# Squalls in the Safe Harbor: Investment Advice & Regulatory Gaps in Regulation Crowdfunding

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## I. INTRODUCTION

In recent years, the crowdfunding website Kickstarter[1] has risen in popularity. Since its launch in April of 2009, more than five million people have pledged more than one

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1. KICKSTARTER, http://www.kickstarter.com (last visited Oct. 24, 2014).

billion dollars to projects.[2] Hopefuls can list a proposed project on the website, with a funding goal and deadline, and if enough people pledge money to the project, it gets funding.[3] Other sites similar to Kickstarter, such as Indiegogo,[4] and RocketHub,[5] have also flourished.[6]

The Obama administration has recognized and stressed its belief that small startup businesses are an important part of the country's economic recovery after the financial crisis of 2008.[7] The purpose of the Jumpstart Our Business Startups Act (JOBS Act) is to assist small businesses by importing the crowdfunding model the above mentioned websites popularized, and "allow Main Street small businesses and high-growth enterprises to raise capital from investors more efficiently, allowing small and young firms across the country to grow and hire faster."[8] While Kickstarter operates on a "reward" model,[9] the JOBS Act's contemplated crowdfunding schemes operate on an "equity" model.[10] Eager issuers[11] post their offerings on crowdfunding sites, known as funding portals,[12] in the hopes of garnering enough attention from potential investors to reach their funding goals and start their businesses. While funding portals are subject to a host of regulations,[13] the JOBS Act also prohibits them from offering potential investors "investment advice."[14]

The Senate passed the JOBS Act on March 22, 2012, after a bipartisan effort; the House of Representatives approved it on March 27, 2012.[15] President Obama signed the bill into law on April 5, 2012.[16] With its passage, the JOBS Act directed the Securities and Exchange Commission (SEC) to issue regulations to implement the JOBS Act's

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2. *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter+basics?ref=help_nav (last visited Feb. 9, 2015).

3. *Id.*

4. INDIEGOGO, http://www.indiegogo.com/ (last visited Feb. 9, 2015).

5. ROCKETHUB, http://www.rockethub.com/ (last visited Feb. 9, 2015). GoFundMe and similar sites have also risen in popularity, though such sites are generally for personal, rather than project-driven, fundraising. GOFUNDME, http://www.gofundme.com/ (last visited Feb. 9, 2015).

6. *See generally* Seth Fiegerman, *8 Kickstarter Alternatives You Should Know About*, MASHABLE (Dec. 6, 2012), http://mashable.com/2012/12/06/kickstarter-alternatives/ (noting that, while Kickstarter is "virtually synonymous" with crowdfunding, there are many other platforms available to consumers which function in essentially the same manner).

7. Press Release, Office of the Press Secretary, The White House, President Obama to Sign Jumpstart Our Business Startups (JOBS) Act (Apr. 5, 2012), *available at* http://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act ("The President believes that our small businesses and startups are driving the recovery and job creation.").

8. *Id.*

9. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 16 (2012) ("The reward model offers something to the investor in return for the contribution, but does not offer interest or a part of the earnings of the business.").

10. *See id.* at 24 ("Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund."). For the remainder of this Note, the term "crowdfunding" will refer to equity crowdfunding unless otherwise noted.

11. An "issuer" is defined as a "person or entity (such as a corporation or bank) that issues securities . . . ." BLACK'S LAW DICTIONARY 960 (10th ed. 2014).

12. *See infra* Part II.C (discussing the JOBS Act's various provisions, including a more in-depth discussion of funding portals).

13. *See infra* Part II.C (outlining the various requirements for funding portals).

14. *See infra* Part II.C (noting also that the JOBS Act fails to define the term "investment advice").

15. Jumpstart Our Business Startups Act of 2012, H.R. 3606, 112th Cong. (2012), Bill Summary & Status, *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d112:HR03606:@@@X.

16. *Id.*

crowdfunding provisions within one year.[17] The SEC opened an initial public commenting period on the JOBS Act's crowdfunding provisions, but it did not issue any proposed rules until October 23, 2013.[18] The proposed rules provide no definition of "investment advice," though they do create a safe harbor for certain activities.[19]

This Note examines the JOBS Act's various provisions and the proposed SEC rules. It then analyzes how the SEC has construed the term "investment advice" in the past and discerns two standards that the SEC appears to use in this context. This Note then applies these standards to two provisions that fall between the gaps of the safe harbor in the proposed rules: an offering removal provision and a crowd rating system provision, and then determines whether either would constitute investment advice under the prior SEC standards. This Note then argues that, because of the unique role the "crowd" plays in crowdfunding schemes and the tension between providing low-cost capital financing and investor protection, an activity that may constitute investment advice under traditional SEC analysis would not constitute investment advice if performed by a funding portal, and vice versa.

## II. BACKGROUND

At its most basic level, crowdfunding is a form of capital financing that utilizes relatively small investments drawn from a large group of people, usually facilitated through internet transactions.[20] The concept of crowdfunding as a capital financing scheme is not new, but it has recently gained popularity in the wake of the 2008 financial crisis.[21] The impetus driving the crowdfunding initiative is democratized access, both by small businesses to low-cost capital financing[22] as well as by the general public to input in

17. Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106 § 602, 126 Stat. 306 (2012).

18. Press Release, Securities and Exchange Commission, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Uo24imSglkJ [hereinafter SEC Issues Proposal on Crowdfunding]. As of February 9, 2015, the SEC has still not issued a finalized version of its rules. Recent impatience with the SEC's refusal to finalize the proposed Regulation Crowdfunding has led some in the investing community to turn to grassroots efforts to pressure the SEC into acting. *See* Devin Thorpe, *Grassroots Lobbying Effort Asks SEC to Issue Final Crowdfunding Rules*, FORBES (Sept. 9, 2014), http://www.forbes.com/sites/devinthorpe/2014/09/09/grassroots-lobbying-effort-asks-sec-to-issue-final-crowdfunding-rules/ (noting that the organizers have taken to social media, utilizing the hashtag "#VoteOnCrowdfunding" as part of their efforts).

19. *See infra* Part II.D (discussing the safe harbor provision of Regulation Crowdfunding).

20. *See* Bradford, *supra* note 9, at 10 (describing the general features of crowdfunding); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1736 (2012) (noting that crowdfunding entails "mass collaboration efforts through large numbers of people, generally using social media or the Internet"); Thomas Powers, *SEC Regulation of Crowdfunding Intermediaries Under Title III of the JOBS Act*, 31 BANKING & FIN. SERVS. POL'Y REP. 1, 1 (2012) ("[C]rowdfunding is a financing mechanism that allows startup companies to solicit funds from the general public through website intermediaries.").

21. *See* Powers, *supra* note 20, at 1 (noting the increasing popularity of crowdfunding due to the need "for entrepreneurs to raise capital quickly and inexpensively in the wake of the financial crisis").

22. This is especially true where more traditional methods are undesirable or unfeasible. *See* Bradford, *supra* note 9, at 5 (noting that small or "micro-businesses" have a difficult time securing capital financing from traditional sources of business finance).

emerging growth sectors and industries.[23] This democratizing impulse is apparent in crowdfunding schemes wherein "[a]nyone who can convince the public he has a good business idea can become an entrepreneur, and anyone with a few dollars to spend can become an investor."[24] This proposition rings even more true when one considers the ubiquity and importance of the Internet in connecting people together and sharing information and opportunities in today's society.[25]

Crowdfunding has its conceptual origins in two distinct principles: crowdsourcing and microfinance.[26] Microfinance was developed in the late-1970s primarily to design a banking and credit system targeting the rural poor in developing nations, such as Bangladesh.[27] It traditionally involves issuing small, low-interest, unsecured loans (of about $50–$500), repayable in installments.[28] Grameen Bank is the most prominent microfinance platform,[29] disbursing more than $15 billion since its inception and currently servicing over 81,000 villages worldwide.[30] Crowdfunding is the conceptual "inverse of microfinance; instead of one institution making loans to thousands of individuals, crowdfunding allows thousands of individuals to make contributions to a single entrepreneur or business."[31]

Crowdsourcing, like crowdfunding, draws on the power of a large and diversified group of contributors to undertake a task in a collaborative manner.[32] As opposed to crowdfunding, which contemplates monetary contributions, crowdsourcing asks the crowd

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23. *See* Karina Sigar, *Fret No More: Inapplicability of Crowdfunding Concerns in the Internet Age & The JOBS Act's Safeguards*, 64 ADMIN. L. REV. 473, 481 (2012) (arguing that the growth of small businesses benefits not only entrepreneurs, but also society at large because "small businesses provide consumers with more product and service options").

24. Bradford, *supra* note 9, at 10.

25. *See* Andrew C. Fink, *Protecting the Crowd and Raising Capital Through the CROWDFUND Act*, 90 U. DET. MERCY L. REV. 1, 7 (2012) (observing that the growth of social media and "the Crowd" make information-sharing easier, helping crowdfunding to prosper).

26. *Id.* at 6.

27. *See The History of Microfinance*, GLOBAL ENVISION (Apr. 14, 2006), http://www.globalenvision.org/library/4/1051/ ("[S]tarting in the 1970s, experimental programs in Bangladesh, Brazil, and a few other countries extended tiny loans to groups of poor women to invest in micro-businesses . . . . These 'microenterprise lending' programs had an almost exclusive focus on credit . . . targeting very poor (often women) borrowers.").

28. *Essentials: A Synthesis of Lessons Learned—Microfinance*, UNITED NATIONS DEV. PROGRAMME, EVALUATION OFFICE 1 (Dec. 1999), *available at* http://web.undp.org/evaluation/documents/Essential-on-microfinance.pdf.

29. Both its founder, Muhammad Yunus, and the bank itself, won the 2006 Nobel Peace Prize "for their efforts to create economic and social development from below." Press Release, The Norwegian Nobel Committee, The Nobel Peace Prize for 2006 (Oct. 13, 2006), *available at* http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/press.html.

30. *Grameen Bank Monthly Update in US$: August, 2014*, GRAMEEN BANK: BANK FOR THE POOR (Sept. 7, 2014), http://www.grameen.com/index.php?option=com_content&task=view&id=1339&Itemid=84.

31. Fink, *supra* note 25, at 7. Of course, the two share many similarities as well. Certain microfinance platforms involving "peer-to-peer" lending utilize crowdfunding principles to connect potential lenders to borrowers. *See About Us*, KIVA, http://www.kiva.org/about (last visited Feb. 9, 2015) (stating that the organization serves as a platform for lenders to "connect people through lending to alleviate poverty").

32. *See* Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1459 (2013) (defining the term "crowdsourcing" as "a type of participative online activity in which an individual, an institution, a non-profit organization, or company proposes to a group of individuals . . . the voluntary undertaking of a task").

to contribute labor to the project.[33] Generally, crowdsourced projects are completed online, and contributors tend not to be employees or contractors but instead work on a voluntary basis.[34] Well-known and successful examples of crowdsourcing efforts include Wikipedia, the online encyclopedia, and the user-generated restaurant reviewing site Yelp!.[35]

Microfinance is defined in reference to its recipients: those without access to traditional banking and lending infrastructure.[36] Crowdsourcing is defined in reference to its contributors: a large and diversified "crowd" working together to further a common goal.[37] Crowdfunding is thus a synthesis of both of these concepts: a group of people working together to fund an emerging business that struggles to access traditional forms of capital financing.[38]

### *A. Crowdfunding in the Pre-JOBS Act Era*

Prior to the JOBS Act's passage in early 2012,[39] crowdfunding occupied an indeterminate position in the federal securities laws.[40] The primary concern underlying the pre-JOBS Act crowdfunding schemes was the extent to which such schemes were subject to the various federal securities laws' stringent registration and reporting requirements.[41] The remainder of this section discusses this concern by examining whether crowdfunding schemes offered securities in the pre-JOBS Act era and crowdfunding schemes' organizational status at the time.

#### *1. Crowdfunding Offerings as Securities*

Section 5(c) of the Securities Act of 1933 (Securities Act) requires any business offering sale of securities to register those securities with the SEC or qualify under one of the available exemptions.[42] Thus, if crowdfunders did not offer crowdfunding investments as securities, there would be no breach of the Securities Act. As a result, the SEC would not require crowdfunders to register their offerings, and crowdfunding schemes could continue operating without fear of violating the Securities Act's registration requirements.

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33. *Id.* ("Crowdfunding differs from crowdsourcing in that the crowd is asked to contribute capital, as opposed to labor, to the project.").

34. *See* GEORGE B. DELTA & JEFFREY H. MATSUURA, LAW OF THE INTERNET § 14.12 (3d ed. 2013) (noting that crowdsourcing is an Internet-enabled non-traditional form of outsourcing).

35. Schwartz, *supra* note 32, at 1459.

36. *See* Bradford, *supra* note 9, at 29 (noting that microfinance generally services "very small entrepreneurial ventures").

37. *Id.*

38. *See id.* (defining crowdfunding schemes as "small contributions from a large number of people to fund small entrepreneurial ventures").

39. Jumpstart Our Business Startups Act, H.R. 3606, 112 Cong. (2012), Bill Summary & Status, *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d112:HR03606:@@@X.

40. *See generally* Bradford, *supra* note 9 (questioning both the legal status of crowdfunding offerings and crowdfunding sites themselves); Hazen, *supra* note 20 (discussing the legal status of crowdfunding efforts under Pre-JOBS Act securities laws); Sigar, *supra* note 23 (arguing that pre-JOBS Act, existing securities laws were unsuitable for crowdfunding).

41. *See, e.g.*, Bradford, *supra* note 9, at 29 (arguing that crowdfunding raises both issues of whether offerings constitute securities subject to registration and issues of the legal status of crowdfunding platforms subject to registration).

42. Securities Act of 1933, 15 U.S.C. § 77e(c) (2006).

Under the Supreme Court's test in *SEC v. W.J. Howey Co.*,[43] an "investment contract"—a catch-all category in the Security Act's definition of "security"—is 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 the promoter or a third party."[44] Since *Howey*, the "solely" of the latter portion of the test has shifted to an analysis of the "undeniable significance" of a third-party promoter's actions.[45] Under this test, it is likely that any crowdfunding scheme offering equities (such as stocks) or operating on a peer-to-peer lending model[46] with investors expecting to make a profit[47] would fall under the *Howey* definition of "investment contract" and thus constitute a security.[48]

Therefore, pre-JOBS Act crowdfunding schemes had to choose whether to register their offerings with the SEC or to seek refuge in one of the several exemptions to registration. The cost and time associated with registration prevent most small businesses from registering.[49] Indeed, the cost of registration[50] could exceed the target amount of capital being raised for many crowdfunded offerings, an impact that is doubly prohibitive considering that crowdfunded operations usually need to raise capital quickly.[51] Instead, any pre-JOBS Act crowdfunding offering would have had to find its way into one of several registration exemptions.[52]

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43. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); *see also* Bradford, *supra* note 9, at 31 (introducing the *Howey* test and the Court's application of it to investment contracts).

44. *W.J. Howey Co.*, 328 U.S. at 298–99.

45. *See* Bradford, *supra* note 9, at 31 (discussing, in greater detail, the rationale behind the assertion that crowdfunding investments constitute securities); *see also* Hazen, *supra* note 20, at 1740 (arguing that any fundraising offering a return on investment constitutes an investment contract). Depending on the type of offered security, a court might apply a different test as well. For example, if the offered securities were stocks, the court would apply the test from *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985) (outlining a multi-factor test for determining whether stocks constitute securities). On the other hand, if the offered securities were notes, the court would apply the test outlined in *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990) (determining that the "family resemblance" test is the appropriate test to determine whether or not notes constitute securities). For the reasons outlined below in Part II.B, application of such tests to crowdfunding schemes are no longer necessary.

46. Peer-to-peer lending models, like the website Kiva, involve loans. The loans consist of "[c]ontributors provid[ing] funds on a temporary basis, expecting repayment." Bradford, *supra* note 9, at 20. Depending on the platform, peer-to-peer lenders can even expect to make interest in their loans. *Id.*

47. Note that pure donation/charity sites do not sell securities under this definition. In addition, reward sites like Kickstarter would not fall under this definition either because they offer "perks" rather than a return on investment. The reward model is instead based on "consumption." Bradford, *supra* note 9, at 31–33; *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 858 (1975) (holding that "shares" of a housing corporation which did nothing more than entitle a person to live in a given housing complex did not constitute securities because the "investors" purchased the shares with an eye toward personal consumption).

48. Bradford, *supra* note 9, at 33–42. Note that a prolonged discussion regarding the exact legal status of crowdfunding investments is unnecessary because that selfsame uncertainty drives the need for the clarification that the JOBS Act purported to give these investments.

49. *See id.* at 42–44 (discussing the burdens of registration for "early-stage small businesses seeking relatively small amounts of capital").

50. Issuers seeking to register securities with the SEC must first file a registration statement, pay a registration fee and then become subject to subsequent reporting obligations. The costs associated with the initial registration, including the bare cost of generating the statement, can reach the hundreds of thousands of dollars. Bradford, *supra* note 9, at 42.

51. *Id.* at 42–43.

52. *See generally* Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 265 (2013) (stating that an issuer can avoid the extensive registration processes

Most notably, sections 4(2)[53] and 4(5)[54] of the Securities Act, as well as Regulations D[55] and A[56] (and their attendant rules) could provide viable alternatives to crowdfunding registration.[57] Unfortunately, none of these are conducive to the crowdfunding model. Many of the exemptions preclude issuers from making general solicitations to the public, largely defeating the very basis of crowdfunding efforts.[58] Any exemption that does allow general solicitation involves instead some sort of disclosure or offering circular.[59] Such requirements are inconsistent with crowdfunding because they impose burdens similar to the section 5(2) registration requirement.[60]

### *2. The Legal Status of Crowdfunding Sites*

An additional concern surrounding pre-JOBS Act crowdfunding was the legal status of crowdfunding websites *qua* crowdfunding websites.[61] If the offerings made under crowdfunding schemes are indeed securities, a given website's hosting of transactions between issuers and investors could qualify it as a broker or dealer under the Securities Exchange Act of 1934[62] (Exchange Act). The website could also qualify as an investment adviser under the Investment Advisers Act of 1940[63] (Advisers Act), subjecting it to all attendant regulation and potential registration costs. Because the definitions of these terms are so ambiguous, the legal status of crowdfunding sites pre-JOBS Act remained largely uncertain.[64]

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if it complies with one of several registration exemptions); Bradford, *supra* note 9, at 44 (noting that the alternative to registration is finding an exemption); Hazen, *supra* note 20, at 1744 (observing that federal securities laws provide exemptions to registration to encourage small business formation).

53. 15 U.S.C. § 77d(a)(2) (this exemption applies to non-public (private) offerings and only applies to "sophisticated" investors).

54. 15 U.S.C. § 77d(a)(5) (this exemption allows companies to offer securities up to five-million dollars, but only to accredited investors).

55. 17 C.F.R. §§ 230.501–.508 (2013). Regulation D encompasses a whole host of Rules which effectively constitute a safe harbor for the section 4(2) exemption.

56. 17 C.F.R. §§ 230.251–.263.

57. Hazen, *supra* note 20, at 1745.

58. *Id.* With the passage of the JOBS Act, the SEC removed the ban on general solicitation for Rule 506 (part of Regulation D) offerings, but such removal does not truly help crowdfunding offerings because only accredited investors can partake in these offerings. *See* JOBS Act § 201(a)(1), Pub. L. No. 112-106, 126 Stat. 306 (2012) ("[T]he Securities and Exchange Commission shall revise its rules . . . to provide that the prohibition against general solicitation . . . shall not apply to offers and sales of securities made pursuant to this section . . . provided that all purchases of securities are accredited investors.").

59. Hazen, *supra* note 20, at 1748.

60. *See generally* Bradford, *supra* note 9, at 48 (noting that Regulation A requires a "mini-registration," the costs of which reach into the tens of thousands of dollars).

61. *See, e.g.*, *id.* at 49–50 (noting that "the status of crowdfunding sites [as brokers or investment advisers] is uncertain").

62. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4), (15) (2010).

63. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2006).

64. *See* Bradford, *supra* note 9, at 49–80 (providing an in-depth discussion of whether crowdfunding sites pre-JOBS Act indeed constituted brokers or investment advisers).

### *B. The JOBS Act*[65]

With the passage of the JOBS Act, Congress squarely answered both of the questions above. The Act's stated purpose is "[t]o increase American job creation and economic growth by improving access to public capital markets for emerging growth companies."[66] It purports to achieve this end through Title III, which amends section 4 of the Securities Act to add section 4(6), providing a crowdfunding registration exemption.[67]

Section 4(6) imposes a one million dollar per year cap on the aggregate amount of securities any one issuer may sell under the exemption.[68] It also imposes an annual cap on the total amount any individual investor can pay to an issuer based on the investor's income or net worth.[69] The issuer must also make several disclosures in compliance with amended section 4A(b) of the Securities Act by filing with the SEC and providing investors and the relevant funding intermediary[70] with basic information such as, *inter alia*, its business structure,[71] the names of its directors and officers[72] and a business plan.[73] Such information provides "potential investor[s] some insight into how their investment money would be spent."[74] Title III requires any offerings made under section 4(6) to occur through an intermediary that must register with the SEC either as a traditional broker or a new type of intermediary called a "funding portal."[75]

While the exemption is essential for crowdfunding initiatives, section 4(6) "is not available for foreign issuers, mutual funds, or most private investment companies," including reporting companies.[76] The exemption itself resolves the question of the status of the offerings made under crowdfunding schemes—they are indeed securities, but they are exempt from registration under the new section 4(6).[77] One requirement for compliance with the exemption—the use of a broker or funding portal—answers the question about the status of crowdfunding sites.[78]

### *C. Funding Portals: What Are the Requirements?*

Although the JOBS Act introduced many significant changes to the securities laws, this Note focuses on the requirements imposed on funding portals operating under the exemption. As previously mentioned, the requirement of transaction through a broker or a

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65. It is worth noting that the JOBS Act is not meant to encompass reward-based crowdfunding schemes such as Kickstarter because such sites do not likely offer securities under the *Howey* test. *See* Bradford, *supra* note 9, at 32 (noting that because reward-based crowdfunding models do not offer "financial returns of any kind" to contributors, the federal securities laws do not apply).

66. Jump Start Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

67. *Id.* at 126 Stat. 315.

68. Jump Start Our Business Startups Act, 15 U.S.C. § 77d(6)(A).

69. 15 U.S.C. § 77d(6)(B).

70. 15 U.S.C. § 77d-1(b)(1).

71. 15 U.S.C. § 77d-1(b)(1)(A).

72. 15 U.S.C. § 77d-1(b)(1)(B).

73. 15 U.S.C. § 77d-1(b)(1)(C). For a complete list of the disclosure requirements, see 15 U.S.C. § 77d-1(b)(1)(A)–(H).

74. Baritot, *supra* note 52, at 269.

75. 15 U.S.C. § 77d(6)(C).

76. HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 10 INT'L CAP. MARKETS & SEC. REG. § 1:250 (2013).

77. 15 U.S.C. § 77d(a).

78. 15 U.S.C. § 77d(b).

funding portal clears up the indeterminate status of crowdfunding sites pre-JOBS Act. It does so by creating a new type of intermediary—the funding portal—and by requiring such sites to register as a funding portal or as a broker. Under the section 4(6) exemption, intermediaries facilitating transactions between issuers and investors are subject to a host of requirements, regardless of their status as a broker or a funding portal.[79] Many of these requirements aim to protect unsophisticated investors[80] and prevent funding portal fraud,[81] while others, such as the requirement to register with a self-regulatory organization such as the Financial Industry Regulatory Authority, appear merely procedural.[82]

The JOBS Act also amended the Exchange Act to provide an exemption for properly organized funding portals from registration as a broker or dealer.[83] More importantly, it provided a definition of a funding portal.[84] Under the JOBS Act, a funding portal is "any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act."[85] The JOBS Act lists five activities that a funding portal cannot participate in if it wants to retain its funding portal status and broker-dealer registration exemption.[86] Included in this list is a simple and general prohibition on "offer[ing] investment advice or recommendations."[87] Congress chose not to elaborate on what "investment advice" might entail, leaving it up to the SEC to define this term when it issued its rules on Title III.[88]

### *D. Regulation Crowdfunding*

On October 23, 2013, the SEC unanimously voted to propose rules pursuant to the JOBS Act's mandate.[89] When the SEC proposed these rules, dubbed Regulation Crowdfunding, it recognized the potential impact that the regulations could have on the

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79. *See generally* 15 U.S.C. § 77d-1(a) (listing the compliance requirements for crowdfunding intermediaries).

80. *See, e.g.*, 15 U.S.C. § 77d-1(a)(4) (requiring that intermediaries institute an "investor education" program, ensuring that investors understand the risks they are undertaking); 15 U.S.C. § 77d-1(a)(5) (requiring that intermediaries run background checks on major issuer shareholders); *see also* Baritot, *supra* note 52, at 268–69 (noting that the JOBS Act attempts to limit risks to investors both through regulating issuers and intermediaries as well as capping investment amounts for individual investors).

81. *See, e.g.*, 15 U.S.C. § 77d-1(a)(10) (preventing intermediaries from compensating promoters for furnishing potential investor information); 15 U.S.C. § 77d-1(a)(11) (2013) (prohibiting intermediary management from having a financial stake in any issuer utilizing that intermediary). Both provisions have the effect of limiting interested transactions between the issuer and funding portal, so as to prevent collusion.

82. 15 U.S.C. § 77d-1(a)(2); *see also, e.g.*, 15 U.S.C. § 77d-1(a)(6) (setting a timeline for issuer disclosure publication).

83. Jump Start Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 321 (2012) (codified in scattered section of 15 U.S.C.).

84. 15 U.S.C. § 78c(a)(80).

85. *Id.*

86. *Id.*

87. 15 U.S.C. § 78c(a)(80)(A). Other prohibitions include soliciting the purchase of securities on its portal (solicitation is instead up to the issuer), compensating employees or agents for such solicitation, or handling investor funds or securities, all subject to any further SEC rulemaking. 15 U.S.C. § 78c(a)(80)(B)–(E).

88. *See* Douglas S. Ellenoff, *Making Crowdfunding CREDIBLE*, 66 VAND. L. REV. EN BANC 19, 22–24 (2013), *available at* http://www.vanderbiltlawreview.org/content/articles/2013/05/Ellenoff_66_Vand_L_Rev_En_Banc_19.pdf (noting that "how the SEC drafts the proposed rules for Title III . . . could have a significant impact on investors and the emergence of the crowdfunding industry").

89. SEC Issues Proposal on Crowdfunding, *supra* note 18.

viability of crowdfunding as a capital financing scheme.[90] In particular, overly restrictive rules could chill funding portal creation,[91] while overly lenient rules could create unjustifiable risks for potential investors.[92] The JOBS Act embodies a tension between creating deregulated intermediaries in the form of funding portals on one hand, and affording unsophisticated investors adequate protection from fraud and doomed-to-fail issuers on the other hand.[93]

Regulation Crowdfunding includes a conditional safe harbor provision outlining several activities in which funding portals may engage without running afoul of provisions prohibiting the giving of investment advice or making securities recommendations.[94] The SEC chose to create the safe harbor provision in response to general unease with the vagueness in the investment advice prohibition.[95] The safe harbor provision purports to be "a non-exclusive, conditional safe harbor for funding portals that engage in certain limited activities."[96] The SEC notes that failure to follow the exact specifications of the various safe harbor provisions would not raise the presumption of violation of either the JOBS Act's prohibition on giving investment advice or Regulation Crowdfunding itself.[97] The SEC reiterates that none of the various securities laws define the term "investment advice," and it points out that it does not now purport to define the term in the proposed rules.[98] The remainder of this Part examines activities outlined in the safe harbor provision of Regulation Crowdfunding pertinent to the prohibition on giving investment advice.

### *1. Limiting Offerings*

In noting that some funding portals may wish to limit the various offerings listed on their websites,[99] the SEC recognizes that limiting offerings in this way could be viewed as providing investment advice.[100] The safe harbor provision allows funding portals to limit their offerings to those falling within a certain set of objective criteria and still be deemed

90. *See* Regulation Crowdfunding, Exchange Act Release Nos. 33-9470; 34-70741, 13 (to be codified as 17 C.F.R. § 227.402), *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf [hereinafter Regulation Crowdfunding] ("We understand that these proposed rules, if adopted, could significantly affect the viability of crowdfunding as a capital-raising method for startups and small businesses.").

91. *Id.* ("Rules that are unduly burdensome could discourage participation in crowdfunding.").

92. *Id.* ("Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses.").

93. *See, e.g.*, Fink, *supra* note 25, at 29–30 (questioning whether the risks to investors associated with "regulatory gaps" are outweighed by the potential for economic and entrepreneurial growth); Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 43, 62 (2013), *available at* http://www.vanderbiltlawreview.org/content/articles/2013/05/Schwartz_66_Vand_L_Rev_En_Banc_431.pdf (concluding that the SEC should craft "light and simple" rules to provide crowdfunding adequate "breathing room" to flourish).

94. Regulation Crowdfunding, *supra* note 90, at 224.

95. *Id.* ("A number of commenters sought guidance on services they might be permitted to provide consistent with the prohibition on offering investment advice or recommendations.").

96. *Id.* at 227.

97. *Id.* at 227–28.

98. *Id.* at 227–28 n.585.

99. *See* Regulation Crowdfunding, *supra* note 90, at 229 (discussing the desire for some funding portals to limit their business).

100. *Id.*

not to be providing investment advice.[101] The criteria must be "reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform . . . [as] applied [] to all potential issuers and offerings and are clearly displayed on the funding portal's platform."[102] This requirement ensures that a funding portal does not apply criteria that are so limiting as to implicitly render investment advice.[103]

The SEC suggests several criteria that funding portals can utilize in crafting their own limiting criteria, including: the "type of security," the issuer's "geographic location," or the issuer's "industry or business segment."[104] However, the SEC warns that a funding portal may not use criteria "based on an assessment of the merits or the shortcomings of a particular issuer or offering."[105] The requirement that the funding portal must list the criteria used in limiting offerings assists investors in determining the "niche focus" of a funding portal and the types of offerings investors can expect to find on the portal.[106]

*2. Highlighting Issuers & Offerings*

A funding portal may also "highlight" certain issuers or offerings based on objective criteria.[107] As with limiting offerings, the criteria used to highlight issuers or offerings could include: the type of securities offered, the location of the issuer, or the industry or business segment of the issuer.[108] The SEC also suggests that funding portals might highlight certain issuers or offerings based on: the "number or amount" of pledged investments, the "progress in meeting the target offering amount," or various other criteria such as maximum or minimum investment amounts.[109] Highlighting these issuers and offerings assists potential investors in choosing specific offerings in which they may be more interested in investing.[110] At the same time, these highlights should be "sufficiently objective, so as to reduce the risk of a funding portal . . . advanc[ing] a particular bias or subjective assessment of the issuers or offerings."[111]

As with limiting offerings, a funding portal highlighting issuers or offerings must use criteria that will highlight a broad selection of issuers, so as not to inadvertently advise investment in certain issuers over others.[112] The criteria must not have the effect of assessing the merits or shortcomings of a particular issuer or offering.[113] Furthermore, the SEC has stated that a criteria based on an investment's "riskiness" would constitute investment advice and is prohibited under Regulation Crowdfunding.[114] To prevent

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101. *Id.*; *see also* 78 Fed. Reg. 66560 (Nov. 5, 2013) (to be codified as 17 C.F.R. § 227.402(b)(1) (outlining the limiting offering provision of the safe harbor)).

102. 78 Fed. Reg. 66560 (Nov. 5, 2013) (to be codified as 17 C.F.R. § 227.402(b)(1)(i)).

103. Regulation Crowdfunding, *supra* note 90, at 230.

104. *Id.*

105. *Id.* at 231.

106. *Id.* at 230.

107. *Id.* at 232; 78 Fed. Reg. 66560 (Nov. 5, 2013) (to be codified as 17 C.F.R. § 227.402(b)(2)).

108. Regulation Crowdfunding, *supra* note 90, at 232.

109. *Id.*

110. For example, the SEC notes that a potential investor may be motivated by a desire to invest in local businesses, or in offerings that have almost reached their target investment amount. *Id.*

111. *Id.*

112. *Id.*

113. Regulation Crowdfunding, *supra* note 90, at 232.

114. *Id.* at 233.

investors from mistakenly taking the highlighted issuers or offerings as investment advice, portals must publish the highlighting criteria on their platform.[115]

### *3. Providing Communication Channels*

Regulation Crowdfunding also allows funding portals to set up "communication channels" on their platforms for investors and issuer representatives to message each other.[116] Neither the portal nor its agents may participate in the communications except to "establish guidelines about communication and to remove abusive or potentially fraudulent communications."[117] Issuers and their representatives must disclose if they utilize the communication channels.[118]

As opposed to the funding portal providing investment advice, the communication channels "facilitate . . . access to information among members of the public and provide investors with the crowd's insight as to the merits of an issuer or business plan."[119] Funding portals can advance this end by restricting those participating in the communications to those who have accounts—in other words, potential investors.[120] By requiring potential investors to create an account, funding portals can ensure "accountability for comments made and help ensure that interested persons, such as those associated with the issuer or receiving compensation to promote the issuer, are properly identified."[121]

### *4. Various Other Activities*

In addition to the activities outlined above, Regulation Crowdfunding authorizes funding portals to engage in several other activities under the safe harbor provision.[122] The SEC makes it clear that funding portals may provide "search" functionality such that investors can filter offerings based on specific criteria.[123] These criteria should be objective in the same manner as those outlined for limiting offerings or highlighting issuers above.[124] Similarly, funding portals may not filter offerings based on the advisability or risk of the offering.[125] Finally, funding portals may advertise their own existence in a variety of manners, including through social media.[126] Portals may also "identify" issuers and offerings in those advertisements, so long as they do so "on the basis of criteria that are reasonably designed to identify a broad selection of issuers . . . and are applied consistently to all potential issuers and offerings."[127] The portal may not advertise in a manner constituting implicit advice regarding the desirability or advisability of one offering or

115. *Id.* at 232–33.
116. *Id.* at 234; 78 Fed. Reg. 66560 (Nov. 5, 2013) (to be codified as 17 C.F.R. § 227.402(b)(4)).
117. Regulation Crowdfunding, *supra* note 90, at 235.
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *See generally* Regulation Crowdfunding, *supra* note 90, at 233–41 (outlining the search function and advertising provisions of the safe harbor).
123. *Id.* at 233–34.
124. *Id.* at 234.
125. *Id.*
126. *Id.* at 240.
127. Regulation Crowdfunding, *supra* note 90, at 240.

issuer over another,[128] or from receiving special compensation from an issuer for the advertisements.[129]

## III. ANALYSIS

### *A. Investment Advice & the Investment Advisers Act of 1940*[130]

To determine the meaning of "investment advice" as provided in Title III of the JOBS Act,[131] it is necessary to turn to the Investment Advisers Act of 1940. The Advisers Act definition of "investment adviser" encompasses the definition of investment advice. The Advisers Act defines an "investment adviser" as:

> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[132]

The SEC's staff traditionally uses a three-part test to determine whether the person is operating as an investment adviser.[133] They examine: (1) whether the person is "providing advice or issuing reports or analyses regarding securities;" (2) whether the person is "in the business" of providing such services; and (3) whether the person is doing so "for compensation."[134] Giving "investment advice" is an essential element in determining whether someone is an investment adviser under the first part of the test.

While the application of this test might at first appear to be straightforward, the general approach "must be accepted with caution as it tends to obscure some nuances of the definition and exclusions that are controlling in the contexts of specific categories of potential investment advisers."[135] Because the definition of "investment advice" defies

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128. *Id.*

129. *Id.*

130. "Investment advice" is implicated in a variety of other contexts, notably including the Employee Retirement Income Security Act of 1974 (ERISA). *Final Rule to Increase Workers' Access to High Quality Investment Advice*, U.S. DEP'T OF LABOR (Oct. 2011), http://www.dol.gov/ebsa/pdf/fsinvestmentadvicefinal.pdf. The SEC also exempts a registered broker-dealer from registration when he gives investment advice that is "solely incidental" to his business as a broker-dealer and for which he receives no "special compensation." 15 U.S.C. § 80b-2(a)(11). This Note does not discuss investment advice in the ERISA or broker-dealer contexts but rather confines its analysis to the definition under the Advisers Act.

131. For this Part of the Note, this analysis only interprets the bare wording of the JOBS Act's prohibition on giving investment advice. It does so without reference to any potential impact on the investment advice prohibition encompassed under Regulation Crowdfunding. For an examination of Regulation Crowdfunding, see *supra* Part II.D (discussing the conditional safe harbors established by Regulation Crowdfunding); *infra* Part III.C (discussing safe harbor gaps).

132. 15 U.S.C. § 80b-2(a)(11).

133. Harold S. Bloomenthal & Samuel Wolff, *Proposed SEC Rules on Crowdfunding: Part 2*, *in* 3 SECURITIES & FEDERAL CORPORATE LAW § 1:87 (2013).

134. *Id.* Note that this three-part test is not encompassed within the prohibition on giving investment advice under the JOBS Act because the JOBS Act provision leaves out any reference to compensation or being in the business of giving such advice. Thus the analysis of the language of the JOBS Act is not an analysis of whether the funding portals will be operating as investment advisers per se. *See supra* Part II.C (citing the exact language used in the JOBS Act).

135. Bloomenthal & Wolff, *supra* note 133, at § 1:87.

black letter or statutory certainty, it is necessary to turn to other sources to determine the contours of statements that may constitute investment advice. Determining whether a given activity or statement might constitute "investment advice" resists any simple definition.[136]

### *B. SEC Guidance & the Broad Construction of "Investment Advice"*

SEC no-action letters are the primary source of guidance on whether a given activity constitutes investment advice.[137] The SEC has issued so many no-action letters construing the definition of "investment adviser" under the Adviser Act that it "will no longer respond to requests for interpretive or no-action letters in this area unless they present novel or unusual issues."[138] However, the letters still provide a rich source of information regarding the type of activities that constitute investment advice under the Act. Although the no-action letters provide case-by-case guidance, the SEC has also issued some limited general guidance for interpretation of the phrase "advice or analyses concerning securities."[139] Generally, a person who "gives advice or makes recommendations or issues reports or analysis with respect to *specific* securities is an investment adviser."[140] But such a definition is not limited to advice on specific offerings. Rather, any investment recommendation related to securities, including even general advice on the relative advantages and disadvantages of securities investments over some other non-security investment, could require the provider of this advice to register under the Advisers Act.[141] Indeed, the SEC generally interprets both the Advisers Act itself,[142] as well as the definition of "investment advice" quite broadly.[143] Keeping in mind these general guidelines, this Note now examines two more opaque standards that the SEC seems to apply in these analyses: activeness and level of choice.

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136. *See supra* Part II.D (noting that neither the federal securities statutes nor Regulation Crowdfunding define "investment advice").

137. Bradford, *supra* note 9, at 73.

138. Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949, at *4 (Oct. 19, 1995).

139. *See* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as an Integral Component of Other Financial Related Services, Advisers Act Release No. 770, 23 SEC Docket 556, 1 (Aug. 13, 1981) [hereinafter Applicability Release] (providing a "[s]tatement of staff interpretative position" of key provisions of the Act including the rendering of investment advice).

140. *Id.* at 4 (emphasis added).

141. *Id.* Many of the no-action letters construing the definition of investment adviser under the Advisers Act recognize the limited impact the distinction between specific and general advice has in regards to the investment advice issue. *See, e.g.*, Baker, Watts & Co., SEC No-Action Letter, 1984 WL 45313, at *3 (June 11, 1084) (finding that even where presentations on securities were "neither client nor security specific," such presentations still constituted investment advice); First United Mgmt. Corp., SEC No-Action Letter, 1974 WL 10912, at *4 (Feb. 28, 1974) ("[E]ven if no specific securities are recommended, advice concerning the relative desirability of investing or not investing any portion of a client's assets in securities would constitute [investment] advice . . . .").

142. *See* Allan E. Korpela, Annotation, *Construction and Effect of Investment Advisers Act of 1940, as Amended (15 U.S.C.A. § 80b-1-80b-21)*, 5 A.L.R. FED. 246, § 3 (1970) (noting that courts construing the Act do so broadly "in order to carry out its purpose of affording protection to the investing public").

143. *See, e.g.*, Am. Gen. Capital Planning, Inc., SEC No-Action Letter, 1976 WL 11250, at *2 (Sept. 18, 1976) ("It is possible that the nature of [a computerized investment] report may bring this particular service within the *broad* definition of investment advice.") (emphasis added); Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949, at *12 (Oct. 17, 1995) ("The SEC has determined that a broad range of activities constitute giving advice or analyses concerning securities.").

### *1. Activeness*

Professor C. Steven Bradford provides an in-depth examination of whether or not pre-JOBS Act crowdfunding sites constituted investment advisers under the Advisers Act.[144] Though his analysis of the investment adviser issue is inapplicable in the funding portals context, his discussion of SEC no-action letters is particularly useful. He notes that the SEC has historically exempted from registration networking sites that "merely post information about securities,"[145] provided that such networks (1) do not partake in negotiations for securities trading between network members, (2) provide no advice in regards to "the merits or shortcomings of any particular trade," and (3) do not receive compensation "in connection with" any trade made on the network.[146] By focusing on these aspects, Bradford seems to be pointing to the "activeness" of the intermediary in facilitating the transactions. Indeed, he characterizes the networks as "'*passive*' [as opposed to 'active'] bulletin boards."[147]

Bradford notes a distinction between these exempted networks and crowdfunding schemes. "Crowdfunding schemes do not usually pick opportunities for investors or attempt to match them to 'appropriate' opportunities" whereas "[m]atching services, by definition, attempt to match investors with suitable offerings."[148] Thus, he argues, while they may differ from the matching networks in other ways that may tend to make them seem like investment advisers under the Advisers Act,[149] they arguably do not provide advice.[150] Again, the key distinction between providing and failing to provide advice seems to be the activeness of the intermediary in the transactions.

Bradford also cites the dearth of SEC decisions examining matching networks and expressed uncertainty as to the true importance of the distinction between matching services and crowdfunding sites in determining whether they constitute investment advisers.[151] This uncertainty, however, appears unwarranted in light of the SEC's no-action letter issued to Internet Capital Corporation (ICC).[152] In that case, ICC wanted to create a website similar to the matching networks discussed by Bradford above.[153] In determining that it would not take enforcement action, the SEC emphasized that ICC would not be giving investment advice because ICC would not "give advice regarding the merits or shortcomings of any particular trade."[154] The SEC further reasoned that their determination was also based on the fact that the ICC would "play no role in effecting

144. Bradford, *supra* note 9, at 67–80; *see also supra* Part II.A.2 (expressing confusion about the legal status of crowdfunding entities prior to the JOBS Act's passage).

145. Bradford, *supra* note 9, at 75.

146. *Id.* (quoting THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 30 (6th ed. 2009); THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISORS 10 (2011)).

147. Bradford, *supra* note 9, at 75 (emphasis added).

148. *Id.* at 76.

149. For instance, crowdfunding sites are operated for-profit, often charge per-transaction fees, and both facilitate negotiations between seller and purchaser as well as the transaction itself (money necessarily flows through the site). *Id.* at 75.

150. *Id.* at 76.

151. *Id.* at 76–77.

152. Internet Capital Corp., SEC No-Action Letter, 1998 WL 9357 (Jan. 13, 1998).

153. *Id.* at *1 ("The web site will provide Participants with a directory of Companies included on the web site [sic] . . . [as well as] a bulletin board designed to allow Participants to communicate their interest in buying or selling the stock of a Company [listed on the website].").

154. *Id.* at *3.

trades between" buyers and sellers.[155] In this case as well, the SEC looked to the level of activity the intermediary engaged in when determining whether its actions constituted investment advice. In all of these situations, the SEC seems to have focused on whether the website merely hosts the buying and selling activities or whether it takes a substantively important role in the transactions. It additionally looks to whether the site provides qualitative advice as to the particular securities traded on the site.

### *2. Level of Choice*

One aspect that the SEC considers when determining whether to take enforcement action is the level of choice the agent[156] affords the potential investors in its offering scheme.[157] In the SEC's no-action letter to First Financial Management Corporation (Van Hummell), it declined to take a no-action stance towards Van Hummell's offering scheme.[158] There, Van Hummell sought to send out prospectuses of various "no-load" mutual funds[159] that provided a "check box" of ten mutual funds about which recipients could request more information from the issuer through the agent if they desired to invest.[160] The mutual funds chosen were to be "of substantial size with a variety of investment objectives" ranging from "those interested purely in growth with little regard to income funds to funds whose primary objective is income."[161] The SEC noted that the selection of just ten funds out of the "universe of all possible no-load and load funds and other securities" constituted investment advice, and advising investment in those funds.[162] In limiting the options investors could choose from, the agent was implicitly advising the investors that some funds were more advantageous than others.

In comparison, in its no-action letter to American Express Company (American Express),[163] the SEC adopted a no-action stance where the agent sought to send out prospectuses about various money market accounts.[164] But it did so without explicitly accepting the legal principles laid out within the letter.[165] American Express "would select the fund or funds . . . after conducting its own investigation as to the completeness and

155. *Id.* The letter continued on to state that, assuming ICC did not give investment advice while doing so, the SEC would not necessarily take action even if it facilitated the trades. *Id.*

156. In order to simplify the discussions that follow, this Note refers to the party seeking clarification as to whether or not its actions make it an investment adviser under the Advisers Act as the "agent" in the transaction. "Offering scheme" refers to the plan upon which the agent seeks clarification.

157. *See generally* First Fin. Mgmt. Corp., SEC No-Action Letter, 1973 WL 11807 (Aug. 27, 2013) [hereinafter First Fin. Mgmt. Corp.] (declining to take a no-action stance where the agent purported to generate a mailing allowing investors to choose to receive information from any or all of ten different mutual funds); Bradford, *supra* note 9, at 76 (citing Venture Capital Network, Inc., SEC No-Action Letter, 1984 WL 45334 (May 7, 1984) (finding the agent to be furnishing "analyses or reports" where it provided investors information based on the answers to a questionnaire in an attempt to match investors and issuers)).

158. First Fin. Mgmt. Corp., *supra* note 157, at *4.

159. "No-load," as opposed to "load," mutual funds are those that do not charge a sales commission. BLACK'S LAW DICTIONARY 1178–79 (10th ed. 2014).

160. First Fin. Mgmt. Corp., *supra* note 157, at *1–2.

161. *Id.* at *2.

162. *Id.* at *4.

163. Am. Express Co., SEC No-Action Letter, 1980 WL 17931, at *1 (Mar. 9, 1980) [hereinafter Am. Express Co.].

164. *Id.*

165. *Id.* at *1–2.

accuracy of the fund's prospectus" with the help of outside consultants.[166] The prospectuses would "call attention to the fact that in recent years money market funds have increased in popularity, but would not recommend investment in money market funds in general or in any specific fund."[167] In the event that a recipient chose to invest in a fund, such investor would contact the fund directly and American Express would do nothing further.[168] American Express stressed that the information provided would be publicly available and that it would "merely call the recipients' attention to certain information."[169]

The distinction between Van Hummell and American Express is not immediately clear. The SEC's reluctance to accept American Express's reasoning as to why its actions did not constitute investment advice further obscures the distinction. American Express itself cited Van Hummell in its initial letter to the SEC, noting that an agent's offering of one security rather than another may indeed implicitly constitute investment advice, but it distinguished itself from cases similar to Van Hummell by urging that its offering scheme would "express no opinion" about the investments themselves.[170] American Express's self-stated distinction is unimpressive on its face (because Van Hummell did not explicitly direct investors to one or another of the offered mutual funds),[171] but makes theoretical sense under closer examination.

While both situations present potential investors with a pre-determined list of potential investments, Van Hummell's was more limited because the subsequent initial transaction between the investor and the seller would necessarily flow through the agent.[172] Conversely, in the American Express situation, any subsequent transactions between investor and seller would occur directly between the parties.[173] Investors were more apt to rely on Van Hummell's representations than American Express's, as Van Hummell was the conduit through which all information flowed. In American Express, if a customer accidentally made an inquiry to American Express regarding one of the funds, the policy directed the employee handling the communication to refer the investor to the appropriate fund.[174] The Van Hummell offering scheme did not provide such guidance.[175]

Though the SEC has indicated that limiting investors' choice to one or several investments in a universe of other choices constitutes investment advice,[176] it has also demonstrated that such a condition is not dispositive. The true distinction between Van

166. *Id.* at *2.

167. *Id.*

168. Am. Express Co., *supra* note 163, at *2.

169. *Id.* at *5.

170. *Id.*

171. *See* First Fin. Mgmt. Corp., *supra* note 157, at *1–2 (listing the information included in each prospectus).

172. *Id.* at *2.

173. Am. Express Co., *supra* note 163, at *2.

174. *Id.* at *8.

175. The scheme only required that, "[i]f any check or other payment for a fund investment should erroneously be forwarded to Van Hummell or the Association, it would be returned to the member." First Fin. Mgmt. Corp., *supra* note 157, at *2. Furthermore, investors would be more likely to contact Van Hummell with questions about the mutual funds because Van Hummell itself advised investors that they would "find [investment] risks clearly explained in the various prospectuses" which Van Hummell, rather than the funds, sent out. *Id.* at *2.

176. *See id.* at *4 ("[S]electing ten no-load funds out of the universe of all possible no-load and load funds and other securities for the list of funds which may be purchases constitutes rendering investment advice to others . . . .").

Hummell and American Express—and the justification for their disparate outcomes—lies in the degree of the agent's activeness in the facilitation of the transactions.[177] Both of these standards, however, are important in analyzing whether "gap" provisions constitute investment advice under the JOBS Act. This Note now discusses two such provisions: a removal provision and a crowd rating provision.

### *C. Regulation Crowdfunding Safe Harbor "Gaps"*

When the SEC voted to propose Regulation Crowdfunding and its "Conditional Safe Harbor" rule, it answered many questions about the sort of activities in which funding portals could safely partake.[178] Even though the SEC has spoken on the issue, it is not necessarily true that the Regulation Crowdfunding rule effectively brings an end to discussion on permissible activities under the JOBS Act's prohibition on giving investment advice. The SEC warns that the list of permissible activities enumerated in the safe harbor rule is non-exhaustive,[179] leaving the door open for further questions regarding what activities portals can engage in under the JOBS Act without forfeiting their status as a funding portal for violation of the prohibition on giving investment advice. The rest of this Part examines some of the suggestions proposed to the SEC during the initial public commenting period, but which the SEC chose not to address.[180]

#### *1. Removal Provisions*

The SEC has not chosen to provide a safe harbor for the ability to "remov[e] an offering before the offering period is over for lack of investor interest."[181] A removal provision would implicate activeness concerns on the part of the funding portal. While a removal provision is different in kind from the "matching networks" that Bradford discusses in that it seeks to prevent investors from access to an offering, rather than pairing them with one,[182] it still requires the same sort of intermeddling that raised concern in that context.[183] In particular, by its very nature, a removal provision requires a high degree of activity in the transactions, or lack thereof, between the issuer and investors—in other words, it requires the funding portal to act directly upon the security itself. This is a higher degree of activity than that in which even matching services engage.[184] In choosing to

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177. *See supra* Part III.B.1 (explaining that merely posting information is not enough).

178. *See generally* Regulation Crowdfunding, *supra* note 90, at 224 ("We received a number of comments concerning the scope and definition of permissible activities for a funding portal. A number of commenters sought guidance on services they might be permitted to provide consistent with the prohibition on offering investment advice or recommendations.").

179. *Id.* at 228.

180. *See supra* Part II.D (discussing Regulation Crowdfunding's various safe harbor provisions).

181. *See* Regulation Crowdfunding, *supra* note 90, at 225–46 (listing the removal provision as one among "numerous examples of potential funding portal activities" but then failing to discuss it further); *see also* Letter from David R. Burton, Gen. Counsel, Nat'l Small Bus. Assoc., to SEC (June 12, 2012), *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-85.htm (suggesting that the SEC provide clarification as to whether "removing an offering before its offering period has expired for lack of sufficient investor commitments" constitutes investment advice).

182. *See* Bradford, *supra* note 9, at 76 (raising concerns that it was the "matching" function of matching networks that constituted investment advice).

183. *Id.*

184. *See id.* ("Matching services, by definition, attempt to match investors with suitable offerings.").

"pull-the-plug" on certain investments due to investor inactivity, the funding portal is certainly speaking to, and publicly acknowledging, the shortcoming of that particular security.[185]

In examining the level of choice the removal provision leaves for investors, like the activeness standard, the provision differs in kind from both Van Hummell and American Express.[186] In those cases, the agent's actions served to restrict the offering scheme's initial offerings.[187] In Van Hummell, the SEC held that such a restriction constituted implicit advice to invest in those securities.[188] A removal provision, on the other hand, would serve to reduce the number of securities that are already being offered by the funding portal. In contrast to Van Hummell, the removal provision constitutes implicit advice *not* to invest in the removed security. It does even more than simply provide "advice" against investing; it entirely proscribes investors from even considering it as a viable offering.

Considering both the high level of activity required in the enforcement of a removal provision, as well as the limited level of choice provided to investors, it is likely that such a provision would constitute investment advice. The general propensity to broadly construe "investment advice,"[189] as well as the fact that the removal provision affects a specific security,[190] further bolsters the conclusion that such a provision would constitute investment advice under the Advisers Act and fall outside the safe harbor of Regulation Crowdfunding. Therefore, without a justification to the contrary, funding portals would not be able to implement a removal provision because doing so would constitute impermissible investment advice under the JOBS Act.

### *2. Crowd Rating Systems*

The SEC itself—in requesting public commenting on Regulation Crowdfunding—questioned whether it should create a safe harbor for crowd-based rating systems.[191] Such a system might, to modify one commenter's suggestion, allow users to up-vote or down-vote certain offerings or issuers.[192] "The results of such [rating] processes can be instantly reflected to the reader in such ways as by changing the font or prominence of [offerings], adding 'badges' or other indicia of imputed credibility . . . ."[193]

These ratings seem to be passing on "the merits or shortcomings" of certain securities.[194] Arguably, the analysis reaches its end here. Crowd rating systems are clearly meant to provide others within the crowd with advice as to which specific securities are

185. *Id.*

186. *See supra* Part III.B.2 (examining the SEC's motive in issuing those decisions).

187. *See* Am. Express Co., *supra* note 163, at *2 (seeking to offer a limited number of money market funds to potential investors); First Fin. Mgmt. Corp., *supra* note 157, at *2 (seeking to offer potential investors approximately ten mutual funds).

188. First Fin. Mgmt. Corp., *supra* note 157, at *4.

189. *Supra* Part III.B.

190. Advice regarding a specific security can be distinguished from generalized advice regarding securities investments. Applicability Release, *supra* note 139; *but see supra* note 142 (questioning the true impact of the specific versus general advice distinction).

191. Regulation Crowdfunding, *supra* note 90, at 245.

192. *See* Letter from Randall Lucas, Applied Dynamite Inc., to SEC (May 4, 2012), *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-50.pdf (suggesting that the SEC adopt this "meta-moderation" in the context of investor and issuer commenting forums).

193. *Id.*

194. Bradford, *supra* note 9, at 75.

and are not going to be a good investment—information which clearly constitutes investment advice.[195]

But it is important to remember that the JOBS Act only proscribes funding portals from rendering investment advice. Here the only persons providing advice of any kind are investors themselves. The portals play only a limited role in hosting the rating system. Providing a platform for a crowd rating system in this manner is exactly the kind of passive role contemplated under the ICC no-action letter.[196] By focusing on the funding portal's potential rendering of investment advice, the funding portal is not active in facilitating these transactions.

These crowd rating systems do not have any direct effect on the availability of offerings. Any possible impact on the availability of offerings would simply result from a sufficient number of "down-votes" on a certain security or offering. However, the mere ability to make an investment less popular does not impact the availability of an offering severely enough to violate the level of choice standard. In both Van Hummell and American Express, the offering schemes completely excluded certain securities from being offered in the first place.[197] The minimal ability to "down-vote" a security by a single member of the crowd is a far cry from the sweeping ability to actually exclude entire offerings by a funding portal.[198]

Even broadly reading the definition of investment advice, as applied to funding portals, the institution of a crowd rating system does not constitute investment advice. Primarily, the JOBS Act prohibits only funding portals from rendering investment advice, not the crowd itself, and the portal's limited passive role in maintaining the rating system satisfies the activeness standard. Because the rating system does not have the broad ability to wholly remove or prevent the offering of a given security, the investor's level of choice remains intact.

## IV. RECOMMENDATION

While the SEC has a long history of providing guidance in the form of no-action letters, dictating what may or may not constitute investment advice under the Adviser's Act, it has not yet had the occasion to provide any such guidance in the context of the JOBS Act. It is conceivable that the SEC would continue applying the same logic it has in the past in issuing future no-action letters to funding portals. However, it is equally conceivable, perhaps even likely, that the SEC will nuance its decisions in those cases by an understanding of not only the JOBS Act and its purposes, but also by the unique nature of the "crowd." This Note posits that this unique nature is what justifies a departure from more traditional analyses of investment advice under the Adviser's Act to support implementation of removal provisions and prohibit implementation of crowd rating systems for funding portals.

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195. *Id.*

196. Internet Capital Corp., SEC No-Action Letter, 1998 WL 9357, at *3 (Jan. 13, 1998).

197. *See generally* Am. Express Co., *supra* note 163 (recommending no action for providing information on funds which investments are sharply limited); First Fin. Mgmt. Corp., *supra* note 157 (determining that the selection of ten no-load funds out of the universe of all possible no-load and load funds and other securities for the list of funds which may be purchased would be rendering investment advice to others).

198. *See* First Fin. Mgmt. Corp., *supra* note 157, at *4 (stressing the agent's choice to offer some securities over others in declining to take a no-action stance).

### *A. The Crowd and Its Effectiveness as a Self-Regulating Body*

The added dimension of the "crowd" as an integral part of the crowdfunding scheme itself creates a dynamic of collective self-regulation not present in other more traditional forms of capital financing.[199] The SEC itself recognized the important and interactive role the crowd plays when it observed that, in crowdfunding initiatives, "individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd."[200] Some commenters have also suggested that the crowd itself serves as a useful "check" on potential fraud.[201] Others are not so optimistic and point out that the crowd can be "stupid" in its decision-making, and a group of investors could mislead others to jump off a proverbial bridge.[202]

However, the SEC should take this dynamic—with both its positive and negative aspects—into serious consideration when either issuing future no-action letters to funding portals or revising Regulation Crowdfunding. Though the degree to which the crowd will be effectively self-regulating is unclear, the SEC must be mindful of the powerful influence the crowd could have within funding portals. The crowd will perform its function to make some companies succeed and prevent others from even getting off the ground. Individual investors have the potential to become powerful leaders within the crowd, dictating which issuers succeed and which ones fail. These leaders, upon making one mistaken judgment, could lead the crowd into disaster. The SEC should not take such outcomes lightly and must carefully consider what potential impact—both positive and negative—the crowd's dynamic could have when considering further rulemaking or amending Regulation Crowdfunding. With this in mind, this Note now turns to the two gap provisions discussed in Part III.C.

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199. For instance, resorting to a traditional capital financing scheme through the "three Fs" (family, friends, and fools) does not afford the same level of inter-investor interaction and communication that crowdfunding schemes contemplate. *Cf.* Martin Zwilling, *Early-Stage Startups Need Friends, Family, & Fools*, FORBES (Dec. 19, 2011), http://www.forbes.com/sites/martinzwilling/2011/12/19/early-stage-startups-need-friends-family-and-fools/ (describing the necessity for startup business owners to turn to friends and family for initial capital financing); Thomas M. Klueter, *Crowdfunding and the Financing of Entrepreneurial Ventures*, ENTREPRENEURSHIP (July 18, 2014), http://blog.iese.edu/entrepreneurship/2014/07/18/crowdfunding-and-the-financing-of-entrepreneurial-ventures/ (commenting on the impact crowdfunding has on traditional modes of startup financing).

200. *See* Regulation Crowdfunding, *supra* note 90, at 11–12 (noting further that "[i]n this role, members of the crowd are not only sharing information about the idea or business, but also are expected to help evaluate the idea or business before deciding whether or not to invest").

201. *See* Ellenoff, *supra* note 88, at 24 (suggesting that an active crowd can facilitate transparent and public discussion of due diligence concerns); Sigar, *supra* note 23, at 489–95 (arguing that, in today's "tech-savvy market," the "information asymmetry" between issuers and investors that raised concerns in the past no longer presents a legitimate danger).

202. *See* Memorandum from Daniel Isenberg, Prof. of Mgmt. Practice, Babson Global Exec. Dir., Babson Entrepreneurship Ecosystem Project, to SEC (Apr. 15, 2012), *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-70.pdf (noting that "crowds are 'wise' only in a very limited set of circumstances" and suggesting that crowdfunding may be an example of "pluralistic ignorance"); *see also* Hazen, *supra* note 20, at 1763–68 (arguing that an overly permissive crowdfunding exemption would seriously endanger investor protection).

### *B. Venturing Outside the Safe Harbor*

In determining whether to allow a funding portal to use a removal provision or crowd rating system, the SEC should focus not only on whether either of these provisions would constitute investment advice, but also on how the crowd will interact with those provisions if allowed. If the provisions are substantially vulnerable to crowd misuse, then the SEC should be especially suspicious of approving their use. In essence, the SEC should consider not only whether the approval of the provisions would ostensibly protect investors from the portals in the form of investment advice, but also whether it would protect investors from themselves.

#### *1. The SEC Should Allow Funding Portals to Implement Removal Provisions with Published Objective Criteria*

The SEC should not prohibit a funding portal from implementing the removal provision even though it would likely constitute investment advice under the Adviser's Act.[203] Though the SEC could reasonably find that the funding portal was proffering advice not to invest in a certain removed security,[204] such advice is sharply curtailed by the crowd's own implicit statement that it is not interested in a particular security. Rather than the funding portal itself making the determination that a given security is a "bad" investment, the crowd itself has already done so. The funding portal would only be taking action on the crowd's decision rather than making an independent analysis of the desirability of one offering over another. The role of the portal in this case, however active, would be more clerical than advisory.

An appropriate safeguard ensuring that funding portals do not abuse a removal provision would be mandatory objective criteria. The SEC has already demonstrated its willingness to allow funding portals to use objective criteria to keep securities from even appearing on the site.[205] If a funding portal were to craft a removal provision with reference to certain benchmarks that have to be reached by certain points in time in the offering period,[206] the criteria would be sufficiently objective to protect the portal from any claims of providing investment advice.[207] Publishing these benchmarks would provide potential issuers with notice of the funding portal's expectations and likely success of their offering. It would also provide notice to investors that the portal may be close to removing a favored security, thus allowing them to rally support for the cause if they so choose. It could finally boost the legitimacy of a funding portal by allowing it to "de-clutter" its offerings and boast a higher success rate, attracting more issuers and investors.

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203. *See supra* Part III.C.1 (discussing the removal provision).

204. *Id.*

205. *See supra* Part II.D.1 (outlining the limiting offerings provision of the safe harbor exemption in Regulation Crowdfunding).

206. For instance, a funding portal could require that a security must reach 20% of its funding goal by the time its offering period is half over or else it will be removed. Such a provision would not unduly burden offerings that may be slow to garner attention when they are newly offered but that would reach their goal by the time the offering period expires.

207. The SEC maintains that "the number or amount of investment commitments made" and "progress in meeting the target offering amount" are both appropriate objective criteria for highlighting issuers or offerings under the safe harbor. Regulation Crowdfunding, *supra* note 90, at 252.

One obvious danger is the potential for powerful investor-leaders to persuade the crowd to invest in a security to "save" it from removal when the issuer has little real chance of success, even if it reaches its funding goal. A particularly powerful and vocal investor could overrule the wisdom of the crowd. These concerns have merit, but only insofar as the authoritative investor miscalculates a given offering's viability. Assuming the crowd responds to those investors who demonstrate some capability of choosing good investments, the dangers of investors being misled should be minimized. All investments come with a certain degree of risk, and it is fair to expect investors to use some amount of independent judgment in evaluating offerings, especially because the JOBS Act requires funding portals to provide minimal investor education.[208]

The other obvious danger is the potential for funding portals to craft overly-lax criteria for removal so that only those offerings that are virtually guaranteed to succeed are allowed to remain on the site; in essence, the danger that the funding portal will set the bar too high to boost its own credibility. The response to this danger is simple: allow the SEC to provide enforceable guidelines that govern the acceptable benchmarks a funding portal can set for its offerings. It has already provided some guidance in other contexts, such as limiting and highlighting offerings.[209]

### *2. The SEC Should Prohibit Portals from Creating Crowd Rating Systems for Offerings or Issuers*

On the other hand, while the SEC would likely not consider the crowd rating systems to be investment advice under the Adviser's Act,[210] the SEC should broadly construe the definition to prohibit funding portals from creating these systems. Even though crowd rating systems do not implicate extensive action or implementation by the funding portal itself, the dangers presented by the crowd justify a refusal to grant an exemption for crowd rating systems. A crowd rating system coincides with the communication channel provision of the safe harbor rule[211] and essentially seeks to perform the same function. However, the rating system is vulnerable to misuse by the crowd in ways that the communication channels are not.

Primarily, while the communication channels allow investors to communicate with each other regarding the merits of certain securities and offerings, the rating system would reduce these discussions to a number or percentage. That figure is devoid of any justification for the rating whatsoever. The funding portal dumps all the ratings into a black box, meaning that the final number it produces lacks any obvious meaning, justification, or reliability. Based on such a bare number, the crowd cannot discern why or how the funding portal produced this figure. If readers accept the modest proposition that the crowd is sometimes wrong, allowing potential investors to rely on a self-issued rating without providing any rationale behind the rating is dangerous.

Even assuming funding portals chose to create both communication channels and a rating system, unsophisticated investors could easily rely solely on an offering's rating

208. *See supra* Part II.C (discussing the various requirements for funding portals under the JOBS Act).

209. *See supra* Part II.D (discussing the criteria for limiting offerings and highlighting offerings and issuers under Regulation Crowdfunding).

210. *See supra* Part III.C.2 (discussing the crowd rating systems).

211. *See supra* Part II.D.3 (outlining the communication channel provision of the safe harbor exemption under Regulation Crowdfunding).

without even glancing at the relevant discussion boards. At the very least, prohibiting funding portals from creating crowd rating systems forces concerned investors to visit the discussion boards and immerse themselves in the conversations. The communication channels have the added advantage of allowing investors to pose questions to representatives of issuers and get questions answered directly from the source.[212] While this is no guarantee of any greater degree of investor safety, at the very least, if the investor seeks information or advice from the crowd about certain securities, the communication channels are much more transparent and informative than a single rating. Because the SEC has already approved the use of communication channels, which serve the same general purpose of the crowd rating system but without the same dangers, the SEC should broadly read the definition of investment advice and refuse to take a no-action stance or amend Regulation Crowdfunding to include implementing crowd rating systems.

If the SEC decides to allow funding portals to do so, however, it should place restrictions on them to reduce their misuse by the crowd. First, the funding portal should restrict each user to only one vote or rate per offering. This would reduce the risk of particularly motivated users either up-voting or down-voting an offering so as to disproportionately affect its rating. The one-vote-per-user requirement would ensure some semblance of accuracy to the rating itself. Second, funding portals should restrict voting to investors. Because the rating is essentially anonymous, there is no effective way of allowing a representative of the issuer to disclose that they are rating their own offering as the communication channels provision requires them to do.[213] Furthermore, funding portals should prohibit issuer representatives from voting or rating for the more obvious reason of bias—they are simply going to give themselves the highest rating possible, thus skewing the rating.[214] Finally, the SEC should require every funding portal that offers a crowd rating system to also offer the channels of communication established in Regulation Crowdfunding. This dual requirement ensures that an interested and prudent investor need not solely rely on the potentially misleading rating system and can instead turn to a more in-depth discussion. If the SEC restricts these rating systems in this way, investors are at least assured a reasonably accurate, non-biased rating with an alternative method of information gathering.

## V. CONCLUSION

Title III of the JOBS Act has the potential to change the way in which small business startups raise initial capital. For crowdfunding to work properly, funding portals must be able to operate at a lower cost and with fewer regulations than traditional broker-dealers. Because the investors in crowdfunding schemes are likely to be unsophisticated, investor protection is a competing concern. Regulation Crowdfunding's safe harbor provision provides some guidance regarding the sort of activities that funding portals may use, while still operating within the confines of JOBS Act's prohibition on providing investment advice.

212. *Id.* Regulation Crowdfunding additionally requires any party receiving compensation for promoting the issuer to disclose that in the channel. Regulation Crowdfunding, *supra* note 90, at 235.

213. *See* Regulation Crowdfunding, *supra* note 90, at 235 (requiring an issuer representative to disclose this information when participating in the communication channels established under Regulation Crowdfunding).

214. One can also argue that issuer representatives are not properly part of the "crowd" either, further militating against their inclusion under the crowd rating system.

Gaps still do exist in the safe harbor, inviting questions as to what might constitute giving investment advice that the JOBS Act prohibits. Though a removal provision would constitute investment advice under the Adviser's Act because the crowd's own choices preempt the dangers that such a provision would pose to unsophisticated investors, the SEC should allow funding portals to implement such provisions. On the other hand, while a crowd rating system would not constitute investment advice under a traditional analysis, the SEC should limit the use of such systems because of the risks they pose to investors. Both of these provisions, falling outside the scope of the safe harbor provision of Regulation Crowdfunding, dictate that the SEC consider forces unique to the crowd in evaluating investment advice for funding portals.