

Staying the Course with Broker-Dealer Registration: The SEC’s Impending Regulation of Crowdfunding Portals Under the JOBS Act

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I. INTRODUCTION

Collecting donations to run a political campaign, fundraising to support an artistic project, and contributing towards a charitable cause or foundation’s funding goal; these examples illustrate diverse yet successful applications of crowdfunding. Investors’ rewards for these commonplace transactions include sponsor recognition, a prototype or memorabilia from the launch of a product or project, and personal gratification. None of these circumstances, however, involve investor donations in exchange for ownership—otherwise known as securities—until now.

In 2012, the Jumpstart Our Business Startups Act (JOBS Act) created a broker-dealer

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registration exemption for crowdfunding portals under Title III, allowing these security intermediaries to raise capital in exchange for securities.¹ The Securities Exchange Act of 1934 (Exchange Act) charges the Securities and Exchange Commission (SEC) to govern the securities market to protect investors.² Save for a few exceptions, the SEC requires those buying and selling securities, or doing so on behalf of others, to register as a broker-dealer.³ The JOBS Act creates another exception to broker-dealer registration for crowdfunding portals and suggests guidelines for the SEC to adopt in order to regulate the intermediaries.⁴

The guidelines the JOBS Act suggests, however, meaningfully stray and conflict with the SEC's history of broker-dealer regulation.⁵ The SEC currently recognizes three exceptions: an issuer,⁶ finder,⁷ and investment advisor exception.⁸ These exceptions, however, are narrow. None of the exceptions allow a person to exchange securities if he exhibits hallmark broker-dealer activity, including, but not limited to, receiving transaction-based compensation, possessing investor funds, participating in negotiations of the sale of securities, or even providing certain types of information about the securities.⁹ Although the SEC has yet to issue formal guidelines for the JOBS Act's crowdfunding exception to broker-dealer registration, the public commenting period is underway and the SEC addressed the issue in two no-action letters.¹⁰

This Note reviews the Exchange Act and its underlying policy objectives, focusing on the Act's regulation of the securities market and broker-dealer registration. This Note first explores the SEC's past regulation of broker-dealer registration and continues with a summary and analysis of two SEC no-action letters addressing the proposed crowdfunding exception. The analysis concludes by comparing and contrasting the existing exceptions with the proposed guidelines for the new crowdfunding exception from both the JOBS Act and SEC no-action letters.

This Note contends that the JOBS Act's crowdfunding portal guidelines are too liberal and do not adhere to previous SEC precedent. As a result, this Note argues that crowdfunding portals would participate in hallmark broker-dealer activities if the SEC adopts Congress's JOBS Act guidelines. Moreover, recent SEC no-action letters regarding the regulation of crowdfunding portals do not align with past SEC rulings and exceptions. This Note argues that the SEC must take a more conservative approach in requiring crowdfunding portals to register as a broker-dealer when formally issuing guidelines than it took in its recent no-action letters or the guidelines under the JOBS Act. If it is impractical

1. Douglas S. Ellenoff, *Making Crowdfunding Credible*, 66 VAND. L. REV. EN BANC 19, 20 (2013).

2. John Polanin, Jr., *The "Finder's" Exception From Federal Broker-Dealer Registration*, 40 CATH. U. L. REV. 787, 787 (1991).

3. David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899, 904–05 (1987).

4. Ellenoff, *supra* note 1, at 20.

5. See *infra* Part II.A (describing details of broker-dealer registration under the Exchange Act and stating current exceptions to registration that the SEC recognizes); see *infra* Part II.D (describing the JOBS Act's suggested guidelines for a new crowdfunding portal exception to broker-dealer registration).

6. Lipton, *supra* note 3, at 916.

7. *Id.* at 927.

8. *Id.* at 933.

9. See *infra* Part III.A (describing the factors and actions the SEC views as constituting hallmark broker-dealer activity).

10. See *infra* Part III.E (detailing the SEC's response to the FundersClub and AngelList no-action letter requests for acting as a crowdfunding portal under the proposed JOBS Act guidelines).

to create another exception without conflicting with the guidelines set forth for other exceptions, then the SEC should disallow a crowdfunding portal exception altogether, rather than straying from its course of 80 years.

II. BACKGROUND

In an effort to combat securities trading abuses in the American securities markets, the Exchange Act authorized a commission to adopt rules to “protect[] the public . . . with respect to trading in securities, through . . . the regulation of brokers and dealers and the securities markets.”¹¹ Congress codified the Commission’s rules into law two years later.¹² Therefore, the underlying policy for this regulatory framework is to protect and provide investor safeguards.¹³ Although not mutually exclusive, a person may exchange securities by acting as a broker, dealer, or trader.¹⁴ The Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.”¹⁵ A “dealer” is “any person engaged in the business of buying and selling securities . . . for such person’s own account through a broker or otherwise.”¹⁶ A “trader” does not fall into either of these classifications and is defined as “a person who buys and sells securities for his or her own account, either individually or in a fiduciary capacity, but not as part of a regular business.”¹⁷ This Note will generally refer to brokers and dealers collectively as “broker-dealers,” because application of the rules of the Exchange Act does not differ between the two.¹⁸

A. Broker-Dealer Registration

Acting as a broker-dealer is expensive and complex. Broker-dealers must register with the SEC, join self-regulatory organizations (SROs) to satisfy competency and training standards under the Financial Industry Regulatory Authority (FINRA), satisfy rigorous net worth and capital requirements,¹⁹ and comply with financial reporting guidelines, among other oversight requirements.²⁰ Once a person has registered with the SEC, the SEC then has the authority to conduct investigations to detect securities law violations.²¹ If there are any infractions, or if a broker-dealer fails to register, the SEC may seek civil injunctions in federal court,²² impose monetary penalties,²³ issue cease-and-desist orders,²⁴ or even refer

11. Polanin, *supra* note 2, at 787.

12. *Id.*

13. Persons Deemed Not to Be Brokers, SEC Release No. 34-20943 (May 9, 1984).

14. See *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM’N (Apr. 2008), available at <http://www.sec.gov/divisions/marketreg/bdguide.htm> (defining brokers and dealers separately while addressing common trade practices representative of both brokers and dealers).

15. 15 U.S.C. § 78c(a)(4)(A) (2012).

16. 15 U.S.C. § 78c(a)(5)(A).

17. *Guide to Broker-Dealer Registration*, *supra* note 14, at Part II.B.

18. Lipton, *supra* note 3, at 909–10.

19. 15 U.S.C. § 78o-5 (including maintaining at least a minimum net worth in addition to a minimum ratio of net capital to total indebtedness).

20. Lipton, *supra* note 3, at 907.

21. 15 U.S.C. § 78u(a)(1).

22. 15 U.S.C. § 78u(d)(1).

23. 15 U.S.C. § 78u(d)(3).

24. *Id.*

the matter to the attorney general for prosecution.²⁵

Broker-dealers are subjected to this regulatory framework because they perform financially sensitive functions that necessitate investor protection.²⁶ The consequences of failing to register as a broker-dealer exist to (1) ensure broker-dealer competence, (2) provide information to the public regarding a broker-dealer's business and integrity, (3) promote broker-dealer financial solvency, and (4) subject broker-dealers to the jurisdiction, rules, and oversight of the National Association of Securities Dealers (NASD).²⁷ As such, registration is "prohibitively expensive."²⁸

Exemptions to broker-dealer registration exist,²⁹ but the policy considerations for allowing them do not trigger the same societal or regulatory concerns that an offering to the general public would.³⁰ The SEC recognizes an issuer exemption for self-selling issuers who only sell their own securities and do not both buy and sell securities.³¹ A finder exemption for broker-dealer registration also exists where a person can identify purchasers or sellers of securities but may not participate in effecting transactions of others.³² The SEC also recognizes an investment advisor exemption that applies to persons who only act as consultants and never possess customer funds or securities.³³ Ultimately, however, the Exchange Act requires regulation of virtually all instances of buying and selling securities.³⁴ These transactions typically occur either by traders not as a part of regular business, or by broker-dealers for the account of others as a part of ordinary business.³⁵

B. Crowdsourcing and the Advent of Crowdfunding

Although Internet-based crowdfunding is relatively new, crowdsourcing, "which refers to mass collaboration efforts through large numbers of people," is vastly prevalent because any collective community contribution towards achieving a goal or adopting an idea constitutes crowdsourcing.³⁶ For instance, politicians have long collected public campaign donations, and crowdsourcing also funds scientific research projects and data collection.³⁷ The Internet and social media's progression, however, lowered the transaction

25. 15 U.S.C. § 78u(d)(1).

26. Lipton, *supra* note 3, at 899.

27. *Id.* at 907.

28. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 6 (2012) (discussing the requirements for registration as a broker-dealer and the limited manner in which securities are traded).

29. 15 U.S.C. § 78o(a)(2) (stating that the SEC, "by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order").

30. See Ellenoff, *supra* note 1, at 20 (stating that qualifying potential investors under these exemptions "either know the entrepreneurs by virtue of their relationships or have the financial sophistication to understand or the means to assume the risk of loss of their investments").

31. Lipton, *supra* note 3, at 916.

32. *Id.* at 927.

33. *Id.* at 933–37.

34. See *id.* at 905 (stating exemptions and the principles that exemptions must adhere to).

35. *Id.*

36. See 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) (referencing past examples of crowdfunding and crowdsourcing and including examples that do not involve security exchanges).

37. Bradford, *supra* note 28, at 11–13.

costs associated with attempting to raise small amounts of money from a large group of investors.³⁸ This phenomenon of “lending very small amounts of money, typically to poorer borrowers” is known as microlending or microfinance.³⁹ Crowdfunding, then, is just a combination of microlending and crowdsourcing involving “small contributions from a large number of people to fund small entrepreneurial ventures.”⁴⁰

Depending upon what investors obtain in return for their contributions, there are five different crowdfunding models: (1) the reward model, (2) the donation model, (3) the pre-purchase model, (4) the lending model, and (5) the equity model.⁴¹ Besides the equity model, the other models only offer interest on any money invested while some models do not even return the money invested and consider it a donation.⁴² In contrast, the equity model offers investors a portion of the company and thus a share of the profits.⁴³ By receiving a share of the profits from the businesses that investors are helping to fund, the equity model involves the sale of a security;⁴⁴ this raises regulatory issues, which is the main reason for the equity model’s scarce popularity in the United States.⁴⁵

C. The JOBS Act and a New Broker-Dealer Registration Exception

In 2012, Congress enacted the JOBS Act in an attempt “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”⁴⁶ Titles II and III of the JOBS Act meaningfully depart from the previously discussed longstanding tenets of the Exchange Act;⁴⁷ most pertinently, the Exchange Act defined the difference between a private placement and public offering, and thus, when broker-dealer registration was necessary.⁴⁸ Title III of the JOBS Act, however, creates a new type of security intermediary called a “funding portal,” which is exempt from the distinction and broker-dealer registration requirement.⁴⁹ This new broker-dealer registration exemption applies to qualified crowdfunding transactions, thereby expanding the usage of the equity model of crowdfunding transactions.⁵⁰ The JOBS Act responded to a recession—in which limited capital was available to smaller businesses—by creating this exception to broker-dealer registration and thus increasing economic activity through

38. *Id.* at 5 (“Through these sites, entrepreneurs have access to anyone in the world with a computer, Internet access, and free cash.”).

39. *Id.* at 28.

40. *See id.* at 28–29 (defining microlending by the recipient as “very small entrepreneurial ventures,” crowdsourcing by the contributor as “small contributions from a large number of people to achieve a common goal,” and discussing how these two practices are the antecedent to crowdfunding).

41. *Id.* at 14–15.

42. *See* Bradford, *supra* note 28, at 15–25 (discussing each different model in detail and the benefits investors receive from each model).

43. *Id.*

44. *Id.*

45. *Id.* at 24.

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

47. Ellenoff, *supra* note 1, at 20.

48. *Id.*

49. *Id.*

50. *See id.* at 20–21 (“Crowdfunding is a new exemption under the Securities Act that will permit entrepreneurs to raise up to \$1 million from investors, including nonaccredited investors, through the sale of unregistered securities. Such offerings must be conducted through Internet-based funding portals, which are regulated by both the SEC and FINRA, or through FINRA-licensed broker-dealers.”).

increased security exchange and investor activity.⁵¹

D. Guidelines for Crowdfunding Intermediaries

Even though Congress enacted the JOBS Act and Title III, Congress mandated that the SEC establish guidelines for the crowdfunding provision and for the creation of a broker-dealer registration exemption.⁵² Nevertheless, the JOBS Act states four criteria that all crowdfunding portal offerings *must* meet: (1) there is a \$1 million cap on the total amount of securities an issuer can sell; (2) an investor may not invest more than five or ten percent of the investor's annual income;⁵³ (3) the intermediary must register with the SEC and a SRO as a broker-dealer, or under the new registration category for a crowdfunding portal; and (4) the issuer must disclose certain financial information and comply with other statutory requirements.⁵⁴

In addition to the criteria applicable to all offerings under Title III, the JOBS Act provided rules for crowdfunding portals to serve as safeguards for investors.⁵⁵ Regardless of the funding amount, issuers must provide the name of any person holding more than 20% of the issuer's shares, a description of the anticipated business plan, and the target offering amount among other information for all offerings stemming from Section 4(6), which is the new equity-based crowdfunding exemption.⁵⁶ Issuers must also file annual reports with the SEC and provide financial reports to investors.⁵⁷ Finally, in addition to any further rules set by the SEC, issuers may not themselves advertise the offering to the general public but can give notices that direct investors to intermediaries.⁵⁸

Once an intermediary registers with the SEC, and if it is relying on the Section 4(6) crowdfunding exception and registering as a funding portal, then the crowdfunding intermediary must also comply with many disclosure and due diligence requirements.⁵⁹ Intermediaries must provide investors with educational materials and affirm that the investors understand the risks associated with crowdfunding transactions.⁶⁰ For example, intermediaries must provide questions that investors, by answering, would demonstrate an acknowledgement and understanding of the risk of losing their investment.⁶¹ Intermediaries must also obtain background checks in an effort to reduce the risk of fraud,

51. *Id.*

52. Ellenoff, *supra* note 1, at 20. This logically follows because the SEC is the main government agency responsible for regulating the securities industry.

53. Karina Sigar, *Fret No More: Inapplicability of Crowdfunding Concerns in the Internet Age and the JOBS Act's Safeguards*, 64 ADMIN. L. REV. 473, 475 (2012) (citing 15 U.S.C.A. § 77d (a)(6)(B)(i)–(ii) which requires that the total amount sold to a single investor not exceed either \$2,000 or 5% of the investor's annual income or net worth within a 12-month period if the investor has an annual income or net worth below \$100,000, or up to 10% of the investor's annual income or net worth capped at \$100,000 over the 12 month period if the investor's annual income or net worth exceeds \$100,000).

54. *Id.*

55. *Id.* at 477.

56. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1441–43 (2012).

57. *Id.* at 1441.

58. *Id.* at 1443.

59. Thomas V. Powers, *SEC Regulation of Crowdfunding Intermediaries Under Title III of the JOBS Act*, 31 BANKING & FIN. SERVICES POL'Y REP. 1, 2 (2012).

60. *Id.*

61. *Id.*

distribute all issuer disclosures to both the SEC and investors no later than 21 days before the first sale, and become a member of a national SRO in addition to other disclosure and due diligence requirements.⁶² An intermediary may not offer investment advice or recommendations, solicit investors to purchase through their platforms, handle investor funds or securities, or compensate persons for soliciting investors.⁶³

When issuing its guidelines for crowdfunding portals under Title III of the JOBS Act, the SEC “must fulfill its dual role of facilitating capital formation and protecting investors.”⁶⁴ Bearing this in mind, this Note argues that the SEC should require stricter guidelines for exemption from broker-dealer registration for crowdfunding portals than Title III of the JOBS Act currently proposes. If the SEC cannot establish exemption guidelines for funding portals without conflicting with existing guidelines for other exemptions to broker-dealer registration, then the SEC should eliminate the JOBS Act’s new crowdfunding exception altogether to preserve investor protection.

III. ANALYSIS

Registering as a broker-dealer is prohibitively expensive; registrants must comply with specific record keeping and financial compliance measures, including rigorous net worth and capital requirements, maintain numerous records of securities transactions and funds, and file quarterly financial reports with the SEC.⁶⁵ Broker-dealers must also join an insurance program to cover customer losses in instances of brokerage house failure, even though they are also required to maintain a minimum net worth and a minimum ratio of net capital to total indebtedness.⁶⁶ Recognizing these hurdles to securities trading and acquiring capital, the JOBS Act created an exception to broker-dealer registration for crowdfunding portals.⁶⁷ Congressional guidelines for this exception, however, conflict with the SEC’s past regulation of broker-dealer registration under the Exchange Act. In addition to this new crowdfunding portal exception, certain other exceptions exist that the SEC recognizes and comments upon as well.

A. Hallmark Broker-Dealer Activities

As previously stated, a broker-dealer is “any person engaged in effecting transactions in securities for the account of others or buying and selling securities for a person’s own account.”⁶⁸ The SEC considers a variety of factors and activities when deciding whether to require broker-dealer registration. Merely selling or purchasing securities for one’s own account, for example, is not sufficient to trigger broker-dealer registration.⁶⁹ Rather, a person must seek to buy as well as sell securities for one’s own account to require broker-dealer registration.⁷⁰

Moreover, success in effecting transactions for the account of others results in

62. *Id.*

63. *Id.* at 3.

64. Sigar, *supra* note 53, at 476.

65. Lipton, *supra* note 3, at 907.

66. *Id.* at 907–08.

67. Ellenoff, *supra* note 1, at 20.

68. 15 U.S.C. § 78c(a)(4)(A).

69. Lipton, *supra* note 3, at 913.

70. *Id.*

commission or transaction-based compensation, which is a hallmark of broker-dealer activity.⁷¹ Consequently, employees whose compensation is related to the success of the sale of the subject securities must register as broker-dealers.⁷² Additionally, solicitation of business signifies security activity that is within the scope of broker-dealer activity.⁷³ A person may not solicit business on his own behalf or in the form of media advertisements.⁷⁴ Mindful of these trademark broker-dealer activities, this Note analyzes the SEC's recognition of broker-dealer registration exceptions prior to the JOBS Act.

B. Issuer Exception Elements

First, the SEC recognizes an issuer exception from broker-dealer registration for self-selling issuers who often sell their own securities through their officers and employees.⁷⁵ The primary issues relevant to broker-dealer registration are: (1) whether the issuer is acting as a broker-dealer and (2) whether the employees are acting as broker-dealers.⁷⁶ The issuer is not acting as a broker-dealer in this case because it is selling securities for its own account and not for the account of others.⁷⁷ Also, the issuer is not both buying and selling its securities.⁷⁸

Although the determination of whether an issuer's employees are acting as broker-dealers warrants a case-by-case analysis, the SEC historically discusses employees' need for registration alongside the issuer's need for registration, even considering similar factors for both.⁷⁹ The most important and frequently considered factor, however, is the degree to which employee compensation reflects success in sales or is commission-based.⁸⁰ The SEC is concerned about commission or transaction-based compensation because it increases the likelihood of high pressure sales tactics and threatens the underlying purpose of investor protection.⁸¹ Historically, the SEC looks at compensation—whether an issuer is both buying and selling securities, and whether it is doing so for its own account—to determine if an issuer needs to register as a broker-dealer.⁸²

C. Finder Exception Elements

The SEC also recognizes a finder exception for broker-dealer registration.⁸³ A finder is a person who does not participate in effecting transactions of others but rather limits his activities to merely identifying securities purchasers or sellers.⁸⁴ The SEC examines a series of factors to determine whether a finder should register as a broker-dealer.⁸⁵

71. *Id.* at 914.

72. *Id.*

73. *Id.*

74. Lipton, *supra* note 3, at 914.

75. *Id.* at 916.

76. *Id.*

77. *Id.*

78. *Id.*

79. Lipton, *supra* note 3, at 917.

80. *Id.* at 920.

81. *Id.*

82. *Id.* at 916.

83. *Id.* at 927.

84. Lipton, *supra* note 3, at 927.

85. *Id.*

The SEC is more likely to require registration where the finder is involved in negotiations for the sale of securities or discussions detailing the nature of the securities sold.⁸⁶ Other factors include whether the finder provides any recommendations, receives commission-based compensation, and whether the finder previously sold securities.⁸⁷ A history of abusive securities practices, in which a person had already been disciplined, overrides all other factors and makes a person's current compliance efforts futile toward obtaining an exception from broker-dealer registration.⁸⁸ These factors help the SEC determine if customers would be exposed to abusive sales practices and whether the finder is in the business of effecting transactions, thereby maintaining the principles behind requiring broker-dealer registration.⁸⁹

D. Investment Advisor Exception Elements

Investment advisors and financial consultants also often seek an exception from registering as a broker-dealer.⁹⁰ To curtail customer exposure to abusive sales practices, the Exchange Act requires registration when investment advisors: (1) execute transactions for customers, (2) charge commission-based compensation related to the volume of securities transactions effected by customers, or (3) handle customers' funds or securities.⁹¹ The first two instances are not unique to this exception and apply here just as they did to the previous exceptions. Concerns over the misuse of customer funds and securities arise due to misidentification of funds, inability to segregate client assets, and systemic confusion and abuse when allocating commission.⁹²

Advisors and their employees should combat this issue by instituting safeguards, such as "providing the executing broker with a list of" clients and specific transactions that are being effected, obtaining client agreements in advance of aggregated transactions, maintaining separate client accounts, and "avoiding effecting any transactions for the advisor" while working with client transactions.⁹³ Also, if an advisor keeps the uninvested client funds in separate trust accounts in third-party banks, the SEC finds that broker-dealer registration on the basis of possessing customer funds or securities is unnecessary.⁹⁴ Investment advisors and financial consultants need not register if they are only acting as a consultant to an issuer in negotiations and not as an agent for the issuer by soliciting purchasers for a negotiated sale.⁹⁵

E. New Crowdfunding Intermediary Exception Elements

Section 201(c) of the JOBS Act seeks to reduce costs that intermediaries may incur when providing companies with access to potential investors because many of these

86. *Id.* at 927–28.

87. *Id.*

88. *Id.* at 931.

89. Lipton, *supra* note 3, at 928.

90. *Id.* at 933.

91. *Id.* at 933–34.

92. *Id.* at 935.

93. *Id.*

94. Lipton, *supra* note 3, at 935.

95. *Id.* at 937.

companies struggle to raise capital.⁹⁶ The JOBS Act creates another exception to broker-dealer registration by not requiring any person who conducts offerings in compliance with the regulation to register.⁹⁷ Although an intermediary relying on the exception may not receive compensation in connection with the purchase or sale of a security or have actual possession of customer funds, an intermediary *may* co-invest in the securities and provide ancillary services.⁹⁸

To provide clarification and guidance regarding these stipulations, the SEC issued two investment portal no-action letters to FundersClub and AngelList.⁹⁹ Both letters provide advice consistent with prior SEC no-action letters on broker-dealer registration.¹⁰⁰ Similar to the other exceptions, the SEC found that the relevant factors were: the firm either operated as an investment advisor, there was no commission based on the outcome or completion of any securities transaction, the sponsors would not participate in any negotiations, and the entities would not hold any funds or securities.¹⁰¹

I. FundersClub No-Action Letter

FundersClub first sought relief from the SEC for its actions as an advisor to venture capital funds.¹⁰² FundersClub “solely advises venture capital funds as defined in Rule 203(1)-(1) under the Investment Advisers Act of 1940.”¹⁰³ FC Management is a wholly-owned subsidiary of FundersClub and is also a venture capital fund advisor.¹⁰⁴ FC Management manages multiple Delaware limited liability company investment funds formed to invest in start-up company securities.¹⁰⁵ FundersClub and FC Management collectively identify and perform due diligence on these start-up companies.¹⁰⁶ Once FC Management decides to invest, “it enters into a non-binding agreement with that company setting a target amount of capital for which FC Management will invest.”¹⁰⁷ The start-up company provides FundersClub with information to then post on the FundersClub website, which is only accessible to FundersClub members.¹⁰⁸ All members must be accredited investors.¹⁰⁹

FundersClub only requires member investors to submit non-binding indications of

96. Ellenoff, *supra* note 1, at 19–20.

97. 15 U.S.C. § 77d (2012).

98. *Id.*

99. FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf> [hereinafter FundersClub Letter]; AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf> [hereinafter AngelList Letter].

100. Lipton, *supra* note 3.

101. FundersClub Letter, *supra* note 99; AngelList Letter, *supra* note 99.

102. FundersClub Letter, *supra* note 99 (noting that FundersClub sent a letter on March 22, 2013 to the staff of the Division of Trading and Markets, requesting assurance that it would not recommend enforcement action to the SEC under the Exchange Act).

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. FundersClub Letter, *supra* note 99.

108. *Id.*

109. *Id.*

interest regarding these companies, and closes the indication of interest process when interest in an investment fund reaches the target amount originally agreed upon between FundersClub and the start-up company.¹¹⁰ FundersClub reconfirms investors' interest and accredited investor status, notifying members that they may withdraw their indications of interest without penalty.¹¹¹ FundersClub management next signs the investment fund agreements with the investors and completes the transaction.¹¹² Investors then provide funds directly or indirectly to a custody account at a custodian bank or trust company, thereby ensuring that FundersClub never possesses funds.¹¹³

Although FundersClub will not receive compensation for selling securities, it is compensated for organizing and managing the investment funds.¹¹⁴ FundersClub expects to receive around 20% of the profits from the investment funds.¹¹⁵ Finally, FundersClub may also charge administrative fees to defray any legal, fund formation, state filing, or tax reporting fees.¹¹⁶

2. AngelList No-Action Letter

AngelList, the recipient of the other SEC no-action letter that granted relief from broker-dealer registration for an investment portal, approves portfolio companies and identifies potential investors.¹¹⁷ AngelList Advisors forms a limited liability company and registers as an investment advisor.¹¹⁸ AngelList Advisors is a wholly-owned subsidiary of AngelList.¹¹⁹ AngelList Advisors then establishes a new angel investing platform to help identify and invest in companies seeking capital and in which an investor already intends to invest.¹²⁰ Once AngelList Advisors approves both a portfolio company and investor, then AngelList Advisors forms a separate investment vehicle to invest in a particular Portfolio Company.¹²¹

After AngelList receives sufficient interest, it creates another investment vehicle.¹²² AngelList proceeds to collect the subscription agreements from the investors, and then close the investment vehicle it just opened.¹²³ Although AngelList only provides investment advice and administrative services, it still receives compensation in the form of carried interest.¹²⁴ Even though AngelList does not receive commission-based compensation, its compensation equals an agreed upon portion of the potential increase in

110. *Id.*

111. *Id.*

112. FundersClub Letter, *supra* note 99.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. AngelList Letter, *supra* note 99 (noting that AngelList sent a letter on March 26, 2013 to the Division of Trading and Markets staff, requesting assurance that it would not recommend enforcement action by the SEC under the Exchange Act).

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. AngelList Letter, *supra* note 99.

123. *Id.*

124. *Id.*

value of the investment.¹²⁵

In both no-action letters, the SEC's guidance indicated that these alternate forms of compensation would not constitute commission-based compensation and would be eligible for exemption under the JOBS Act from broker-dealer registration.¹²⁶ In other words, the SEC would approve the proposed guidelines from Title III of the JOBS Act and grant yet another exception to broker-dealer registration, despite potential discrepancies with rulings on other broker-dealer registration exceptions. Although much has been said of the potential benefits of a crowdfunding exception under the JOBS Act, this Note argues that any potential benefits are outweighed by the cost of contradicting precedent.

IV. RECOMMENDATION

Current broker-dealer registration requirements are prohibitively expensive, making it difficult for all crowdfunding companies to trade securities and acquire capital.¹²⁷ For decades, and to the present day, however, the SEC upheld these guidelines under the same notion of protecting investors.¹²⁸ In an effort to facilitate trading activity while maintaining safeguards, the SEC recognizes an issuer, finder, and investment advisor exception.¹²⁹ Section 201(c) of the JOBS Act creates another exception to broker-dealer registration for crowdfunding intermediaries as long as they do not receive transaction-based compensation or possess investor funds.¹³⁰

The JOBS Act directs the SEC to create concrete guidelines concerning this exception, and although the SEC has yet to do so, the SEC addressed some concerns in the FundersClub and Angellist no-action letters.¹³¹ To uphold the Exchange Act's underlying principle of protecting investors and to follow past precedent, however, the SEC should adopt guidelines for crowdfunding portals registering under Section 201(c) of the JOBS Act that are stricter than those conveyed in the no-action letters. If stricter measures are impractical or render this new broker-dealer exception moot then, the SEC should eliminate the exception altogether.

A. The Issuer Exception Compared

The SEC only recognizes current broker-dealer registration exceptions through no-action letters that permit activities that do not trigger broker-dealer registration. In regard to the issuer exception, issuers do not sell securities for accounts held by others; those under the exception do not engage in both buying and selling securities, and issuers thereby do not fall under the definition of a broker-dealer.¹³² The SEC does not allow employees of

125. *Id.*

126. *Id.*; FundersClub Letter, *supra* note 99.

127. Powers, *supra* note 59, at 3 (discussing disclosure and due diligence requirements for crowdfunding intermediaries).

128. See Polanin, *supra* note 2, at 787 (describing the codification of the Exchange Act, which is still in effect today).

129. See *supra* Part III.B–D (describing the elements of each SEC-recognized exception to broker-dealer registration).

130. See *supra* Part II.C–D (describing the JOBS Act's creation of a crowdfunding intermediary exception to broker-dealer registration and proposed guidelines for regulation).

131. See *supra* Part III.E (analyzing the FundersClub and Angellist no-action letters).

132. Lipton, *supra* note 3, at 916.

an issuer to fall under the exception when they receive transaction-based compensation, because pressure sales tactics threaten the underlying principle of investor protection.¹³³

First, the no-action letters to FundersClub and AngelList approved the companies' compensation models.¹³⁴ These compensation models, however, depart from the SEC standard of disallowing transaction-based compensation.¹³⁵ FundersClub receives 20% of the profits of any investment fund that it organizes and manages.¹³⁶ AngelList receives compensation in the form of carried interest,¹³⁷ which is similar to the form of compensation that FundersClub receives¹³⁸ because AngelList receives an amount of compensation directly correlated to any potential increase in the value of the investment it manages.

If these two investment portals received compensation for every investor or every issuer they helped succeed in acquiring his capital goals, it would be a clear violation of broker-dealer registration by accepting compensation directly related to each transaction. However, receiving compensation correlated with the success of the investment funds that the funding portals manage and help garner investors for also constitutes transaction-based compensation.¹³⁹ In neither instance are the portals receiving a flat fee regardless of the issuer or the success of the investments, which is what the SEC approved via the issuer exception.¹⁴⁰ Moreover, the pressure sales tactics that led the SEC to bar issuer exemptions because they threatened the bedrock principle of investor protection remain at stake with the funding portals. The portals only receive compensation if an investment increases in value,¹⁴¹ so they are motivated to ensure that they obtain investors at all costs, including partaking in pressure sales tactics such as misleading advertisements and false portrayals of information. If the SEC wishes to maintain investor protection and ensure that investors are able to make investment decisions with accurate information, then the SEC must disallow a compensation model where funding portals only receive compensation if the investments they manage succeed.

B. The Finder Exception Compared

Furthermore, the SEC bars use of the finder exception when finders are involved in the negotiations for the sale of securities or provide information regarding the nature of the securities.¹⁴² Both no-action letters to FundersClub and AngelList approved the portals' method of collecting investor funds and portraying information regarding investments.¹⁴³

133. *Id.* at 917.

134. *See supra* Part III.E (discussing the SEC's approval of FundersClub and AngelList's no-action request when acting as a crowdfunding intermediary in accordance to the proposed guidelines of the JOBS Act).

135. *See supra* note 114 (describing FundersClub's compensation method); *see supra* note 125 (describing AngelList's compensation method).

136. *Supra* note 115 (stating that FundersClub expects to get about 20% of profits).

137. *Supra* note 125 (stating that AngelList's compensation is the potential increase in value of the investment).

138. *Supra* note 115 (stating the FundersClub expects to get about 20% of profits).

139. *See supra* note 72 (discussing transaction-based compensation as a hallmark of broker-dealer activity).

140. *See supra* Part III.B (describing the SEC's guidelines for the issuer exception to broker-dealer registration).

141. *See supra* note 114 (describing FundersClub's compensation method); *see supra* note 125 (describing AngelList's compensation method).

142. Lipton, *supra* note 3, at 927–28.

143. *See supra* Part III.E (describing FundersClub's and AngelList's actions, and the SEC's approval of both

Although the portals do not negotiate a price with investors, they do convey a price to investors and request their funds once a targeted amount of capital is reached. Moreover, as a requirement, the portals and issuers provide information about the investments to the investors.¹⁴⁴ Although the SEC will mandate minimum information conveyance requirements, portals can provide substantive information regarding the securities in a variety of ways, thereby influencing investors and not allowing them to make an accurately informed decision. At the very least, the portals must provide information regarding the securities, which the SEC has not allowed in the past with those attempting to utilize the issuer exception.¹⁴⁵ These practices would threaten investor protection because it would lead the portals to commit abusive sales practices in garnering investors; by providing information on the securities, the portals would be in the business of effecting transactions.¹⁴⁶

C. Investment Advisor Exception Compared

The SEC does not grant investment advisors an exemption from broker-dealer registration when the advisors execute transactions for customers or receive transaction-based compensation.¹⁴⁷ In addition, the SEC does not grant exemption from registration when investment advisors handle customer funds or securities.¹⁴⁸ Both FundersClub and AngelList did not accept investor funds until investor commitments reached the target amount; once the crowdfunding portals succeeded in achieving the target amount, however, they fulfilled their duty as intermediaries by requesting funds from investors in exchange for securities.¹⁴⁹ The exception for investment advisors precludes them from handling customer funds or securities, and both FundersClub and AngelList conflict with this stipulation when the portals achieve their funding goal for an investment and direct the exchange of funds for securities.¹⁵⁰ The SEC should strive to eliminate this discrepancy among the current investment advisor exception and the proposed crowdfunding portal exception when drafting guidelines for the latter.

D. Rectifying Discrepancies

The JOBS Act should not achieve gains in the economy by increasing economic activity if those gains constitute sacrificing investor and public protection in the securities market. For decades, the SEC meticulously monitored securities activity and granted few exceptions to registering as a broker-dealer.¹⁵¹ Those that use the current exceptions cannot

no-action letter requests).

144. See *supra* note 108 (describing the manner in which start-up companies provide FundersClub information regarding the company and/or investment to post on the FundersClub managed website to their member investors).

145. See *supra* Part III.B (detailing elements of the issuer exception and the SEC's regulation of the exception).

146. Lipton, *supra* note 3, at 928.

147. See *supra* Part III.D (detailing elements of the investment advisor exception and the SEC's regulation of the exception).

148. Lipton, *supra* note 3, at 933–34.

149. See *supra* notes 122–23 (describing AngelList's creation of an investment vehicle and collection of investor subscription agreements once AngelList receives its targeted interest level for each investment).

150. *Id.*

151. See *supra* Part III.A–D (detailing the SEC's four recognized exceptions and its treatment of each

participate in activities such as affecting transactions involving the securities of others, receiving transaction-based compensation, providing securities information, or handling investor funds or securities.¹⁵²

Crowdfunding portals registering under Section 201(c) of the JOBS Act violate each of the elements discussed in the FundersClub and AngelList SEC no-action letters;¹⁵³ as such, the intermediaries should register as broker-dealers. Moving forward, the SEC should disallow similar activity and require stricter guidelines, such as requiring funding portals to accept a flat fee for their services regardless of the investment security. If the SEC cannot align the guidelines for funding portals with those for the current broker-dealer registration exceptions, then the SEC should eliminate the new exception altogether. When fulfilling its duty under the JOBS Act and issuing guidelines for funding portals registering under Section 201(c), the SEC should bear in mind the other bedrock principle of the Exchange Act: investor protection.

V. CONCLUSION

Congress passed the Exchange Act in 1934 to provide public-investor protection by regulating brokers, dealers, and the securities markets. Registering as a broker-dealer is prohibitively expensive and can therefore restrict security market activity during times of economic downturn. Throughout the years, the SEC balanced the need for increased security market activity with investor protection by recognizing few exceptions to broker-dealer registration. Though exempt from registration, traders seeking refuge under these recognized exceptions could not participate in recognized hallmark broker-dealer activity without registering as a broker-dealer.

Title III of the JOBS Act created another exception to broker-dealer registration to further increase economic activity in the recent economic downturn. The JOBS Act's proposed guidelines to the new crowdfunding exception, however, meaningfully stray from the SEC's historical regulation of broker-dealer registration. Prior to issuing final guidelines for the crowdfunding exception, the SEC opened Congress's proposed guidelines to public comment and even approved two requests for no-action following these guidelines.

By approving FundersClub's and AngelList's proposed actions, the SEC set a new precedent for broker-dealer registration and allowed crowdfunding portals to participate in activities that it disallows with other recognized exceptions. FundersClub and AngelList both propose a transaction-based compensation model, which encourages pressure sales tactics and creates information asymmetry. The SEC should require crowdfunding portals to charge their investors a flat fee, regardless of the security or success of investments. Moreover, both companies' proposals include providing securities information that start-up companies provide, conveying a price to investors for securities, and directing the exchange of investor funds for securities.

Participation in these hallmark broker-dealer activities without registering as a broker-

exception).

152. *See supra* Part III.A (describing hallmark broker-dealer activities that trigger a registration requirement).

153. *See supra* Part III (discussing guidelines for other broker-dealer registration exceptions and the SEC's approval of two no-action letters acting under the guidelines of the JOBS Act's new crowdfunding intermediary exception).

dealer threatens the Exchange Act's underlying policy goal and longstanding tenet of investor protection. The SEC must stay its course of broker-dealer registration regulation by issuing stricter guidelines for crowdfunding portals than those proposed by the JOBS Act and approved in the recent FundersClub and AngelList no-action letters. If necessary, the SEC should eliminate the new crowdfunding intermediary exception altogether—now is not the time for the SEC to abandon ship.