COMMENTS

THE COMMON DENOMINATOR BETWEEN CROWDFUNDING AND SECURITIZATION OF SUBPRIME MORTGAGES: THE SEC

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ABSTRACT

The Jumpstart Our Business Startups (JOBS) Act opened a closed financial market to average Americans. The JOBS Act permits entrepreneurs to seek business funding from unsophisticated investors by selling them a portion of their company. As the landscape of small business funding shifts from institutional and expert investors to unsophisticated investors under the new act, the U.S. Securities and Exchange Commission (SEC) has attempted to keep pace. Yet a closer look at how crowdfunding has developed, and how the SEC has moved to regulate it, reveals that measures already enacted are insufficient to protect novice investors. This is not a new failure. In the past, the SEC failed to properly supervise entities involved in the securitization of subprime mortgages, which contributed to the largest economic collapse since the Great Depression. This Comment draws parallels between the SEC's role during the subprime market's collapse and its current role in regulating the equity crowdfunding industry. Further, this Comment aims to offer recommendations, informed by the SEC's shortcomings in regulating key industry players of the subprime market, in order to enact regulations protecting equity crowdfunding investors.

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* J.D. Candidate, 2018, American University Washington College of Law. This Comment has only become a reality with the constant support of my husband, Ross Cohen. I would also like to thank my parents and siblings for their love and encouragement throughout the process. Additionally, I want to thank Professor Heather Hughes and Professor Jeffrey Lubbers for their invaluable guidance in shaping this Comment. Finally, I want to thank Keiran Bleich, Amber Unwala, and the rest of the dedicated *Administrative Law Review* staff for their hard work, recommendations, and assistance.

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INTRODUCTION

In the United States, entrepreneurs like Steve Jobs, chief executive officer of Apple, and Mark Zuckerberg, co-founder of Facebook, changed the course of history.[1] Many people living in the United States believe this country fosters entrepreneurial ventures.[2] Perhaps it is this belief that fuels the increasing number of people starting their own businesses.[3] Americans

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1. *See Steve Jobs*, BIOGRAPHY.COM, http://www.biography.com/people/steve-jobs-9354805 (last updated Apr. 27, 2017) (noting that Jobs and his partner, Steve Wozniak, transformed and democratized technology by creating products that were smaller, cheaper, and easier for average consumers to access); *Mark Zuckerberg*, BIOGRAPHY.COM, http://www.biography.com/people/mark-zuckerberg-507402 (last updated Apr. 27, 2017) (explaining that Zuckerberg created an online social network platform that revolutionized the way people connected with one another).

2. *See* Elaine Pofeldt, *U.S. Entrepreneurship Hits Record High*, FORBES (May 27, 2013, 6:45 PM), https://www.forbes.com/sites/elainepofeldt/2013/05/27/u-s-entrepreneurship-hits-record-high (finding that 43% of Americans believe that entrepreneurs have good opportunities in this country).

3. *See* ROBERT W. FAIRLINE ET AL., 2015 KAUFFMAN INDEX OF STARTUP ACTIVITY: NATIONAL TRENDS 7–9 (2015), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2015/05/kauffman_index_startup_activity_natio

have witnessed startup companies like GoPro—which designs wearable cameras—leverage initial funding of ten thousand dollars to a net worth of over one billion dollars.[4] However, most startups do not attain GoPro's level of success; nine out of ten startups are likely to fail.[5] Two main reasons startups tend to fail are lack of cash flow and inability to generate additional investments.[6]

In 2012, Congress enacted the Jumpstart Our Business Startups (JOBS) Act to resolve the issue of small companies' lack of access to capital.[7] The Act contains seven titles, each deregulating or amending prior securities laws that may improve startups' ability to generate additional funds.[8] The Securities and Exchange Commission (SEC or Commission), as required under the JOBS Act, promulgated Regulation Crowdfunding.[9] Prior to Regulation Crowdfunding, startups could only raise capital from a limited number of public investors.[10] When signing the JOBS Act, President Obama said, "This bill is a potential game changer" for startups because "[f]or the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."[11] The JOBS Act opened a closed fi-

nal_trends_2015.pdf (showing the largest increase in startup activity occurred between 2014 and 2015 as measured by its index, which is based on three components: the percentage of adults who became entrepreneurs in a given month, whether the entrepreneur started her business based on need or opportunity, and the number of new employers in a given region).

4. *See, e.g.*, Archie Bland, *The Rise of GoPro: Why Wearable Cameras Make Us Film Everything*, GUARDIAN, Oct. 4, 2014, https://www.theguardian.com/technology/2014/oct/04/rise-of-gopro-wearable-cameras; Robert Scoble, *Why Do Most of the Successful Startups Come Out of the USA?*, FORBES (July 29, 2013, 12:47 PM), http://www.forbes.com/sites/quora/2013/07/29/why-do-most-of-the-successful-startups-come-out-of-the-usa.

5. Neil Patel, *90% of Startups Fail: Here's What You Need to Know About the 10%*, FORBES (Jan. 16, 2015, 10:00 AM), http://www.forbes.com/sites/neilpatel/2015/01/16/90-of-startups-will-fail-heres-what-you-need-to-know-about-the-10.

6. *See* David Skok, *5 Reasons Startups Fail*, FORENTREPRENEURS, http://www.forentrepreneurs.com/why-startups-fail (last visited June 12, 2017).

7. Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C.).

8. *See id.*

9. 80 Fed. Reg. 71,388 (Nov. 16, 2015) (codified at 17 C.F.R. 200, 227, 232, 239, 240, 249, 269, & 274).

10. *See* Pofeldt, *supra* note 2 (discussing a study that indicated startups gained only 16% of needed capital from banks and 82% of funds came from personal savings, family, and friends).

11. President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012) (transcript available at https://obamawhitehouse.archives.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing).

nancial market for startups and investors. Startups can now sell securities online without registering with the SEC,[12] and middle class Americans can use the Internet to invest in businesses.[13]

Crowdfunding is a new financial innovation that enables companies to raise funds, usually in exchange for a small reward from individuals through online platforms.[14] Equity crowdfunding allows startups to sell shares of their business to raise money from investors.[15] Equity crowdfunding is a recent phenomenon and thus its proper regulation depends on understanding and learning from another financial innovation with a longer history—securitization of subprime mortgages. Securitization of subprime mortgages expanded the credit market to people who could not otherwise afford to purchase homes,[16] just as equity crowdfunding expands the capital market for businesses that cannot acquire funds through conventional methods.

Part I of this Comment will discuss the evolution of crowdfunding and

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12. *Eliminating the Prohibition Against General Solicitation & General Advertising in Rule 506 and Rule 144A Offerings*, SEC. EXCHANGE COMMISSION, https://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm (last modified Sept. 20, 2013); *see also* Stacy Cowley, *New Crowdfunding Rules Let the Small Fry Swim with Sharks*, N.Y. TIMES, May 14, 2016, http://www.nytimes.com/2016/05/15/business/dealbook/new-crowdfunding-rules-let-the-small-fry-swim-with-sharks.html (explaining that Regulation Crowdfunding is an exemption from securities registration requirements for companies attempting to raise funds through an online portal).

13. Sharon Yamen & 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. REV. 41, 41–42, 42 n.5 (2015).

14. *See The Basics of Crowdfunding*, ENTREPRENEUR, https://www.entrepreneur.com/article/228125 (last visited Aug. 11, 2017).

15. *See* David Glickman, *Equity-Based Crowdfunding: The New Kid on the Block*, HUFFINGTON POST, http://www.huffingtonpost.com/david-glickman/equitybased-crowdfunding-_b_9694588.html (last updated Apr. 19, 2017).

16. *See generally* Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis*, 124 Q.J. ECON. 1449 (2009). Two of the reasons for the growth of subprime borrowers' credit may have been income prospects of the borrowers and the lenders' expectation of future increase in housing prices. *Id.* at 1450–51. The authors demonstrate that neither of the above reasons effectively explain the rise of subprime borrowers' credit; securitization of subprime mortgages, however, provides the most support in explaining the rapid growth of credit. *Id.* at 1453–55; *accord* Governor Edward M. Gramlich, Remarks at the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004), https://www.federalreserve.gov/boarddocs/speeches/2004/20040521 (noting the rise in credit and homeownership was due to increased subprime mortgages).

different models that led to the creation of equity crowdfunding. It will also address how changes in the law impact available models. Part II will connect equity crowdfunding to its predecessor, securitization of subprime mortgages, by examining the historical and structural similarities between the two. It will also explain some of the reasons for the subprime mortgage market's downfall. Part III will address how the JOBS Act and the SEC's Regulation Crowdfunding affect different players in the securities industry. Finally, Part IV notes the problematic similarities between key industry players of subprime mortgage market and equity crowdfunding. It will also recommend some modifications to the SEC's Regulation Crowdfunding to avoid repeating past mistakes and protect investors.

I. THE PHENOMENON OF CROWDFUNDING

A. What is Crowdfunding?

Equity crowdfunding is a way for individuals, businesses, and organizations to raise capital from other organizations and people using the Internet.[17] This new method of raising funds became increasingly essential as angel investors[18] and venture capital firms became highly selective in the types of companies they funded.[19] Since using an online platform allows small businesses to reach a wider pool of investors, many industry experts believe that equity crowdfunding will change the financial investment market.[20]

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17. *See* Ryan Goodrich, *What is Crowdfunding?*, BUS. NEWS DAILY (Mar. 13, 2013, 5:15 PM), http://www.businessnewsdaily.com/4134-what-is-crowdfunding.html.

18. *See* Entrepreneur Staff, *Angel Investor*, ENTREPRENEUR, https://www.entrepreneur.com/encyclopedia/angel-investor (last visited Aug. 11, 2017) (defining angel investors as people who invest their own money, whereas venture capitalists invest other people's money into promising companies).

19. *See* Richard Swart, *Why Equity Crowdfunding Matters to Small Business*, ENTREPRENEUR (July 21, 2016), https://www.entrepreneur.com/article/278744.

20. *See* Jonathan Thornton & Guy Wilmot, *New Crowdfunding Rules: Implications for Small Businesses*, GUARDIAN, Apr. 22, 2014, https://www.theguardian.com/small-business-network/2014/apr/22/new-crowdfunding-rules-small-businesses; *see also* Steven Chase, *Foreword* to CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 4, 4 (Colin Blackman ed., 2013), https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf. Crowdfunding is an efficient way for investors to assess multiple companies simultaneously and quickly determine whether the company fits their portfolio strategy and risk tolerance. WORLD BANK, CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 26 (Colin Blackman ed., 2013), https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf. Additionally, crowdfunding permits investors to fund companies located in foreign

The most common and popular type of crowdfunding allows people to seek donations from average Internet users, and donors generally donate without any expectation of a return.[21] The three most popular non-equity crowdfunding platforms are Kickstarter, GoFundMe, and Indiegogo.[22] Kickstarter mandates that people who raise funds on its website set and meet their predetermined fundraising goals; if the fundraisers fail to meet their goal, the funds are returned to the backers.[23] Kickstarter also permits fundraisers to offer rewards to backers.[24] GoFundMe has a simple model: begin a campaign, advertise it to everyone on the Internet, and collect the donations.[25] The website retains 5% of the donations; the rest go to the fundraisers.[26] Indiegogo combines the other two platforms' models; users are allowed to choose between the entirely donative model of GoFundMe or the all-or-nothing model of Kickstarter.[27] The SEC does not supervise these platforms or startups that use them to raise money because donors cannot claim any ownership or profits earned by the startups.[28] Equity crowdfunding, however, changes the relationship between its users and the SEC. Companies that choose the equity crowdfunding method to raise funds would be selling securities[29] to the general public, and securities sold

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countries, and such a boundless approach to investment will spur a new form of economic growth. *Id.* at 31.

21. Frank Vargas et al., *Understanding Crowdfunding: The SEC's New Crowdfunding Rules and the Universe of Public Fund-Raising*, BUS. L. TODAY, Dec. 2015, at 1–2.

22. *Id.*

23. *Id.* at 2; *see also* Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 3 (2014) (describing that a reward-based crowdfunding system allows funders to be early customers, which can mean that they are given first access to products or discounts on purchases).

24. *See* Kathryn Judge, *The Future of Direct Finance: The Diverging Paths of Peer-To-Peer Lending and Kickstarter*, 50 WAKE FOREST L. REV. 603, 630 (2015) (explaining that entrepreneurs establish the amount of funding that would make a funder eligible for a reward).

25. *See How It Works*, GOFUNDME, https://www.gofundme.com/tour (last visited Aug. 11, 2017).

26. *See* Vargas et al., *supra* note 21, at 2.

27. *See* Chance Barnett, *Donation-Based Crowdfunding Sites: Kickstarter vs. Indiegogo*, FORBES (Sep. 9, 2013, 9:00 AM), http://www.forbes.com/sites/chancebarnett/2013/09/09/donation-based-crowdfunding-sites-kickstarter-vs-indiegogo (claiming that many users choose Indiegogo because it provides flexibility).

28. *See* Reza Dibadj, *Crowdfunding Delusions*, 12 HASTING BUS. L.J. 15, 20–21 (2015) (discussing how Kickstarter and Indiegogo make it explicit to their users that their fund is not a "for-profit 'investment'").

29. The definition of securities as stated in the Securities Act of 1933 is too vague but the Supreme Court case *SEC v. Howey* provides a more precise definition of securities: "[A]n

in the United States must be registered with the SEC or exempted from registration.[30] Congress created the SEC to administer the securities laws, to promote stability in the markets, and ultimately, to protect investors.[31] In order to protect investors, Congress has given the SEC "broad authority over all aspects of the securities industry."[32]

B. Models of Equity Crowdfunding

Startups generally could not afford the extensive and expensive registration requirements with the SEC;[33] thus, selling securities to raise funds was not economically sound.[34] The JOBS Act attempts to resolve this conundrum by providing exemptions to the registration requirements that could reduce startups' initial costs.[35] Prior to Congress's enactment of the JOBS Act, SEC's Rule 502(c) prohibited companies from advertising and soliciting the sale of securities via sources like the Internet.[36] Title II of the JOBS Act removes such prohibitions for companies if they offer securities only to accredited investors—individuals whose net worth is more than one million dollars or whose annual income is more than two hundred thousand dollars for the past two years and who expect the same amount of income in the year of investment.[37] Title II of the JOBS Act also directed the SEC to

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investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party." *Id.* at 18–19 (citing 328 U.S. 293, 298–99 (1946)).

30. 15 U.S.C. § 77e (2012).

31. *Id.* § 78b.

32. *What we do*, SEC. EXCHANGE COMMISSION, https://www.sec.gov/Article/whatwedo.html#laws (last modified June 10, 2013).

33. *See* Matthew A. Pei, Note, *Intrastate Crowdfunding*, 2014 COLUM. BUS. L. REV. 854, 863 (2014).

34. *See id.* at 863–64.

35. *See* Susan Chaplinsky et al., *The JOBS Act and the Costs of Going Public*, CLS BLUE SKY BLOG (Sept. 25, 2014), http://clsbluesky.law.columbia.edu/2014/09/25/the-jobs-act-and-the-costs-of-going-public/ (noting the primary purpose of the Jumpstart Our Business Startups (JOBS) Act was to reduce costs for small businesses attempting to become public companies).

36. Pub. L. No. 112-106, 126 Stat. 306, § 201(a) (2012).

37. 17 C.F.R. § 230.501(a)(5)–(6) (2016). This is not an exhaustive list of prerequisites that can qualify someone as an accredited investor. *Id.* § 230.501(a)(1)–(7). Entities can also qualify as accredited investors, but the standard for qualification varies. *Id.* § 230.501(a)(8), (e)(2).

amend Rule 506,[38] which now permits issuers to raise capital from unlimited accredited investors, but only from thirty-five non-accredited investors—individuals who do not meet the accredited investor standards.[39] Under Rule 506's exemption, companies seeking funds from non-accredited investors bear the responsibility to ensure that those investors have the knowledge of and experience in the financial industry to appreciate risks associated with their investment.[40] Additionally, investors can no longer self-certify their status as accredited or not, leaving issuers accountable for doing due diligence to verify investors' status.[41]

The change that President Obama referred to in his speech, and the main focus of this Comment, is part of Title III of the JOBS Act. Title III of the JOBS Act amended the Securities Act of 1933 ('33 Act)[42] by adding § 4(a)(6), which permits issuers to sell securities up to one million dollars in a twelve-month period without registering with the SEC.[43] Under the new 4(a)(6) exemption, entrepreneurs can advertise and solicit investments from non-accredited investors.[44] Anyone can invest, but the law limits how much one is permitted to spend within a twelve-month period.[45] The ex-

38. *Id.* § 230.506(c).

39. *Id.* § 230.506; *see also* Michael Raneri, *The New ABCs of Private Placements: 506(b) and 506(c)*, FORBES (Mar. 11, 2015, 3:29 PM), http://www.forbes.com/sites/mraneri/2015/03/11/the-new-abcs-of-private-placements-506b-and-506c (suggesting the addition of the new rule will allow issuers to reach a much broader group of investors, which will increase the amount and speed of available funding).

40. 17 C.F.R § 230.506(c)(2)(ii); *see also Rule 506 of Regulation D*, SEC. EXCHANGE COMMISSION, https://www.sec.gov/answers/rule506.htm (last modified Oct. 6, 2014).

41. *See* § 230.506(c)(2)(ii); *see also* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 585–87 (2015); Raneri, *supra* note 39 (noting that the process of verifying investor status can be fairly simple because some online marketplaces have already verified investors' status with securities attorneys' supervision and can provide proof of the verification to issuers). Accredited investors have joined online platforms, such as FundersClub, to fund startups. Ibrahim, *supra*, at 583. The site has established committees of members who have personal expertise and a network of trusted sources that will prescreen startups before their members invest in the company. *Id.* at 584–85. Ultimately, the onus of due diligence to verify investor status is minimal on issuers since funding portals have already presumed that responsibility. Raneri, *supra* note 39.

42. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

43. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306 (2012).

44. *See* 15 U.S.C. § 77d(a)(6) (2012).

45. *Id.* § 77d(a)(6)(A)–(B); *see* Robert B. Robbins, *Practical Implications of the JOBS Act Changes to Private Placements: Rule 506(c), Crowdfunding, and Reg A+*, PILLSBURY WINTHROP

emption specifies that individuals whose annual income or net worth is one hundred thousand dollars or less can only invest either two thousand dollars or 5% of their income or net worth, whichever is greater in value;[46] individuals whose annual income or net worth is greater than one hundred thousand dollars can invest 10% of their income or net worth, whichever is lesser in value.[47] The exemption also limits how and when investors can sell their securities, which is supposed to be a protective measure for both the investors and the startups; investors are not allowed to sell their securities for a year after purchase unless they are transferring them back to the issuer, an accredited investor, a family member, or as an offering registered with the SEC.[48] Issuers that use the 4(a)(6) exemption must sell their securities via a registered broker or a funding portal.[49] Funding portals are the new category of intermediaries Congress created to aid crowdfunded transactions.[50]

Equity crowdfunding aims to resolve the lack of funding issue for companies that were unsuccessful in traditional financial investment industries.[51] Likewise, subprime mortgage lending attempted to resolve lack of homeownership for people with poor credit histories, but the similarities between the two financial innovations extend beyond their shared methods into their mutual faults.[52] Both financial innovations became a reality due to Congressional deregulations. Therefore, evaluating the deregulations that gave rise to, and brought the downfall of, the subprime mortgage market could offer insights to the SEC in amending its crowdfunding regulations.

SHAW PITTMAN LLP 1, 5 (Oct. 6, 2014), http://www.pillsburylaw.com/siteFiles/Publications/WhitePaperOct2014CorporateandSecuritiesPracticalImplicationsoftheJOBSActChanges.pdf (suggesting that the numerous limitations on both the investors and the issuers will likely discourage companies from using this option to raise funds).

46. 15 U.S.C. § 77d(a)(6)(B)(i).

47. *Id.* § 77d(a)(6)(B)(ii).

48. *Id.* § 77d-1(e)(1); 17 C.F.R. § 227.501 (2016).

49. 15 U.S.C. § 77d(a)(6)(C).

50. *See id.* § 77d-1(a); Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals under the Crowdfunding Act*, 13 U.C. DAVIS BUS. L.J. 177, 179 (2013) (noting that Congress only described some characteristics of funding portals, and directed the U.S. Securities and Exchange Commission (SEC) to fully define features of funding portals).

51. *See* Ibrahim, *supra* note 41, at 562–63.

52. *See infra* Part II.

II. SUBPRIME LENDING

A. How Innovative Mortgage Lending Resembles Crowdfunding

The mortgage lending market changed drastically as regulations evolved throughout the 1980s. In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA),[53] which allowed depository institutions to charge any interest rate they chose on loans and mortgages;[54] however, the DIDMCA also mandated that those institutions follow the Federal Reserve's requirements.[55] In 1982, Congress passed the Alternative Mortgage Transaction Parity Act (AMTPA),[56] which removed a restriction that banks could only make fixed rate amortizing mortgages.[57] The removal of this restriction "allowed lenders to offer adjustable-rate mortgages and balloon payments."[58] Congress then passed the Tax Reform Act of 1986,[59] which permitted homeowners to deduct interest rates on mortgages and home equity loans from their taxable income.[60] The combination of these laws encouraged a more efficient lending market; more people looked to become homeowners, and lenders could meet the higher demand for mortgages by setting interest rates according to consum-

53. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.).

54. *See* Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 6 (2009); *see also* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 477 (2000) (noting that the federal government began regulating interest rates after the Great Depression to "preserve and encourage homeownership and to provide relief to homeowners who found it difficult or impossible to make their mortgage payments").

55. *See* Kenneth J. Robinson, *Depository Institutions Deregulation and Monetary Control Act of 1980*, FED. RES. HIST. (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/43 (explaining that the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) imposed requirements, such as setting aside certain amount of funds in cash and paying fees for the Federal Reserve's services, so that the Federal Reserve System could have a better control over money supply).

56. *See* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, tit. VIII (1982) (codified as amended at 12 U.S.C. §§ 3801–3806 (2012)).

57. *See* Mansfield, *supra* note 54, at 511 (explaining that drastic and unpredictable changes in the interest rates made it difficult for lenders to provide consumers with fixed-term, fixed-rate credit on residential properties).

58. Zywicki & Adamson, *supra* note 54, at 6.

59. Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified in scattered sections of 26 U.S.C.)

60. *Id.*; *see also* Zywicki & Adamson, *supra* note 54, at 6.

ers' credit histories.[61] The deregulations and improved underwriting procedures, which allowed lenders to research and assess the financial risk of an applicant, gave rise to subprime lending.[62] However, it was securitization of subprime mortgages that ultimately fueled the growth of the subprime mortgage market.[63]

B. Significance of Securitization

People who qualified for subprime loans were historically excluded from the mortgage industry because they were risky borrowers.[64] Deregulations in the 1980s allowed lenders to loan money to questionable borrowers because lenders could calculate the risk factor into pricing the loan.[65] Technological advancements and automated underwriting software enabled mortgagees to accurately measure the risk of subprime borrowers.[66] The underwriting process is crucial in determining who can afford mortgages; lenders use it to evaluate risks and rewards associated with a given loan.[67] Thus, the more risk a borrower poses, the less likely he will obtain a mortgage. Loan underwriting is based on "observable characteristics of the borrower, loan, and security, and outside influences on the borrower, and then

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61. *See* Zywicki & Adamson, *supra* note 54, at 6–7.

62. *See id.* at 9.

63. *See* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1259 (2009); *see also* Alejo Czerwonko, Understanding the U.S. Residential Subprime Mortgage Market and Its Relation to the 2007 Financial Crisis 1 (Jan. 2010) (unpublished Ph.D. dissertation, Columbia University) (on file with author). The process of securitization starts with an authorized financial institute that originates multiple mortgages, which are secured by claims against the mortgagors' properties. Czerwonko, *supra*, at 3. Afterwards, investment banks buy those mortgages and sell them to a special purpose entity, which then categorizes the mortgages into pools and divides them into tranches. *See* Eggert, *supra*, at 1266. These tranches are then graded according to different risks, rewards, and maturities factors. *Id.* The subprime mortgage market grew rapidly, increasing subprime lending from $65 billion in 1995 to $500 billion in 2005. Czerwonko, *supra*, at 2.

64. *See* Czerwonko, *supra* note 63, at 6 (noting that borrowers become risky when they have a bad credit history).

65. *See* Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 SYRACUSE L. REV. 233, 234 (2006).

66. Zywicki & Adamson, *supra* note 54, at 7, 9; *see* James E. Bauerle, *Technology, Law, and Banking*, 124 BANKING L.J. 714, 715 (2007) (showing that on average lenders were able to save $916 per loan with an automated underwriting system).

67. Eggert, *supra* note 63, at 1268–69.

comparing those characteristics to historical patterns of default."[68] This process limited lenders' losses, but securitization of loans allowed lenders to immediately sell loans on a secondary market to investors, and the core reason for underwriting—avoiding losses—became obsolete.[69] Eventually, lenders shifted most of their risk to investors by carelessly underwriting mortgages.[70] Securitization of subprime mortgages was significant in two ways: 1) it was designed to make mortgage lending more lucrative because the process would provide lenders with increased funds from broader sources, and 2) the process funded small lenders with limited capital so they could enter the subprime market.[71] Under this process, however, small lenders were more likely "to commit loan abuses because they [were] less heavily regulated, ha[d] reduced reputational risk, and operate[d] with low capital, helping to make them judgment-proof."[72] Securitization of subprime mortgages was essential for borrowers as well because it opened the credit market for them that otherwise would have been unfeasible.[73]

Just as risky mortgagors needed the invention of subprime mortgages to

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68. *Id.* at 1269.

69. *See id.* at 1264; *see also* KATALINA M. BIANCO, THE SUBPRIME LENDING CRISIS: CAUSES AND EFFECTS OF MORTGAGE MELTDOWN, at 6–8 (2008), https://business.cch.com/images/banner/subprime.pdf. Before the 2007 housing crisis, people took out more loans due to the rising value of real estate, which led lenders to take higher risks to make profit. BIANCO, *supra*, at 6–8. Lenders began selling loans to people without confirming their income and only using automated underwriting procedures, which required less documentation and thus were less reliable in measuring risk, to generate loans. *Id.* at 7–8.

70. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2048–49 (2007) (noting that before the invention of securitization, lenders managed loans from beginning to end and thus had a strong incentive to reject risky borrowers).

71. *Id.* at 2077.

72. *Id.* at 2041.

73. *See Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Joint Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit & the Subcomm. on Hous. and Cmty. Opportunity of the Comm. on Fin. Servs.*, 108th Cong. 61–62 (2003) (statement of Cameron "Cam" L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP) (listing the benefits to the public: lower borrowing cost, widening availability of credit options to people and areas that were normally denied access; listing benefits to financial institutions: relocation of risks to investors, option to raise funds quickly and efficiently). *But see* BIANCO, *supra* note 69, at 9–10 (explaining that many consumers could only afford the lower cost of subprime loans during the initial incentive period; securitization of mortgages did not even benefit investors—it spread the risk of defaults and losses to investors all over the world that used to be limited to the lenders who actually provided the loan).

qualify for a home mortgage, startups—which are inherently risky—may need equity crowdfunding to obtain funding that traditional financial institutions will not provide.[74] Expert investors assess startup companies' risks based on a combination of factors that include: how quickly the business can generate revenues, the possibility of acquisition, the management team's experience, the number of potential customers, and the cost of production.[75] Traditional funders, like venture capital firms must produce returns for their investors, and as such they are extremely selective when choosing companies in which to invest.[76] To mitigate risks, venture capitalists generally do not invest in startups during the early stages, and if they do, they design contracts with provisions that give them more managing control than their share in the ownership.[77] Thus, equity crowdfunding may be an ideal option for the entrepreneurs who need small amounts of funds at an early stage, need to reduce transactions costs, or need to recruit passive investors.[78] Unlike venture capitalists or sophisticated investors, non-accredited investors of equity crowdfunding may not demand much control over the companies they fund due to lack of expertise in the industry,[79] which make them more vulnerable to startups' imprudent decisions.

Similar to venture capital firms' influence in the startup industry, large investment banks played a major role in the subprime mortgage market.[80] Investment banks provided necessary funds to lenders by purchasing and

74. *See Why VCs Aren't Funding Women-Led Startups*, KNOWLEDGE@WHARTON (May 24, 2016), http://knowledge.wharton.upenn.edu/article/vcs-arent-funding-women-led-startups (suggesting that women entrepreneurs are far less likely to receive funds from venture capitalists because they may unconsciously question women's commitment to their businesses over familial matters).

75. Marianne Hudson, *7 Factors for Deciding to Invest in a Startup—or Not*, FORBES (Sept. 18, 2014, 11:09 AM), http://www.forbes.com/sites/mariannehudson/2014/09/18/7-factors-for-deciding-to-invest-in-a-startup-or-not.

76. *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1431 (2008) (indicating that venture capitalists, contrary to angel investors, are under pressure from investors demanding high returns on their investments in short time).

77. *Id.* at 1412–13, 1416.

78. *See* Ibrahim, *supra* note 41, at 585–86 (explaining that the Internet substantially lowers transaction costs for all parties as it eliminates the middlemen and allows startups to reach a wider pool of investors through social media); *see also infra* Part IV.

79. *See* Ibrahim, *supra* note 41, at 594–95 (arguing that non-accredited investors are unlikely to understand the documents and procedures that venture capitalists use before investing in startups).

80. *See* Bryan J. Orticelli, Note, *Crisis Compounded by Constraint: How Regulatory Inadequacies Impaired the Fed's Bailout of Bear Stearns*, 42 CONN. L. REV. 647, 653–55 (2009).

securitizing loans that the lenders originated.[81] Investment banks were the last line of defense for investors; before acquiring loans, investment banks were supposed to conduct due diligence to ensure that loan originators utilized proper underwriting standards and complied with the applicable law.[82] The banks instead perpetuated lenders' reckless practices by reviewing only about 10% of loans they purchased for their quality.[83] Furthermore, investment banks did not inform their investors about the poor quality of loans, the terms used to purchase subprime mortgages, or the result of their minimal due diligence.[84] Ultimately, investors, like the mortgagors they were funding, experienced the worst of the 2007–2008 financial crisis because they continued investing in a financial product they did not understand.[85]

C. The SEC's Role in the Subprime Mortgage Market Crisis

In 1999, Congress adopted the Financial Services Modernization Act,[86] which deregulated a Depression-era law—the Glass–Steagall Act[87]—that required banks to separate their investment operations from their basic lending operations.[88] The Financial Services Modernization Act permitted commercial and investment banks to consolidate, which provided banks with more capital for investment.[89] Furthermore, it authorized the SEC to oversee investment banks' securities and brokerage operations, but not their holding companies.[90] Instead of directly supervising the consolidated investment banks, the SEC adopted a program called the Consolidated Supervised Entities (CSE), which permitted the investment banks to opt out of

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81. Eggert, *supra* note 63, at 1302.

82. *Id.*

83. E. Scott Reckard, *Sub-Prime Mortgage Watchdogs Kept on Leash*, L.A. TIMES, Mar. 17, 2008, http://articles.latimes.com/2008/mar/17/business/fi-subprime17.

84. *See* Eggert, *supra* note 63, at 1305–06 (indicating that disclosures to investors should have included a myriad of factors used to buy subprime mortgages because such mortgages are an inherently complex and risky investment product).

85. *See id.* at 1307.

86. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12, 15 U.S.C.).

87. 12 U.S.C. § 227 (2012).

88. David Leonhardt, *Washington's Invisible Hand*, N.Y. TIMES, Sept. 26, 2008, http://www.nytimes.com/2008/09/28/magazine/28wwln-reconsider.html.

89. *See id.*

90. *See* Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 26, 2008, http://www.nytimes.com/2008/09/27/business/27sec.html?_r=0 (explaining that the limitations on the SEC's oversight capacity was a political compromise).

any supervision.[91] The SEC adopted a voluntary supervision program because it did not have explicit statutory authority to require investment bank holding companies to comply with its rules.[92]

After the 2007–2008 financial crisis, Congress charged the SEC's Office of Inspector General (OIG) to examine how the SEC supervised the firms that were part of its CSE program, with a special focus on one of the largest global investment banks—Bear Stearns—that collapsed during the crisis.[93] The OIG's audit revealed that the SEC failed at multiple levels in the creation and implementation of the CSE program.[94] It further noted that even though Bear Stearns complied with many of the program's requirements, it collapsed because the program's requirements were inadequate.[95] For example, the CSE program required Bear Stearns to maintain at least five billion dollars of liquidity portfolios, but this was not enough to assist the bank when it was in a high stress environment during the crisis.[96] Moreover, the Division of Trading and Markets was aware that Bear Stearns failed to comply with global banking standards but took no actions against it.[97] Another SEC division failed to properly review the firm's 10-K filing, which provides an overview of the firm's business and financial condition,[98] and permitted the firm to join the CSE program without completing the inspec-

91. Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), https://www.sec.gov/news/press/2008/2008-230.htm.

92. *Id.* (noting that normally the SEC's rules mandate companies to report their capital, maintain a certain level of liquidity, and conform to its leverage requirements).

93. *See Written Testimony of H. David Kotz, Inspector General of the Securities and Exchange Commission*, at 5–7 (May 5, 2010) [hereinafter *Testimony of Kotz*], https://www.sec.gov/about/offices/oig/reports/reppubs/2011/kotzwrittentestimony_92211.pdf (stating that the SEC's Consolidated Supervised Entities (CSE) program included the largest broker-dealers and their holding companies: Bear Stearns, the Goldman Sachs Group, Inc., Morgan Stanley, Merrill Lynch & Co., and Lehman Brothers Holdings Inc.); *see also* OFFICE OF INSPECTOR GEN., SEC, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM, 1, 5 (2008) (determining that Bear Stearns had less capital and was less diversified compared to the other CSE firms, and it had significantly higher debt than equity as most of its assets were concentrated in mortgage-backed securities).

94. *See* OFFICE OF INSPECTOR GEN., *supra* note 93, at 10.

95. *See id.* at 11.

96. *Id.*

97. *Id.*

98. *Form 10-K*, SEC. EXCHANGE COMMISSION, https://www.sec.gov/answers/form10k.htm (last modified June 26, 2009).

tion process.[99] Overall, the OIG listed twelve major failures of the SEC, and noted both that Bear Stearns's collapse could not be directly linked to the SEC's failures,[100] and that the firm could have benefited from more aggressive supervision.[101]

Although the statutory authority was not as clear as the Commission would have preferred, it still had ample discretion in regulating investment banks; the Commission, however, chose not to use its discretion.[102] The SEC could have reevaluated and increased the capital requirement for banks.[103] It also needed to ensure that CSE's risk management staff reviewed and approved CSE firms' conduct and, when necessary, impose strict limits on risks that the firm could not adequately manage.[104] Lastly, different SEC divisions needed to improve collaboration to ensure each firm's inspection was complete before permitting the firm to join the CSE program.[105]

Unlike the participants of the CSE program, companies that will utilize equity crowdfunding exemptions will be smaller, and their compliance with the Commission's regulations will not be on a voluntary basis.[106] Congress has clearly defined the SEC's role[107] in overseeing key players of equity crowdfunding, so its proper oversight will determine the industry's future success.[108]

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99. *See* OFFICE OF INSPECTOR GEN., *supra* note 93, at 7–8.

100. *See id.* at 11.

101. *See* William Ryback, *Case Study on Bear Stearns*, TORONTO LEADERSHIP CTR. 1, 9 http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/J2-BearStearnsCaseStudy.pdf.

102. FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 3 (2011).

103. *Id.* at 33 (acknowledging that, historically, the Commission only focused on ensuring that issuers disclose relevant information to investors and follow procedural requirements, and not on the "safety and soundness of the securities firms").

104. *See Testimony of Kotz*, *supra* note 93, at 11–12.

105. *See id.* at 13. This list of recommendations is non-exhaustive. I have only selected the ones that are most applicable for the focus of this Comment.

106. *See infra* Part III.A.

107. 15 U.S.C. § 77d (2012) (delegating SEC the authority to "issue such rules as the Commission determines may be necessary or appropriate for the protection of investors").

108. *See infra* Part IV.

III. KEY PLAYERS OF EQUITY CROWDFUNDING

A. Issuers

Under Title III of the JOBS Act, issuers must disclose basic information to the SEC, the designated intermediaries, and the investors.[109] The Commission has the authority to change the list of requirements as needed.[110] Currently, it requires issuers to disclose the following information: 1) the name of the company and its office and website addresses; 2) the name of its executives, such as the directors or officers, and any person holding more than twenty percent of its shares; 3) the company's financial state; 4) the amount and purpose of requested funding; 5) the targeted offering amount and updates on the progress made in achieving that amount; and 6) a description of the enterprise and its ownership.[111]

Congress categorized issuers into three classes and imposed additional requirements depending on the class.[112] First, if the issuer offers up to one hundred thousand dollars in securities, then the issuer must disclose his or her most recent income tax return and his or her principal executive officer must certify its financial statement.[113] Second, if the issuer offers securities between one hundred thousand and five hundred thousand dollars, the issuer must have an independent financial accountant review its financial statements.[114] Third, if the issuer is offering securities over five hundred thousand dollars, the issuer must provide audited financial statements.[115]

109. 15 U.S.C. § 77d-1(b)(1).

110. *Id.* § 77d-1(b)(5).

111. This list does not encompass all the information issuers must disclose. *See* 17 C.F.R. § 230.503 (2016); *see also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 908–09 (2011) (noting that disclosure requirements can cost even small companies up to $100,000 for services received by third parties, and then companies must consider ongoing costs of updating financial information and any liability concerns).

112. *Compare* Douglas S. Ellenoff, *Making Crowdfunding Credible*, 66 VAND. L. REV. EN BANC 19, 26–27 (2013) (suggesting the additional requirements on issuers should provide further protection to investors), *with* Nicholas Herdrich, *Just Say No to Crowdfunding*, 6 U.P.R. BUS. L.J. 157, 172 (2015), http://uprblj.org/wp-content/uploads/2015/03/6-UPRBLJ-157-Nicholas-Heirdrich-Just-Say-No-To-Crowdfunding-2015.pdf (noting such mandates force companies to reveal confidential financial information, which is beneficial for larger corporations as it may help them raise more funds, but for small companies it is impracticable to reveal confidential information when the financial return will likely be limited).

113. 15 U.S.C. § 77d-1(b)(1).

114. *Id.*

115. *Id.*

Theoretically, investors should be able to assess potential risks and rewards of their investment from the information companies must disclose.[116] The Commission is authorized to impose other requirements necessary for the protection of investors.[117]

B. Funding Portals

Funding portals are a new class of intermediaries involved in the transaction of offering or selling securities pursuant only to the 4(a)(6) exemption.[118] The SEC mandates that all crowdfunding transactions occur through a broker or a funding portal that complies with Section 4A(a) of the Securities Act.[119] Funding portals must register with the Commission and an applicable self-regulatory organization.[120]

Unlike brokers, funding portals are not permitted to advise investors[121] so that they can remain a neutral body and possibly limit their liability if they are not directly involved in offering and selling securities; they function more like eBay or Craigslist.[122] The Commission requires funding portals to create "communication channels" that their account holders can use to communicate with each other and the issuers.[123] Furthermore, funding portals are only permitted to advertise themselves as places where investors can look for financial opportunities and not highlight specific issuers available on their portals.[124] Intermediaries are also prohibited from purchasing securities offered on their own portals.[125] Funding portals must provide investors with education materials that will assist them in recognizing risks involved in crowdfunding investments.[126] As intermediaries, funding portals

116. *See* Ellenoff, *supra* note 112, at 26.

117. 15 U.S.C. § 77d-1(b)(5).

118. Securities Exchange Act of 1934 § 3(a)(80) (2012), 15 U.S.C. § 78c(a)(80).

119. 17 C.F.R. § 227.100 (2016).

120. 15 U.S.C. §77d-1(a).

121. 17 C.F.R. § 227.300.

122. *See* Ellenoff, *supra* note 112, at 23.

123. *See* 17 C.F.R. § 227.402.

124. *Id.*

125. *Id.*

126. *Id. But see* Joan MacLeod Heminway, *Investors and Market Protection in the Crowdfunding Era: Disclosing To and For the "Crowd"*, 38 VT. L. REV. 827, 836–37 (2014). The characteristics of the crowd will play a significant role in how the crowd measures investment risks. Heminway, *supra*, at 836–37. Two economic theories shed light on how crowd mentality operates: a) Tulipomania suggests that individuals tend to blindly follow the decisions of others when in a crowd and often will not pursue their own rational understanding of the situation; and b) crowds have a higher collective intelligence, and thus, the wisdom of a crowd is

must take reasonable measures to reduce the risk of fraud by issuers.[127] The role of funding portals as gatekeepers will be essential in maintaining the integrity and legitimacy of the crowdfunding market.[128]

IV. PROBLEMS AND RECOMMENDATIONS

A. Controversy Surrounding Equity Crowdfunding

A major criticism of the JOBS Act and the final SEC regulations is that they will fail to protect investors.[129] In an attempt to open the investment market to a wider group of Americans through Title III of the JOBS Act, Congress has taken away the protective measures it took when it implemented the '33 Act.[130] Congress enacted the '33 Act to ensure investors were protected from fraud and insider abuse.[131] In an attempt to protect investors, lawmakers imposed registration and disclosure requirements on all companies regardless of size or value.[132] This made it nearly impossible for small businesses to consider raising funds by selling securities.[133] Companies could file for exemptions from the registration requirements, but the technical and compliance requirements were so onerous that most companies requiring funds less than $50 million abandoned this method.[134]

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better than its individual parts. *Id.*

127. 17 C.F.R. § 227.301.

128. *See* Heminway & Hoffman, *supra* note 111, at 933, 936 (noting that crowdfunding is still in its early stages, and since it utilizes rapidly changing business models, under-regulation may generate distrust in the securities market).

129. *See* Kevin Loria, *The Crowdfunding of the Future is Going to be Even Riskier than It is Right Now*, BUS. INSIDER (June 10, 2016, 5:06 PM), http://www.businessinsider.com/investor-protection-for-equity-crowdfunding-sec-rules-2016-6 (stating the two major issues with equity crowdfunding: (1) it is difficult to properly value startups so investors may be overpaying for stocks, which means they will not be profiting from their investment; and (2) if the startup succeeds after the initial funding, then it may seek a second round of funding from venture capitalists, which would dilute the initial backer's shares).

130. *See* Yamen & Goldfeder, *supra* note 13, at 55 (suggesting that by reducing the amount of information companies must disclose to investors, the JOBS Act effectively leaves middle class Americans open to financial risks).

131. *See* Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 15–16 (2007).

132. *See id.*

133. *See id.* at 80–81 (noting that small companies that could not access public capital or institutional financing were restricted to obtain funding from venture capital firms, and such firms only fund a small fraction of startup businesses).

134. *See id.* at 6.

Although Congress's intent to democratize the securities market is noble, its formulation of Title III of the JOBS Act may not be a viable option for most promising small businesses.[135] The new 506(c) exemption makes more sense for companies most likely to succeed because it permits them to raise unlimited funds from accredited investors who also bring their own expertise to the business, and the exemption preempts states' unique securities laws.[136] Since average American investors are only allowed to invest under Title III, they might be investing in companies too speculative to have the 506(c) exemption as an option.[137] Moreover, many Americans do not comprehend the basic operations of financial markets; people do not understand how securities markets operate, how to evaluate the risks and rewards of investment products, or even how to calculate necessary retirement funds.[138] Therefore, the Commission should amend some of its regulations concerning issuers and funding portals to ensure unsophisticated investors are protected from startups that may misuse the 4(a)(6) exemption.[139]

Issuers and funding portals are akin to lenders and investment banks of the subprime mortgage market. Issuers will likely be thinly capitalized, like the lenders of subprime mortgages, and issuers will need to use the funding portals, as lenders used investment banks, to obtain funds for their businesses. Issuers' and investors' dependency on funding portals makes them gatekeepers as investment banks were supposed to be during the securitization of subprime mortgages. The Commission's failures during the subprime mortgage crisis can be placed in two categories[140]: 1) its requirements were inadequate to assist banks in a high stress environment, and 2) multiple divisions of the Commission failed to review and reject banks' actions that did not conform to its rules. For the Commission to avoid repeated failures, it should impose adequate qualification standards for both issuers and funding portals, and make structural changes within the agency's divi-

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135. *See* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 867 (2013–14) (explaining the cost of maintaining compliance with the JOBS Act outweighs any benefits it offers to startups).

136. Max E. Issacson, *The So-Called Democratization of Capital Markets: Why Title III of the JOBS Act Fails to Fulfill the Promise of Crowdfunding*, 20 N.C. BANKING INST. 439, 444 (2016).

137. *See id.* at 445.

138. OFFICE OF INVESTOR EDUC. & ASSISTANCE, THE FACTS ON SAVING AND INVESTING (1999), https://www.sec.gov/pdf/report99.pdf.

139. *Contra* Heminway, *supra* note 135, at 869–70 (suggesting the legislative process of enacting the JOBS Act was politically driven and that it contains heavy investor protection language, which makes the crowdfunding exemption undesirable to many small businesses).

140. *See supra* Part II.C.

sions.

B. Recommendations

To avoid repeating past shortcomings, this Comment recommends that the Commission modify some of its crowdfunding regulations so that its requirements for issuers are sufficient to promote startups' successes in a rapidly evolving industry. Additionally, funding portals must be treated as a last line of defense for investors, and as such they must be held to a higher standard of conduct when reviewing issuers' disclosures and when educating and protecting investors.

Under the current regulations, startups must disclose information regarding their business and business plans to potential investors, funding portals, and the SEC; however, the Commission does not provide any specific lists of information that issuers must provide regarding the description of their businesses.[141] Just as unsophisticated investors need guidelines to understand their investments, it is crucial that startups receive standards that are clear and consistent as they attempt to meet the disclosure requirements. Some commenters have suggested that the Commission ought to provide guidance or templates that issuers can readily follow when deciding the types of information that should be disclosed to investors.[142] Furthermore, a clear guidance for issuers means that investors can compare materials from different issuers and discern the quality of information.[143] The Commission's existing divisions have also failed to properly address the concerns of small businesses,[144] and thus it should establish a new task force, which is only committed to the needs of small businesses.[145] This task force should be charged with two principal responsibilities: 1) examining laws

141. 17 C.F.R § 227.201(d) (2016).

142. *See, e.g.*, Margaret A Wilson, Comment Letter on Proposed Rule: Crowdfunding (Feb. 3, 2014), https://www.sec.gov/comments/s7-09-13/s70913-237.htm (advocating for a "checklist or prescribed list of questions on key issues"); Kendall Almerico, Comment Letter on Proposed Rule: Crowdfunding (Jan. 29, 2014), https://www.sec.gov/comments/s7-09-13/s70913-166.pdf (suggesting a "'safe harbor' list of requirements to disclose that protect the issuer from later regulatory trouble").

143. *See* Wilson, *supra* note 142.

144. *See* Cohn & Yadley, *supra* note 131, at 66–67 (noting that the Commission devoted countless hours of research to respond to concerns of publicly held companies while giving slight attention to the urgent capital formation problems of small businesses).

145. *Id.* at 81 (suggesting a wide range of key stakeholders—small business owners, state securities administrators, broker-dealers, self-regulating organizations, and accountants—who can assist the Commission).

that hinder small business financing, and 2) recommending ways to improve current laws so that businesses have better access to funds. Ultimately, first-time issuers will be in a better position to enter and succeed in the crowdfunding market if the Commission modifies some of its regulations as suggested here.

Funding portals may likely be the most sophisticated party between the issuers using the 4(a)(6) exemption and the non-accredited investors.[146] Funding portals will be the last line of defense for investors as they must detect and prevent fraud, ensure issuer compliance, and empower investors in making informed investment decisions.[147] The SEC requires intermediaries to reasonably rely on the information disclosed by the issuers in detecting and preventing fraud,[148] instead of compelling portals to conduct some form of due diligence.[149] The reasonable basis standard, however, does not incentivize funding portals to investigate issuers' claims; funding portals can assert they were unaware of problematic representations by the issuers.[150] In order to better protect investors from fraud, the Commission should impose a higher obligation on funding portals to conduct at least basic investigation on issuers to confirm their compliance with the applicable securities law.[151]

As intermediaries, funding portals will be gatekeepers, and as such, they must be the most qualified party in crowdfunded transactions.[152] Unlike brokers, people managing funding portals do not have any licensing requirements.[153] This lack of qualification requirement is troublesome be-

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146. *See* Consumer Federation of America, Comment Letter on Proposed Rule: Crowdfunding (Feb. 2, 2014), https://www.sec.gov/comments/s7-09-13/s70913-78.pdf.

147. *Id.*

148. 17 C.F.R. § 227.301(a) (2016).

149. Louis C. Grassi, Comment Letter on Proposed Rule: Crowdfunding (Jan. 20, 2014), https://www.sec.gov/comments/s7-09-13/s70913-128.pdf.

150. Consumer Federation of American, *supra* note 146.

151. *See id.*; *see also* Americans for Financial Reform, Comment Letter on Proposed Rule: Crowdfunding (Mar. 5, 2014), https://www.sec.gov/comments/s7-09-13/s70913-295.pdf (arguing that the reasonable basis standard will likely promote a "check-the-box approach" where issuers merely acknowledge their obligation by checking a box, but also that the approach is unlikely to prevent "fraud or unintentional compliance errors").

152. *See* Andrew D. Stephenson et al., *From Revolutionary to Palace Guard: The Role and Requirements of Intermediaries under Proposed Regulation Crowdfunding*, 3 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 231, 248–49 (2014) (highlighting that unlike commercial fraud, securities fraud covers a broader concept, and thus a less experienced party may miss issues that would constitute a securities fraud).

153. Crowdfunding, 80 Fed. Reg. 71,388, 71,430 (Nov. 16, 2015) (codified at 17 C.F.R.

cause people behind funding portals may not have the experience and nuanced judgment necessary to make appropriate calls on questionable issuers.[154] Instead of leaving such crucial licensing requirements to self-regulating organizations,[155] the Commission should adopt some type of qualification requirement for funding portals. Alternatively, it can amend current rules to mandate that persons who review and approve issuers' disclosure documents must have reasonable years of experience in the securities industries, or mandate that a licensed broker must review disclosure documents to ensure compliance with state and federal rules.[156] Since the SEC relies heavily on funding portals to take precautionary measures to protect unsophisticated investors,[157] it appears reckless not to require funding portal managers to obtain some form of qualification necessary for investors' protection.

Although funding portals must provide educational materials to investors when they open their accounts, Congress has not defined the scope of this requirement.[158] The SEC outlined broad categories of topics that must be included[159] but does not mandate funding portals to submit their educational materials to the Commission or to a self-regulating organization for approval. Since funding portals have the responsibility to educate unsophisticated investors,[160] the Commission ought to review and certify educational materials to ensure, at a minimum, the following two standards are met: 1) the materials adequately cover potential risks of investing, and 2) information is presented in a manner that first-time investors can under-

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pts. 200, 227, 232, 239, 240, 249, 269, & 274) (noting that the SEC decided "not to impose licensing, testing or qualification requirements" after public comments).

154. *See* Vic Reichman, Comment Letter on Proposed Rule: Crowdfunding (Dec. 2, 2013), https://www.sec.gov/comments/s7-09-13/s70913-75.htm.

155. *See* Crowdfunding, 80 Fed. Reg. at 71,430 (noting that the SEC believes that "a registered national securities association is well-positioned" to decide if additional requirements are needed).

156. *See* Stephenson, *supra* note 152, at 249 (explaining that inexperienced people and funding portals are more likely than brokers to rely on issuers' own compliance assertions).

157. Crowdfunding, 80 Fed. Reg. at 71,390.

158. 15 U.S.C. § 77d-1(a)(3)–(4) (2012); *see also* Crowdfunding, 80 Fed. Reg. at 71,390.

159. 17 C.F.R. § 227.302(b) (2016).

160. *See* OFFICE OF INVESTOR EDUC. & ASSISTANCE, *supra* note 138. Case studies revealed the impact of education on people's financial decisions: after an 18-month financial education program, high school students demonstrated better money management behavior, and a majority of the students maintained their calculated spending habits well after the education program ended. *Id.*

stand.[161] Alternatively, the Commission can provide exemplar educational materials that funding portals can use instead of creating their own; this method can cut costs[162] and establish clear standards that guide funding portals in a quickly evolving industry.

CONCLUSION

The SEC must learn from its past mistakes. The Commission failed to carry out its obligation of protecting investors during the subprime mortgage crisis, and today it bears the responsibility of protecting an even larger number of investors. Now more than ever, the Commission's regulations must be responsive and cater to the needs of equity crowdfunding so that investors' trust in the securities industry is not jeopardized again. The SEC should provide some guidance to first-time issuers in presenting their business plans and create a task force solely in charge of addressing the concerns of these issuers. Some of the regulations regarding funding portals should also be amended to ensure funding portals are qualified to review issuers' disclosures and use a standard higher than reasonable basis to evaluate compliance. Lastly, the Commission should approve standardized educational materials that effectively educate investors.

161. *See* Consumer Federation of America, *supra* note 146.

162. *Id.*