To Be or Not to Be a Funding Portal: Why Crowdfunding Platforms will Become Broker-Dealers

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The recently enacted JOBS Act created a crowdfunding exemption to securities registration, allowing entrepreneurs to raise capital for their ventures from everyday investors. The crowdfunding exemption has many stipulations such as a maximum investment and offering amounts within a given period. Also, investors can only invest in crowdfunding opportunities through intermediaries that are registered as broker-dealers or funding portals. The JOBS Act created funding portal registration as an easier alternative to the more burdensome broker-dealer registration. Thus, many people believe that crowdfunding platforms will opt to register as funding portals. However, this note argues that crowdfunding platforms would rather choose broker-dealer registration because broker-dealer registration provides more revenue opportunities, flexibility, versatility, and regulatory clarity.

I. INTRODUCTION

On April 5, 2012, President Obama signed the “Jumpstart Our Businesses Startup” Act (“JOBS Act”). The JOBS Act contains a crowdfunding exemption that applies to for-profit enterprises. Crowdfunding is a method for obtaining small amounts of money from a large number of people to fund a particular project, and it is mainly done via the Internet. Previously, crowdfunding was used to fund arts and social projects in the form of small donations. Now, through the JOBS Act, a start-up or a small business can get funding

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2. Id.
3. Id.
4. Id.
from everyday investors to expand its business.5 In return, investors will receive equity in the start-up or small business.6

The crowdfunding exemption under the JOBS Act requires a balance between raising capital and protecting investors. Crowdfunding can help start-ups and small businesses get funding to develop their ideas.7 However, investing in start-ups and small business is very risky.8 Consequently, those that invest in start-ups and small businesses need strong safeguards to protect them. Crowdfunding can benefit and protect investors through the wisdom of the crowds, the idea that a group of inexperienced people can make a collectively wise decision.9 10 The crowdfunding exemption under the JOBS Act provides many protections for crowdfunding investors, such as limitations on investment amounts10 limitations on crowdfunding offerings,11 and investor education materials.12

Under the crowdfunding exemption, securities must be sold through third-party intermediaries.13 These third-party intermediaries must register either as broker-dealers or funding portals with the Securities Exchange Commission (“SEC”).14 Broker-dealer registration and compliance is complicated.15 However, funding portal registration exempts third-party intermediaries, such as crowdfunding platforms, from broker-dealer registration.16 Consequently, funding portal registration was supposed to be a key element for the crowdfunding exemption under the JOBS Act.17 Now, there are fears that funding portal registration may be too complicated and burdensome, jeopardizing the success of the crowdfunding exemption under the JOBS Act.18 However, those

6. Id.
7. Id.
9. Id. at 114.
11. See id. at § 77d-1(b)(1)(D).
12. See id. at § 77d-1(a)(4).
14. Id.
16. JOBS Act Creates Two New Exemptions from Broker-Dealer Registration, SHEARMAN & STERLING LLP 2 (Apr. 2012), http://www.shearman.com/files/Publication/5f0c326-c290-4a5e-bbde-d0426e9a5a/Presentation/PublicationAttachment/c920b58b-de6f-42b18c28-37105e303203/JOBS-Ac...2012._FIA_040312.pdf.
concerns are misplaced because crowdfunding platforms are registering as broker-dealers and will continue to do so, as broker-dealer registration better serves the goals and needs of crowdfunding platforms. Furthermore, crowdfunding platforms registering as broker-dealers better serves the securities market because broker-dealer registration provides stronger investor protections.

Part II of this article discusses the JOBS Act legislation and evaluate crowdfunding. Part III defines broker-dealers and requirements for registration. Part IV defines funding portals and explores the current commentary regarding how funding portals, which are not currently regulated, should be regulated. Part V compares broker-dealer registration and compliance with funding portal registration and compliance and discusses the current trend of crowdfunding platforms’ registration. Part VI concludes.

II. THE JOBS ACT

Before actually discussing whether crowdfunding sites will register as broker-dealers or funding portals, this section explores the JOBS Act. This section discusses the statutory framework of the crowdfunding exemption in the JOBS Act and then analyzes some of the positive and negative aspects of crowdfunding.

A. CROWDFUNDING IN THE JOBS ACT

The JOBS Act allows entrepreneurs to raise money from anybody—not just accredited investors—with certain limitations. As required by the Securities Act of 1933, entities can offer or sell securities to the public if the securities are registered with the SEC or if the securities are exempt from registration. Title III of the JOBS Act provides a crowdfunding exemption to security registration under Section 4(a)(6) of the Securities Act. Specifically, security transactions are exempt from registration “transactions involving the sale of securities” are exempt if the total amount sold to all investors does not exceed $1 million during a twelve-month period.

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21. See id.

Moreover, if an investor’s annual income or net worth is less than $100,000, the total amount sold to such an investor cannot exceed exceed the greater of $2,000 or 5% of the investor’s annual income or net worth during a twelve month period.23 Furthermore, if an investor’s annual income or net worth equals or exceeds $100,000, the total amount sold to such an investor cannot exceed 10% of the investor’s annual income or net worth during a twelve-month period, and, in no event, can the investment exceed $100,000.24

There are also reporting requirements for issuers of crowdfunding securities, depending on the issuer’s offering amount. Issuers who had a total target offering of $100,000 or less during the last twelve months must provide income tax returns and financial statements certified by a principal executive officer to be true and complete in all material respects.25 Issuers who had a total target offering between $100,000 and $500,000 during the last twelve months must provide financial statements reviewed by an independent public accountant.26 Issuers who had a total target offering of $500,000 or more during the last twelve months must provide audited financial statements.27

Crowdfunding transactions must also be conducted through third-party intermediaries.28 There are several requirements for an entity or person acting as an intermediary for a transaction involving the crowdfunding exemption of the JOBS Act. First, intermediaries . . . must register with the SEC as brokers or funding portals.29 Second, the intermediaries must register with a self-regulatory organization (“SRO”).30 SROs assist the SEC in overseeing security transaction activities31 by creating codes of ethics and rules applicable to members of the securities industry and disciplining violations.32 Currently, the Financial Industry Regulatory Authority (“FINRA”) is the only registered self-regulatory organization.33 Therefore, broker-dealers and funding portals will have to register with FINRA to

24. Id.
26. Id.
27. Id.
29. See id. at § 77d-1(a)(1).
30. See id. at § 77d-1(a)(2).
effectuate securities transactions under the crowdfunding exemption of the JOBS Act.

Crowdfunding platforms can register as funding portals, an exemption from broker-dealer registration. Many questions arise from this simple statement. What are broker-dealers? What are funding portals? What are the effects of registering and complying with either designation? Will crowdfunding platforms, which have taken on a more important role as they can be used to finance start-ups under the JOBS Act, choose to register as broker-dealers or funding portals? This note addresses such questions, but first, the next section discusses the advantages and disadvantages of crowdfunding.

B. PROS AND CONS OF CROWDFUNDING

One of the major draws of crowdfunding is that, for some start-ups and small businesses, crowdfunding is the only way to get the funding needed to develop their ideas to reach the angel investing and venture capital stage. Venture capital is “a pool of professionally managed funds provided by passive investors for investment in startup companies.” Angel investors are wealthy individuals who fund start-ups and small businesses, but they are not related to any of the company’s founders. Usually, angel investors invest in companies before such companies are ready for venture capital funding. “There is an expanding funding gap between the amounts of capital entrepreneurs can raise from personal sources such as friends and family (typically below $500,000) and the minimum amounts venture capital funds invest (now, typically $5,000,000).” Traditionally, entrepreneurs used banks, capital markets, and personal resources for the necessary funding to get to angel and venture capital financing. However, banks, capital markets, and even an entrepreneur’s personal resources do not provide enough funding for potentially successful start-ups. Many start-ups and small businesses are denied bank loans because they do not have collateral, an operating history, or a proven track record.

34. SHEARMAN, supra note 16.
35. Crowdfunding 101, supra note 1.
37. Id. at 115.
38. See id. at 108.
39. Id.
40. See Crowdfunding 101, supra note 1.
41. See Bradford, supra note 8, at 5.
42. Sigar, supra note 32, at 481.
Also, many entrepreneurs are from areas underserved by banks and capital markets.43 Estimates suggest that the financial markets are failing to meet early private financing demands of small businesses by nearly $60 billion each year.44

The crowdfunding exemption under the JOBS Act will help start-ups and small businesses get early private financing and eventually become public companies.45 The crowdfunding exemption allows an entrepreneur to get funding from ordinary investors, who are not related to the entrepreneur, in exchange for an equity stake in the entrepreneur’s company.46 As a result, crowdfunding lessens the capital gap faced by start-ups and small businesses to reach the angel and venture capital financing stage.47

There are five types of crowdfunding: (1) donation-based; (2) reward-based; (3) pre-purchase; (4) lending; and (5) equity-based.48 Equity-based crowdfunding, which offers investors an equity stake in their crowdfunding investments that is not offered by other crowdfunding activities, is the focus of the crowdfunding exemption under the JOBS Act. Non-equity based crowdfunding (i.e., donation-based, reward-based, pre-purchase, and lending) is not considered by the JOBS Act because it does not involve securities in that there is no express or implied possibility of a return.49 Though non-equity based crowdfunding is not exempted under the JOBS Act, people are nevertheless investing substantial amounts of money in unregulated, non-equity based crowdfunding offerings.50 However, non-equity based crowdfunding investments have a similar risk of loss as crowdfunding securities without offering the possibility of a financial return.51 With all the benefits of crowdfunding, there are also drawbacks.

One downside to crowdfunding is small business and startup volatility. Investments in start-ups and small businesses are not

43. See Crowdfunding 101, supra note 1.
44. Bradford, supra note 8, at 100 (quoting William K. Sjostrom, Jr., Relaxing the Ban: It’s Time to Allow General Solicitation and Advertising in Exempt Offerings, 32 FLA. ST. L. REV. 1, 3 (2004)).
46. Crowdfunding 101, supra note 1.
47. Bradford, supra note 8, at 9.
48. Id. at 14-15.
50. Bradford, supra note 8, at 105.
51. Id.
liquid because there is no public market that allows an investor to resell or exchange their investments in a start-up or small business. Moreover, start-ups and small businesses are inherently risky because they are developing unproven products or services that have no guarantee of success. Consequently, start-ups and small companies fail much more frequently than established public companies. “Approximately 80 of new businesses ‘either fail or no longer exist within five to seven years of formation.’” This risk cannot be alleviated by any measures because it is the nature of small businesses and start-ups.

Start-up and small business investments also expose investors to a greater likelihood of fraud and provide entrepreneurs with self-dealing opportunities. The Internet makes it difficult for investors to determine the legitimacy of a business because real-life encounters are replaced with virtual meetings. This information asymmetry, an imbalance of access to information between issuers and investors, can be used to take advantage of investors. The “pump and dump” abuses in the 1990s are an example of the Internet perpetuating fraud. In 1992, the SEC rescinded the general solicitation ban. This, combined with increasing Internet use, led to “pump and dump” abuses. In a “pump and dump” scheme, brokers invested in penny stocks (stocks that sold for less than a $1 per share) and artificially inflated share prices through phone and Internet marketing campaigns. Once share prices were inflated, brokers sold shares to other investors. Afterwards, brokers dumped their own shares, causing share prices to drop and leaving investors with devalued shares. Information asymmetry also provides an entrepreneur with self-dealing opportunities because investors do not know information and therefore cannot regulate the entrepreneur, giving the entrepreneur the advantage. As a result, entrepreneurs can self-

52. Bradford, supra note 8, at 105.
53. Id. at 108.
54. Sigar, supra note 32, at 481–82.
55. Bradford, supra note 8, at 105.
57. Id. at 105.
58. Id. at 481.
59. Id. at 491.
60. Id. at 487.
61. Id. at 488.
62. Id.
63. Id.
64. Id.
deal, excessively compensate themselves, misuse corporate opportunities, and dilute investors' interests.66

The statutory framework of the crowdfunding exemption protects investors against fraud and self-dealing. First, the crowdfunding exemption sets low limits on the offering size and the amount an investor may invest in a given year.67 For a crowdfunding offering to receive an exemption, the total amount raised for a crowdfunding offering cannot exceed $1 million and the aggregate amount an individual investor may invest in crowdfunding securities during a given year cannot exceed the statutory cap, based on the investor's annual income or net worth.68 An investor's net worth calculation does not include his or her primary residence as an asset, thus limiting the people who can invest in crowdfunding securities and excluding the people with more to lose.69 The low limit on the aggregate amount an individual can invest in crowdfunding securities during a given year reduces the potential harm to investors because losing a small investment would not greatly impact an investor's finances.70 For example, losing a $1,000 investment would not financially ruin an investor.71 Second, even though crowdfunding securities are exempt from registration, they must still abide by the fraud provisions in the Securities Act and the Exchange Act.72 Thus, the SEC and a buyer or seller that suffers from fraud can bring an action against a fraudulent actor, deterring fraud and promoting public confidence in the market.73 States can also enforce against fraud because the JOBS Act does not preempt state enforcement authority.74

The nature of crowdfunding and the Internet can also protect against fraud and self-dealing by reducing the information asymmetry. Crowdsourcing, a collection of "contributions from many individuals to achieve a goal," is the precursor to crowdfunding.75 One of the best examples of crowdsourcing is Wikipedia.76 Commentators, such as Steven Bradford, have noted that

67. Sigar, supra note 32, at 494.
68. Id.
69. Id. at 495.
70. Id.
71. Id.
72. Id. at 496.
73. Id.
74. Id.
76. Id.
“crowdfunding could benefit from ‘the wisdom of crowds,’ [which is] the notion that ‘even if most of the people within a group are not especially well informed or rational, the group can still reach a collectively wise decision.’ Crowdsourceing teaches us that a diverse, nonexpert group can often make better decisions compared to individual experts. Furthermore, the Internet has reduced the knowledge gap that once separated professionals from laypersons by making information more readily accessible. Increased Internet use has also led to increased information sharing. Through the Internet, people reduce information asymmetry when investing by communicating with one another and verifying facts.

Though the crowdfunding exemption benefits start-ups and small businesses in many ways, the exemption does contain one disadvantage: the reporting requirement. Under the crowdfunding exemption, issuers with a total target offering of $500,000 or more during the last twelve months must provide audited financial statements. Audited financial statements can range from $7,000 to $50,000 in costs, costs that may be prohibitive for many small businesses and may prevent them from utilizing the crowdfunding exemption. However, many start-ups and small businesses can avoid the statutory limits on crowdfunding offerings that require audited financial statements by capping their target offerings at $500,000 for a given year. They would only exceed $500,000 for a given year when absolutely necessary and when they have the money to pay for audited financial statements.

By helping fund small businesses, crowdfunding helps the economy through innovation and creation of jobs. Small businesses benefit society and entrepreneurs. Between 1993 and 2009, sixty percent to seventy percent of new jobs created came from small businesses. Furthermore, consumers benefit from small businesses by receiving more products and services. Crowd funding can help

78. Id.
79. Id.
80. Sigar, supra note 32, at 490.
81. Id. at 491.
84. Sigar, supra note 32, at 481.
85. Id.
86. Id.
fund promising projects, creating many more jobs and spurring innovation in the United States.87

III. BROKER-DEALERS

After evaluating equity crowdfunding, this article will provide a discussion of the implications of crowdfunding platform registration and why crowdfunding platforms will choose to register as broker-dealers. This section provides a brief summary of broker-dealer registration and requirements.

A broker is "any person engaged in the business of effecting transactions in securities for the account of others."88 The term is very broad, but the SEC gives some examples of entities or persons that may be considered brokers. For example, brokers can be entities or persons that find or refer investors or customers to investment companies or other securities intermediaries.89 Also, brokers can be entities or people who operate or control electronic platforms for security trading.90 The term broker will easily apply to equity crowdfunding platforms because such sites are now electronic platforms that will trade crowdfunding securities under the JOBS Act. However, as discussed earlier, crowdfunding sites may not be required to register as brokers for providing this type of service, if they choose to register as funding portals.91

Crowdfunding platforms are not considered dealers. 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."92 This term does not apply to crowdfunding platforms because they do not purchase securities for their own purposes. Rather, crowdfunding platforms simply match crowdfunding opportunities with investors.93 Nonetheless, this article will refer to brokers as “broker-dealers.”

A broker-dealer cannot effectuate any security transaction unless he or she is registered with the SEC.94 Furthermore, a broker-dealer must join an SRO, such as FINRA.95 “Every registered broker-dealer must be a member of the Securities Investor Protection Corporation, or SIPC, . . . [which] insures that its members’ customers receive back

87. See Bradford, supra note 8, at 100.
90. Id.
91. See SHEARMAN, supra note 16.
their cash and securities in the event of a member’s liquidation.”

Moreover, states have their own requirements for broker-dealers, and thus every broker-dealer must abide by state requirements to participate in securities transactions. Lastly, there is the issue of the “associated person.” An “associated person” of a broker-dealer is “any partner, officer, director, branch manager, or employee of the broker-dealer.” Associated persons also includes “any person performing similar functions [as the broker-dealer], or any person controlling, controlled by, or under common control with the broker-dealer.” A broker-dealer must file a form for every associated person who will effect security transactions with the SRO of which the broker-dealer is a member. An associated person must pass the Series 7 exam and meet other qualification requirements, if such person is going to be involved in completing security transactions.

Broker-dealer antifraud provisions “prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices.” Broker-dealers have a duty of fair dealing, which has been interpreted by the SEC through enforcement actions and case law. Also, broker-dealers must recommend only suitable investments or investment strategies to their customers. The duty of best execution requires a broker-dealer to get the “most favorable terms available under the circumstances for its customer orders.” Broker-dealers are not allowed to participate in insider trading. All of these measures serve as investor protection safeguards.

Broker-dealer registration and compliance standards are time-consuming and costly. Broker-dealer registration takes a fair amount of time. FINRA can take up to 180 days to process a membership application. In addition to federal registration, broker-dealers might also have to register with different state entities. After

97. Id.
98. Id.
99. Id.
100. Id.
101. Id.
102. Id.
103. Id.
104. Id.
105. Id.
106. See id.
registration, broker-dealers must also constantly monitor its compliance with SEC broker-dealer standards.

IV. FUNDING PORTALS

Following the above discussion, one can see that the complex broker-dealer registration and compliance standards justify Congress’s creation of the funding portal exemption for crowdfunding. Most crowdfunding platforms do not have enough revenue to justify the expenses for broker-dealer registration and compliance. For example, Kickstarter, a prominent crowdfunding startup, earned just two million dollars of revenue in two years. The funding portal registration exemption will allow crowdfunding sites to register with the SEC as funding portals rather than broker-dealers, thus removing any obstacles that broker-dealer registration might create in the equity crowdfunding industry. This section discusses funding portals, their statutory requirements, and their anticipated SEC regulations.

A funding portal is “any person acting as intermediary in a transaction involving the offer or sale of securities for the account of others” pursuant to the crowdfunding exemption of the JOBS Act. Funding portals cannot provide investment advice or recommendations. Funding portals cannot “solicit purchases, sales, or offers to buy the securities” available on their portal. While there has been no firm definition of solicitation in this context, it is generally believed that funding portals will not be allowed to use blast emails, faxes, mass mailed tout sheets, and other communications that promote a specific investment. Funding portals must compete on the quality of their services and promote their crowdfunding investment services to investors and potential crowdfunding issuers without emphasizing any particular investment opportunity. Funding portals can provide the public with unrestricted access to their online crowdfunding securities platform. However, many believe that the SEC will restrict offering information specific to any particular investment and specify the permissible content of public

110. Id.
111. Id.
112. Zuppone, supra note 33, at 2.
113. Id.
114. Id.
notices. Moreover, funding portals cannot compensate anyone for soliciting or selling securities available on their portal.116

Currently, there are no regulations that have been promulgated for funding portals, though FINRA is accepting comments on proposed requirements for funding portal registration.117 One suggestion is that broker-dealers should automatically qualify to sell crowdfunding securities because they are under more scrutiny than funding portals.118 Another suggestion is that principals and managers of funding portals be subjected to qualification and examination.119 Anyone that has passed the Series 7 would meet the proposed qualification and examination requirements for funding portal principal and managers.120 In lieu of the Series 7, other examination requirements that are more limited should also be considered for funding portal principal and managers.121

V. BROKER-DEALERS VS. FUNDING PORTALS

The above discussion of broker-dealer registration and funding portal registration begs the question why crowdfunding platforms would ever choose to register as broker-dealers, especially, when funding portal registration and compliance would likely be less complicated than broker-dealer registration and compliance.122 It was thought that funding portal registration would be a key feature to the crowdfunding exemption of the JOBS Act.123 However, as this section discusses, crowdfunding platforms prefer broker-dealer registration because broker-dealer registration delivers profitable revenue options, flexibility, clearly defined regulations, stronger investor protection, enhanced client service, and attractiveness to issuers.

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120. Landers & Marlett, supra note 119, at 3.
121. See id.
122. Carleton, supra note 15.
123. Id.
A. TIMING

The crowdfunding exemption under the JOBS Act will not take effect until the SEC issues its regulations. The SEC's deadline to issue regulations for the crowdfunding exemption under the JOBS Act was January 2013. However, the deadline has passed without the SEC issuing any crowdfunding regulations and some fear that the SEC will not do so until the first quarter of 2014. Crowdfunding platforms can take proactive steps during this waiting period. They can submit applications for broker-dealer registration with the SEC and FINRA. FINRA membership applications can take up to 180 days to process. Once crowdfunding platforms attain broker-dealer status, they can participate in securities activities other than crowdfunding, such as trading stock, to sustain their business. When the SEC finally issues crowdfunding regulations, the crowdfunding platforms that have already registered as broker-dealers can immediately participate in equity crowdfunding.

However, crowdfunding platforms that choose to register as funding portals will be at a disadvantage because they will not be able to immediately participate in equity crowdfunding once the SEC issues regulations. Crowdfunding platforms must wait until the SEC regulations are available before they can even begin to register as funding portals, and registration takes time. Consequently, crowdfunding platforms that choose to register as funding portals will lose money because, while crowdfunding portals that registered as broker-dealers can participate in equity crowdfunding on the day the SEC regulations come out, funding portal crowdfunding platforms will not be able to operate until their registrations go through. Therefore, crowdfunding platforms that want to register as funding portals will lag behind crowdfunding platforms that register as broker-dealers in obtaining revenue while waiting for the SEC to issue crowdfunding regulations and setting up operations to participate equity crowdfunding.

B. TRANSACTION-BASED COMPENSATION

Title II of the JOBS Act allows general solicitation to accredited investors under the private placement exemption from securities registration, but the person that generally solicits cannot receive

126. FINRA, supra note 107.
compensation from the purchase or sale of that security unless they are a broker-dealer.\textsuperscript{127} Such compensation is referred to as transaction-based compensation. Thus, the JOBS Act creates another revenue stream for crowdfunding platforms that register as broker-dealers. If crowdfunding platforms register as broker-dealers, then they can generally solicit accredited investors and earn transaction-based compensation for doing so. Transaction-based compensation can be very enticing to crowdfunding platforms. Crowdfunding platforms may have equity crowdfunding opportunities with huge profit potential. These crowdfunding platforms may want to advertise their promising opportunities to their wealthy investors to help the opportunities succeed, which could potentially benefit both investors and the crowdfunding issuers. While performing the service of making two parties successful, the crowdfunding platforms can earn some revenue if they are registered as broker-dealers. However, funding portals are prohibited from earning transaction-based compensation because they are not broker-dealers.

An example will reemphasize this point. Assume the next big idea goes to a crowdfunding platform to raise capital. A crowdfunding platform may choose to offer the opportunity as a private security offering and solicit its wealthy investors about the opportunity because doing so will increase the probability that the opportunity will get the proper capital to succeed. Now, assume the next big idea does become successful. The creators of the opportunity are satisfied because they received the necessary capital that allowed their idea to succeed. The investors are happy because earn a large return on their investment. It is not unreasonable to assume that the crowdfunding platform should receive compensation for providing such a service. However, if the crowdfunding platform is a funding portal, then it cannot receive any compensation in connection with the purchase of those securities and will only collect the fees it charges to the creators of the opportunity.

The SEC disfavors transaction-based compensation because it creates a financial stake in a proposed transaction and thus incentivizes one to engage in sales efforts.\textsuperscript{128} Specifically, the SEC is concerned that transaction-based compensation in securities lead to relentless sales tactics and other investor protection problems related to unregulated and unsupervised brokerage activities.\textsuperscript{129}

\textsuperscript{128} Bradford, \textit{supra} note 8, at 57.
\textsuperscript{129} Cable, \textit{supra} note 36, at 138 (quoting Persons Deemed Not to be Brokers, Exchange Act Release No. 20943, 30 SEC Docket 618, 622 (May 9, 1984)).
Funding portals cannot use current non-equity revenue models because they would be considered transaction-based compensation and will have to instead charge a flat fee. Current non-equity based crowdfunding sites charge fees dependent on successful financing.\textsuperscript{130} For example, Kickstarter, a prominent crowdfunding site, charges five percent of the funds raised, but no fees are charged if fundraising is unsuccessful.\textsuperscript{131} IndieGoGo, another prominent crowdfunding site, charges four or nine percent of raised funds, based on the entrepreneur meeting his or her funding goal.\textsuperscript{132} The fee structure used by current non-equity crowdfunding platforms is considered transaction-based compensation because the crowdfunding platforms' compensation depends on the successful closing a round of funding just as a broker-dealer may receive compensation based on the successful purchase or sale of a security. Consequently, funding portals cannot use the same fee approach. Rather, funding portals will charge a flat fee that is independent of the successful closing of a round of financing or the purchase or sell of a crowdfunding security to avoid violating the restriction of transaction-based compensation for funding portals. Charging a flat fee is not ideal for a crowdfunding platform because it will receive the same amount of revenue regardless of how many crowdfunding trades are done on its site or how successful a round of funding is for a crowdfunding opportunity.

On the other hand, crowdfunding platforms that register as broker-dealers can increase their revenue by participating in transaction-based compensation and avoiding flat fees. Broker-dealer crowdfunding platforms participating in transaction-based compensation can receive more revenue than funding portals that charge a flat fee because the broker-dealer crowdfunding platforms' revenue will be based on the crowdfunding trades done on their platform or the successful completion of a round of funding. For example, assume there is a crowdfunding opportunity trying to raise $100,000. A funding portal charges a flat fee of $500 to display the opportunity. Regardless of what happens, the funding portal will only receive $500. Now, assume a broker-dealer crowdfunding platform charges five percent of the funds raised. If crowdfunding opportunity is successful, the broker-dealer crowdfunding platform will make $5,000. In fact, even if the opportunity only raises $10,000, the broker-dealer crowdfunding platform will still receive $500, which is just as much as the funding portal will receive. A broker-dealer

\textsuperscript{130} Bradford, supra note 8, at 57.
\textsuperscript{131} Id.
\textsuperscript{132} Id.
crowdfunding platform can also charge a flat fee just to display an opportunity to avoid receiving no revenue if the opportunity does not raise any money.

C. INVESTMENT ADVICE

Investment advice can be another source of revenue for crowdfunding platforms. For example, a crowdfunding platform may provide an “Ask an Expert” option on its website for investors. Once the option is selected, an investor will provide information about himself or herself (such as annual income, net worth, size of investment portfolio, etc.). Afterward providing such information, the investor receives the crowdfunding platform’s recommendations on its equity crowdfunding offerings, and the investor will be charged a flat fee for this service. Or, the crowdfunding platform may provide an investor with a financial adviser who will either charge an hourly fee or percentage of the portfolio the adviser manages. However, because funding portals cannot “offer investment advice or recommendations,” these options are only available if the crowdfunding platform registers as a broker-dealer.

Investment advice can assist in investor protection. As discussed earlier, investor protection is one of the goals of the crowdfunding exemption under the JOBS Act. Providing advice does not guarantee that an investor will be protected from fraud and losing his or her investment. However, investment advice can greatly assist the novice or unsophisticated investor because an expert can recommend offerings that have a higher potential of success and lesser likelihood of fraud while steering investors away from offerings that have a lower potential of success and more likelihood of fraud. Moreover, the crowdfunding exemption in the JOBS Act was aimed protecting everyday investors. More than likely these investors are going to be novices or unsophisticated, and, therefore, they will need greater protection. Through registering as a broker-dealer, crowdfunding platforms can provide investment advice that will provide that protection, whereas funding portals cannot offer advice and the added protection.

Broker-dealers can effectively discharge their obligations to crowdfunding investors in the context of investment advice. Under the JOBS Act, intermediaries in crowdfunding have certain obligations to their investors. They must guarantee investors review

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134. Crowdfunding 101, supra note 1.
investor-education information.\textsuperscript{135} Also, intermediaries must ensure investors understand they can lose their entire investment and they will have to bear any such losses.\textsuperscript{136} By obtaining such assurances while simultaneously providing investment advice, broker-dealers can have meaningful conversations with crowdfunding investors to ensure that such investors are aware of the risks of crowdfunding securities and ensure the investors have reviewed the education material. Furthermore, investors will more likely heed such warnings and advice when an investment professional is providing such information because investors are paying for that professional's time and that professional will hold investors accountable. Compare that to investors investing through funding portals, who may not even read such warnings that are listed on a website. Many individuals do not read the terms and conditions when purchasing a service or product online. It is likely that investors using funding portals will falsely affirm that they have read the investor education material and acknowledge the risk by clicking on an "accept" button. Thus, broker-dealer registration is an advantage, as it will allow crowdfunding platforms to successfully discharge their obligations to investors.

Furthermore, the regulation preventing funding portals from giving investment advice is unclear. For example, does a funding portal's decision to work with a particular issuer instead of another constitute investment advice?\textsuperscript{137} Will features that organize how deals are presented on portals constitute investment advice?\textsuperscript{138} Uncertainty about what constitutes investment advice will make it difficult for crowdfunding platforms to comply with funding portal regulations, and thus will drive these platforms to register as broker-dealers.

The prohibition of investment advice from funding portals is not in investors' best interest. If an investor cannot receive investment advice from funding portals, then the investor may not have adequate knowledge about his or her investment, rendering the investment highly speculative. With the risks involved, these investments would be more like donations than investments with the promise of a return.\textsuperscript{139} Consequently, investors will prefer crowdfunding platforms

\textsuperscript{136} Id.
\textsuperscript{138} See Carleton, supra note 15.
that can offer investment advice to minimize the speculation and increase the probability of financial returns. Those crowdfunding platforms will need to register as broker-dealers to provide advice.

However, crowdfunding sites may not want to provide investment advice and thus choose not to register as broker-dealers because of the suitability requirements for broker-dealers. Broker-dealers are required to make recommendations on securities transactions or investment strategies suited to their clients based on knowledge of each client’s investment profile (the “suitability requirement”). A client’s investment profile includes, but is not limited to, age, other investments, financial situation and needs, tax status, investment objectives, investment experience, and risk tolerance. Crowdfunding platforms may not want to provide investment advice because they will have to spend the time and money to ascertain knowledge about their clients’ investment profiles. Furthermore, crowdfunding platforms will have to match transactions and investment strategies to their clients’ profiles. Thus, the suitability requirement can be too burdensome for crowdfunding platforms to satisfy because they may not have the manpower or the money to do so. Crowdfunding platforms may also be hesitant to spend time with each client to understand his or her investment profile because they want to serve as many clients as possible and providing individualized time with each client will prevent them from doing so. Consequently, crowdfunding platforms may not benefit from providing investment advice and will not chose to register as broker-dealers.

While suitability requirements may deter one from broker-dealer registration, they may not affect broker-dealer crowdfunding platforms. The suitability requirements seem to protect investors that are in a broker-dealer relationship with no monetary limit, whereas the crowdfunding exemption under the JOBS Acts limits the money each investor can invest in crowdfunding securities. As a result, broker-dealer crowdfunding platforms may not have to strictly adhere to the suitability requirement because their clients are not in danger of losing significant sums of money or their entire savings.

Crowdfunding platforms may also not want to provide investment advice because of increased chance of litigation. As mentioned above, “80% of new businesses either fail or no longer exist within five to seven years of formation.”

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141. FIN. INDUS. REGULATORY AUTH. R. 2111, supra note 140.
143. Bradford, supra note 8, at 108 (quoting U.S. GOV’T. ACCOUNTABILITY OFFICE,
securities will be investments in small businesses and startups that are extremely volatile and not likely succeed. Crowdfunding platforms that provide investment advice will advise their clients to invest in crowdfunding securities. If investors lose their money in these risky endeavors, they may pursue lawsuits against the crowdfunding platforms that advised them to do so. The investors may assert claims such as breach of the suitability requirement or negligence on part of the crowdfunding platform. Most crowdfunding platforms may not have the capital to defend themselves in such suits. Therefore, crowdfunding platforms may not want to provide investment advice because it will increase the potential for litigation and may not choose to register as broker-dealers.

Crowdfunding investment is capped for individual investors, making litigation less likely. Crowdfunding investors are at risk of losing no more than $5,000 within a given year if their annual income is $100,000 or less. Consequently, crowdfunding investors in this category will most likely not sue because the lost investment is relatively small compared to the cost of litigation. Also, there is no guarantee that investors will be successful in their lawsuits. Crowdfunding investors that have annual incomes of $100,000 or more can lose ten percent of their income or net worth up to a maximum of $100,000 within a given year. These higher-end crowdfunding investors have an incentive to sue because a $100,000 lost investment is a significant sum for most people and the cost of litigation might be minor in comparison. Nonetheless, these investors may not pursue litigation because they most likely will not put such a significant amount into anyone one type of investment vehicle. Rather, they will diversify their investments. Thus, these investors will probably make less significant investments in crowdfunding opportunities that would make the promise of litigation for any violations less appealing.

D. SOLICITING PURCHASES

Funding portals cannot “solicit purchases, sales, or offers to buy securities” available on their portal. As discussed above, funding portals can provide the public with unrestricted access to their online crowdfunding securities platform, but they cannot emphasize any specific investment opportunities or communicate specific

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145. Id.
146. See id. § 78c(a)(80) (2012).
investments to investors.\textsuperscript{147} Such a restriction will make it difficult for funding portals to get investors to purchase the portals’ offerings. This restriction makes funding portals rely on proactive investors that are searching for equity crowdfunding opportunities and, more specifically, the opportunities available on a particular funding portal. Furthermore, this restriction defeats the goal of the crowdfunding exemption of the JOBS Act because funding portals may not be able to get investors to invest in equity crowdfunding if the funding portals cannot advertise to investors.

However, this restriction on soliciting purchasers does not apply to crowdfunding platforms that register as broker-dealers. Therefore, broker-dealer crowdfunding platforms can actively pursue investors through the use of blast emails, faxes, mass mailed tout sheets, and similar communications promoting offerings. Through solicitations, broker-dealer crowdfunding platforms will most likely get more companies funded, and therefore more companies will offer their opportunities to these platforms.

E. COMPENSATING EMPLOYEES

Funding portals cannot compensate anyone for soliciting or selling securities available on their portal.\textsuperscript{148} This is another restriction that can cripple funding portals. If employees are not compensated for effectuating or soliciting purchases, then there is no real incentive for employees to do so. Therefore, funding portals may not get companies effectively funded because the funding portals’ employees are not motivated to do so. Also, employees that are adept at effectuating purchases or solicitation may choose not to go to funding portals because they may not be properly compensated for their efforts. Such employees may choose to go to broker-dealer crowdfunding platforms because such platforms can properly compensate their employees for their efforts. Consequently, broker-dealer crowdfunding platforms will be more effective at funding new companies by attracting more skilled employees, enticing such companies to offer their ideas to broker-dealer crowdfunding platforms.

\textsuperscript{147} Zuppone, supra note 33, at 2.
F. Ancillary Issues with Proposed Regulations for Funding Portals

Commentators have proposed requirements for funding portal registration to FINRA, but those requirements make broker-dealer registration more appealing. The proposal of automatically qualifying broker-dealers to sell crowdfunding securities\textsuperscript{149} gives broker-dealers the flexibility to sell traditional securities or participate in crowdfunding, whereas funding portals will only be allowed to sell securities under the crowdfunding exemption of the JOBS Act. There are proposed requirements that principals and managers of funding portals pass examinations that are more limited than the Series 7.\textsuperscript{150} Also, it is proposed that passage of the Series 7 will satisfy the examination requirements,\textsuperscript{151} which benefits broker-dealers. In order to sell securities, broker-dealers are required to pass the Series 7.\textsuperscript{152} By passing the Series 7, broker-dealers can sell every type of security in the market.\textsuperscript{153} However, under proposed funding portal registration, funding portals may only be required to pass more limited tests such as the Series 22.\textsuperscript{154} The Series 22 only allows one to sell securities in limited partnerships, limited liability companies, etc.\textsuperscript{155}

Other proposed requirements for funding portal registration made to FINRA by commentators are similar to the current requirements for broker-dealer registration, indicating that funding portal registration may be as burdensome as broker-dealer registration. Proposed requirements for funding portal registration focus on investor protection.\textsuperscript{156} Broker-dealers are subject to anti-fraud provisions that are designed to protect investors.\textsuperscript{157} Ultimately, broker-dealer registration is more versatile than funding portal registration, and many of the recommended requirements for funding portal registration already exist for broker-dealers, signifying that

\textsuperscript{149} Fichera Letter, supra note 118.
\textsuperscript{150} See Landers & Marlett, supra note 119.
\textsuperscript{151} See id.
\textsuperscript{153} Id.
\textsuperscript{154} See Landers & Marlett, supra note 119; see also Prive, supra note 20.
\textsuperscript{155} Responsibilities, supra note 152.
\textsuperscript{157} SEC Guide, supra note 31.
funding portal compliance will not be easier than broker-dealer compliance.

G. CURRENT TREND

Participants in the crowdfunding industry are realizing that funding portal registration will not satisfy their goals, thus they are planning to register as broker-dealers. The following crowdfunding platforms have decided to become broker-dealers: Microventures, Fundable, SeedInvest, and Wefunder. It is predicted that this trend will continue.

V. CONCLUSION

The JOBS Act has altered small business investing. Traditionally, equity investment in companies in the form of securities required SEC registration. There was a private placement exemption that allowed accredited investors to invest in start-ups. Many of these accredited investors were wealthy individuals or institutional investors such as venture capital funds or angels. However, the private placement exemption was underserving the small business and start-up market as accredited investors and institutional investors comprise only 1 percent of the U.S. population. Moreover, 98 percent of business plans from small businesses and start-ups are rejected, even when these companies get the opportunity to present to venture capitalists or angel investors. The crowdfunding exemption under the JOBS Act allows companies to raise money from everyday investors with certain income and investment limitations. Investment through the crowdfunding exemption must be raised through intermediaries, creating a new market for crowdfunding platforms. Such platforms can either register as broker-dealers or funding portals.

While crowdfunding platforms have the choice between broker-dealer and funding portal registration, they will opt to register as broker-dealers. First, broker-dealer registration provides more revenue opportunities for crowdfunding platforms. Second, broker-dealer registration has better defined regulations. Third, broker-

158. Carleton, supra note 15.
160. Id.
161. Prive, supra note 20.
162. See id.
dealer registration provides greater investor protection and better serves clients, thus more clients will be drawn to broker-dealer crowdfunding platforms. Fourth, broker-dealer registration provides an effective vehicle for crowdfunding platforms to discharge their duties as intermediaries in equity crowdfunding. By compensating employees and soliciting purchases, crowdfunding platforms that register as broker-dealers can obtain capital funding for companies more efficiently than funding portals. Thus, more companies will be attracted to broker-dealer crowdfunding platforms when seeking such funding. Crowdfunding platforms will also have more flexibility if they register as broker-dealers because they can sell traditional securities and crowdfunding offerings. In terms of timing, crowdfunding platforms can register as broker-dealers immediately and start crowdfunding operations as soon as the SEC issues regulations for the crowdfunding exemption, whereas funding portals will have to first register once SEC issues those regulations, costing funding portals valuable time and revenue while waiting to register. Funding portal registration may be as difficult as broker-dealer registration. Lastly, broker-dealer registration for crowdfunding platforms should be encouraged and funding portal registration for crowdfunding platforms should be discouraged because broker-dealers provide more investor protection and have more regulatory oversight, thus lending credibility to the new industry of equity crowdfunding. Consequently, the near future will see the rise of crowdfunding platforms registered as broker-dealers.