcement could continue to increase.\textsuperscript{97}

\footnotesize
\begin{itemize}
  \item \textsuperscript{92} See Jennings & Gutierrez, \textit{supra} note 45, at 33–34 (noting how the new version of Form D assists the SEC in enforcing compliance with the broker-dealer registration by requiring issuers to note whether it paid the “finder” for its services).
  \item \textsuperscript{95} Speech, David W. Blass, \textit{supra} note 42; Curzon, et al., \textit{supra} note 84.
  \item \textsuperscript{96} Watts, \textit{supra} note 11, at 3.
  \item \textsuperscript{97} \textit{Id.}
\end{itemize}
B. SEC’s Fight Against Fraud

One main criticism of the JOBS Act is that it facilitates fraud.98 For example, some critics believe the Act promotes “pump and dump” schemes.99 This situation occurs when the entity “pumps” share prices by creating excitement through exaggeration of financials and statements, which raises the value causing the company to sell the shares at an inflated price; however, when the entity’s true state becomes public, “the shares become worthless leaving duped investors hanging.” 100 In order to make money, those holding an interest in the Mark’s Toy Company could easily defraud the new investors purchasing its latest offering by advertising on its website using exaggerated financials to create excitement, then dumping their interest once the share prices rise to an inflated price.101 Critics think that the Internet will be the primary source of this type of fraud, because the Internet nurtures impulsivity and houses crowdfunding

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98 See Thompson & Langevoort, supra note 7, at 1574; see Derman supra, note 4, at 140 (asserting that the JOBS Act enables investor fraud).

99 Morsy, supra note 32, at 1382.

100 Id. at 1380; see Wroldsen, supra note 32, at 604 (illustrating the use of “pump and dump” schemes during the 1990s by abusing Rule 504 under Regulation D: a method to create inflated stock prices by inventing widespread interest in the small business with little capital, low share prices, and slight analyst coverage, and then selling the shares before discovery of the inflated stock prices).

101 Markos would likely misuse the advertising and general solicitations provision under Rule 506 of Regulation D. Id.
While the SEC has yet to release the finalized regulations regarding crowdfunding under the JOBS Act, the Act requires the crowdfunding portals and issuers to comply with Section 77d–1; i.e. they must make sure that each investor reviews investor related education materials and confirms an understanding of the risk of loss and who bears that loss.103

Fortunately the JOBS Act provides remedies for defrauded investors.104 For example, Section 77d–1(c)(2) of the Act creates liability for issuers who, by any written or oral means,

102 See id. (describing how the Internet creates opportunities for fraud by encouraging imprudent decisions regarding one’s financial security).

103 See id. (quoting 15 U.S.C. § 77d–1(a)–(b)) (stating that the issuer must meet the requirements in Section 77d–1 in order to qualify for exemptions under the JOBS Act).

104 See id. at 1385 (describing a provision in the JOBS Act as codified in 15 U.S.C. Section 77d–1(c)(2) that creates a liability for issuers who commit fraud or misstate information resulting from the crowdfunding portal). 15 U.S.C. Section 77d–1(c)(2) states:

An issuer shall be liable in an action under paragraph (1), if the issuer—(A) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of section 77d(6) of this title, makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission; and (B) does not sustain the burden of proof that such issuer did not know, and in
mislead investors, make false statements of material facts, or omit necessary or required information in order to induce the purchase of securities under the exemption under Section 77d(6) of the JOBS Act.¹⁰⁵

One example of such fraud for which investors could have taken action under the remedies provisions of the JOBS Act had the bad actor not been caught before defrauding investors occurred just after the JOBS Act was signed into law.¹⁰⁶ The federal government filed its first criminal complaint in 2012 alleging Mr. William J. Reilly committed securities fraud by using the JOBS Act and other securities regulations to exempt Caribbean Pacific from certain filing requirements.¹⁰⁷ The government claims that Mr. Reilly amended Caribbean Pacific’s registration statement defining the company as an “emerging growth company,” which qualified the entity for exemptions from certain offerings, auditing, and reporting obligations.¹⁰⁸ As a result, the exercise of reasonable care could not have known, of such untruth or omission. 15 U.S.C. § 77d–1(c)(2) (2012).

¹⁰⁵ Morsy, supra note 32, at 1385.

¹⁰⁶ Reilly, No. 1:13-cr-20097-MGC.


¹⁰⁸ Reilly, No. 1:13-cr-20097-MGC at 11; see also Morsy, supra note 32, at 1383 (noting how the Caribbean Pacific Marketing advertised itself as an EGC online leading to a charge of securities fraud by the SEC).
result, the company marketed itself to investors online as an “emerging growth company” which convinced investors that the entity had value, which it did not. 109 By using the JOBS Act to qualify for exemptions, Mr. Reilly hid himself from the SEC who had barred him from practicing before it as a result of previous fraudulent acts. 110 The government caught Mr. Reilly, because he had sent a term sheet with supporting documents for a private offering via email to several business associates including one working for the FBI, who used this associate as an informant to investigate penny stock fraud in Florida. 111 Had Mr. Reilly been careful with his email list, the government may not have caught him. 112


112 See id. (illustrating how Mr. Reilly violated securities laws in several ways: he sold stock when the SEC had not yet announced an effective registration statement; he knowingly failed to publicize his association with Caribbean Pacific and his past violations with the SEC; he misappropriated funds from the proceeds of a sale of stock for his personal use violating the company’s Form S–1; he filed a false and misleading registration statement and prospectus with the SEC).
A year after the SEC filed the Reilly case, the SEC filed another in 2013 regarding investor fraud related to the JOBS Act. In that case, a man named Peterson allegedly sold USA Fund securities to several investors by making materially false and misleading statements regarding his business plans. When making these misrepresentations, Peterson promised investors that a future offering would be made pursuant to the JOBS Act rules allowing him to raise billions of dollars by advertising to the general public. These claims were false, and the SEC requested the court require the defendants to “disgorge their ill-gotten gains” and enjoin them from continuing their unlawful conduct. However, Mr. Peterson had already spent the money he received for the original offering on personal items such as rent, food, and vacations. Because Mr. Peterson had already spent the money he received by defrauding investors, this type of SEC action comes too late as the investors are unlikely to recoup their

113 USA Real Estate Fund 1, Inc., Fed. Sec. L. Rep (CCH) P98,012.

114 See id. at 6 (describing how Peterson defrauded investors out of more than $400,000 in an offering for common stock).

115 See id. at 3 (explaining how Peterson used the JOBS Act to sell his offerings to investors by claiming the JOBS Act would give him access to major securities brokerages allowing him to sell to the public as well as conduct his own marketing).

116 Id. at 2.

investment. Thankfully, the SEC was able to enjoin Mr. Peterson and his company from making any such future misrepresentations to potential investors regarding the JOBS Act.

If the government had not found Mr. Peterson before defrauding investors like Mr. Reilly, the investors could seek remedies against him and his company in the form of a private action. However, such lawsuits against issuers are difficult, because the damages do not outweigh the costs of litigation. Because the SEC and the investors have limited resources, the best investor protection rests in the securities regulations.

III. CONCLUSION

When President Obama signed the JOBS Act into law in 2012, it forced the SEC to implement new rules. The purpose of this piece of legislation was to stimulate job growth.

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118 While the SEC stopped Mr. Peterson’s behavior by enjoining him, it does not seem likely Mr. Peterson will pay back the investors, because he spent the money already. See id. at 1–2.


120 See Morsy, supra note 32, at 1385 (citing 15 U.S.C. Section 77d–1(c)(2)) (discussing how a provision in the JOBS Act creates a cause of action against issuers who commit fraud or misstate information resulting from the crowdfunding portal).

121 See Palmiter, supra note 58, at 416 (disclosing that the investor would recover a maximum in damages of consideration paid, which would be low given the investment caps for crowdfunding).

122 See id. at 375 (emphasizing that the SEC would publically enforce the egregious and high-profile cases leaving most complaints up to private enforcement, which is unlikely to occur given the small amounts at issue and the high cost of litigation).

123 Derman supra, note 4, at 140 (2014).
In order to accomplish this goal, the Act changed how small businesses target investors and what kind of investors these small businesses may approach for financing. While the JOBS Act has its restrictions, it allows small businesses with projected growth to go public by qualifying as an EGC giving it time to transition into providing the SEC with all costly reporting requirements.

Despite these benefits, many think this Act has the potential to generate investor fraud by trading investor protection for capital formation and job growth. Because of this potential for fraud, the SEC has taken steps to ensure investor protection by increasing enforcement of broker-dealer securities laws. Unfortunately some investors will be defrauded before the SEC catches the bad actor as is demonstrated by the Real Estate Funds case. While the SEC caught Mr.

124 See Siegel, supra note 7, at 779 (describing the goal of the JOBS Act as stimulating the economy, creating jobs, and increasing business funding); see also Thompson & Langevoort, supra note 7, at 1574 (stating that the JOBS Act’s goal is to generate job creation).

125 See Fargnoli, supra note 8, at 135–36 (explaining that the JOBS Act expands on and creates exemptions, which increases a small business’s access to capital).

126 See BLOOMENTHAL & WOLFF, supra note 16, at § 5.50 (quoting Senator Toomey (R-PA)) (asserting that the EGC option gives small companies the opportunity to go public and transition into paying for all necessary SEC reporting requirements once they no longer qualify).

127 See Thompson & Langevoort, supra note 7, at 1574; see also Derman supra, note 4, at 140 (describing the potential for investor fraud as a result of enacting the JOBS Act).

128 Watts, supra note 11, at 3; see Tozzi, supra note 11 (explaining the SEC’s strong stance on enforcing JOBS Act violations).

129 See USA Real Estate Fund 1, Inc., Fed. Sec. L. Rep (CCH) P98,012 (illustrating how the issuer defrauded investors before the SEC brought charges of securities violations against it).
Reilly before he defrauded investors, this suit illustrates the luck and the difficulty involved in catching bad actors who hide themselves from SEC view.\textsuperscript{130} As a result, monitoring the market post-JOBS Act in order to find these bad actors proves difficult until an investor complains or the SEC notices due to the lack of reporting requirements, and the issuer’s ability to solicit and advertise certain offerings.\textsuperscript{131}

Consequently, the best protection still lies with the reporting requirements in order to aid the SEC in finding these bad actors.\textsuperscript{132} For instance, the Form D filing required for certain offerings requires the issuer to state whether it paid a finder or broker-dealer giving the SEC insight as to whether it needs to investigate a possible securities violation.\textsuperscript{133} Since many favor deregulation as is evidenced by passage of the JOBS Act, the SEC should keep a watch list for those who elect and meet these exemptions ensuring compliance and investor protection by looking for any deviation from what is submitted to the SEC versus what is offered to

\textsuperscript{130} See Reilly, No. 1:13-cr-20097-MGC at 9 n. 1 (explaining how the FBI caught Reilly: through an FBI informant).

\textsuperscript{131} See Siegel,\textit{ supra} note 7, at 780 (observing that the crowdfunding exemption presents a difficulty: “balancing deregulated offering registration exemption, thus increasing a business’s access to capital, and protecting sophisticated and unsophisticated investors from fraud”).

\textsuperscript{132} See Palmiter,\textit{ supra} note 58, at 375 (describing how the SEC generally goes after large violators).

\textsuperscript{133} See Jennings & Gutierrez,\textit{ supra} note 45, at 33–34 (illustrating how the newest version of Form D helps the SEC enforce compliance with the broker-dealer registration by requiring issuers to note whether it paid the “finder” for its services).
investors. With a proactive stance on securities violations, the SEC will be able to combat investor fraud more effectively.

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134 See Judge Stanley Sporkin, The SEC Can No Longer Regulate from Behind, 18 N.C. Banking Inst. 65, 68–69 (2013) (asserting that the SEC should be more proactive rather than reactive when dealing with securities law violations, because putting companies out of business or placing people in prisons is not enough).

135 Id.