

**COMPLIANCE WITH THE SECURITIES LAWS IN CROWDFUNDED  
SECURITIES OFFERINGS:  
STARTUPS IT'S YOUR RESPONSIBILITY!**

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***Introduction***

Even before the Jumpstart Our Business Startups Act (the “*JOBS Act*”)<sup>1</sup> was signed into law, online platforms were proliferating with companies soliciting the sale of their securities online. Transactions for the offer and sale of securities were being conducted using the internet in a fashion that could not be contemplated by the

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<sup>1</sup> Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C. (2012)).

Securities Act of 1933, as amended, (the “*Securities Act*”) which you may gather was enacted in 1933 long before the advent of the internet.<sup>2</sup>

Many claimed that the JOBS Act made legal practices that were already in effect by, among other things, lifting the ban on general solicitation and general advertising which made crowdfunding of by accredited investors permissible. Accredited investors include, among others, individual investors with a minimum net worth of \$1 million (excluding the positive value of the primary residence), held individually or together with a spouse, or an investor who has individual income in excess of \$200,000 per year, or joint income together with such person’s spouse, in excess of \$300,000 per year, and certain institutions with assets in excess of \$5,000,000.<sup>3</sup> In addition to accredited investor crowdfunding, the JOBS Act called for crowdfunding of the crowd, meaning that companies could sell their securities using general solicitation or general advertising to unaccredited investors.<sup>4</sup> Despite the congressional mandate that the Securities and Exchange Commission (“SEC”) adopt rules within 270 days of the JOBS Act being signed into law,<sup>5</sup> as of the publishing of this article, the SEC has only produced proposed rules which are not addressed in this article.<sup>6</sup>

After the passage of the JOBS Act a cottage industry of do-it-yourself securities platforms blossomed, allowing entrepreneurs access to capital which had previously been only available to entrepreneurs with wealthy friends and families or those with ideas enticing to venture capitalists. These platforms offer a one-stop-shop for capital raising with the ease and feel of using eBay, but the entrepreneurs are

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<sup>2</sup> See Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended in scattered sections of 15 U.S.C. (2012)).

<sup>3</sup> 17 C.F.R. § 230.501(a) (2014). Dodd Frank mandated that the Securities and Exchange Commission (“SEC”) revisit the definition of “accredited investor”, which has been in effect since 1982. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 413, 124 Stat. 1376 (2010) (codified as amended at 15. U.S.C. § 77b (2012)). The Commission has made several proposals to change the definition. See, e.g., *Recommendation of the Investor Advisory Committee: Accredited Investor Definition*, SEC, 1 (Oct. 9, 2014), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf>, archived at <https://perma.cc/XBY3-438B>.

<sup>4</sup> JOBS Act § 302(a) (codified as amended at 15 U.S.C. § 77d (2012)).

<sup>5</sup> JOBS Act § 302(c).

<sup>6</sup> See Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66428, 66515 & n.878 (proposed Nov. 5, 2013).

not selling toasters they are selling securities and both federal and state securities laws apply.

In the United States, companies can only sell securities if the securities are either registered with the SEC or eligible for an exemption from registration.<sup>7</sup> For most startups a registered offering followed by on-going SEC reporting requirements is not a viable option.<sup>8</sup> What the JOBS Act provides for, among other things, are exemptions from the registration requirements of the Securities Act provided that certain conditions are met.<sup>9</sup>

In addition, the federal and state securities laws regulate who can sell securities. Issuers of securities and their officers and employees may sell securities, but there are restrictions on the compensation to be paid to those who are not registered to sell securities. While failure to register as a broker has consequences for the unregistered broker, engaging an unregistered broker has consequences for the issuer of the securities as well.

Online platforms allow issuers to sell their securities to the crowd, but nowhere in the JOBS Act does it shift the burden of complying with the registration requirements of the Securities Act from the issuer to the platform. Much of the literature and commentary on crowdfunding centers around investor protection.<sup>10</sup> This article argues that when startups use online platforms to sell their securities,

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<sup>7</sup> 15 USC § 77e (2012).

<sup>8</sup> PRICEWATERHOUSECOOPERS LLP, CONSIDERING AN IPO? THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU 12-19 (2012) (summarizing the costs associated with going public), available at [http://www.pwc.com/en\\_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf](http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf). IPO On-ramp?, archived at <http://perma.cc/TV3K-EPRW>.

<sup>9</sup> See 15 U.S.C. § 77d (2012).

<sup>10</sup> See, e.g., Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and The Securities Act of 1933*, 78 TENN. L. REV. 879, 961 (2011) (“Investor protection and the perception of fair and honest investment markets—key policies underlying the Securities Act—are sources of concern as the crowdfunding market rapidly develops in the absence of a clear regulatory framework or response.”); Sherief Morsy, Note, *The JOBS Act and Crowdfunding*, 79 BROOK. L. REV. 1373, 1374 (2014) (“[W]hile the JOBS Act creates new investment opportunities, it also creates the potential for investment for fraud . . .”). Bradford acknowledges that more fraud will occur, but argues “[t]he real question is whether the benefits of a crowdfunding exemption outweigh the[] costs [of investor losses].” C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 116 (2012).

complying with the securities laws remains the obligation of the startup and failing to do so may have significant consequences to the startup.

This article addresses the federal securities laws, but while not addressed, the securities laws of the fifty states have implications with respect to issues raised herein. Many states have enacted intrastate crowdfunding legislation.<sup>11</sup>

## ***I. General Solicitation***

### **A. Rule 506 of Regulation D**

When entrepreneurs sell securities in their startups, they historically did so using Rule 506 of Regulation D,<sup>12</sup> now referred to as Rule 506(b), which allows for raising an unlimited amount of money from an unlimited number of accredited investors<sup>13</sup> and up to thirty-five

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<sup>11</sup> *E.g.*, 950 Mass. Code Regs, 14.402(B)(13)(o) (2015) (Massachusetts); OR. ADMIN. R. 441-035-0070 to -0230 (2014) (Oregon); 7 TEX. ADMIN. CODE §139.25 (2014) (Texas). In April of last year, the SEC put out guidance suggesting that the use of an online portal would not in and of itself prohibit the reliance on a Rule 147 exemption from the registration requirements of the Securities Act. *Securities Act Rules, Questions and Answers of General Applicability*, SEC. & EXCH. COMM'N (Jan. 23, 2015), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>, *archived at*, <http://perma.cc/5WGM-MJ6W> (Questions 141.04, and as to the issuer's website Question 141.05).

<sup>12</sup> 17 C.F.R. § 230.506 (2014).

<sup>13</sup> While Rule 506 does not limit the number of investors in a given offering, other rules may act to restrict the number of investors a startup allows to become shareholders or members of the company, e.g. Section 12(g)(1)(A) of the Exchange Act provides that “within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by either—(i) 2,000 persons, or (ii) 500 persons who are not accredited investors,” the Company must register as a reporting company with the SEC. 15 U.S.C. § 781(g)(1)(A) (2012). For issuers that are either partnerships or limited liability companies, the publicly traded partnership rules may apply, which may limit the number of partners or members to 100. *See* DAVID H. KAPLAN, SULLIVAN & WORCESTER LLP, TAX IMPLICATIONS OF CROWDFUNDED EQUITY, *available at* <http://www.sandw.com/assets/htmldocuments/CLIENT%20ADV.%20-%20Tax%20Implications%20of%20Crowdfunded%20Equity%20B1830775.PDF>, *archived at* <http://perma.cc/3H98-XPRA>. The Investment Company Act of 1940, as amended, exempts certain issuers of securities from the definition of “Investment Company”, so long as among

unaccredited investors provided that, among other things, the issuer did not generally solicit or generally advertise for the sale of their securities. This exemption has arguably been the most widely used exemption,<sup>14</sup> and even after the passage of the JOBS Act continues to remain the most popular exemption.<sup>15</sup> Many platforms operating today continue to rely on this exemption, some questionably.

With the passage of the JOBS Act and the promulgation of the mandated rules, the SEC lifted the ban on general solicitation and general advertising in connection with Rule 506 private placement, but all investors must be accredited investors, the issuer must take reasonable steps to verify that the investors are in fact accredited,<sup>16</sup> and

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other things they have less than 100 beneficial owners. 15 U.S.C. § 80a-3(c)(1) (2012).

<sup>14</sup> VLADIMIR IVANOV & SCOTT BAUGUESS, DIV. OF ECON. & RISK ANALYSIS (DERA), U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, at 7 (2013) (“Rule 506 offerings account for more than 99% of the reported capital raised through Regulation D offerings since 2009.”), available at <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf>, archived at <http://perma.cc/H4JU-2VZP>.

<sup>15</sup> OFFERBOARD, EQUITY CROWDFUNDING UNDER TITLE II OF THE JOBS ACT: THE FIRST YEAR 1-15 (2014).

<sup>16</sup> In its initial proposing release, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9354, 77 Fed. Reg. 54,464 (proposed Sept. 5, 2015), the SEC proposed a principles based approach to what constitutes reasonable steps to verify that accredited investors are in fact accredited. Largely in response to comments, in its adopting release, the SEC adopted rules that provided for both the principles based approach as well as a safe harbor, which is discussed in this article. *Eliminating the Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44771 (July 24, 2013) (codified at 17 C.F.R. pts. 230, 239, 242). Some practitioners, including this author, questioned whether issuers would rely on the principles based approach or should rely on the principles based approach when conducting a general solicitation, given the consequences of failing to satisfy the condition. However, in the Keynote Address at the 2014 Angel Capital Association Summit, Keith F. Higgins, Director, Division of Corporation Finance, addressed the naysayers, “some believe that the reluctance of issuers to use the new Rule 506(c) exemption is because the rule requires that the issuer take ‘reasonable steps to verify’ the accredited investor status of a purchaser. The legislative history of the JOBS Act made it clear that self-certification—without something more—was not enough if the ban was to be

the issuer must otherwise comply with Rule 506.<sup>17</sup> This new Rule 506(c) is what essentially permits crowdfunding of accredited investors.<sup>18</sup> Rule 506(c) is essentially just like Rule 506(b) except that only accredited investors are permitted to participate in the offering and issuers of securities need to take reasonable steps to verify that the investors are in fact accredited investors.<sup>19</sup> The SEC adopted two paths for determining whether or not an investor is an accredited investor: the principles based approach and a safe harbor.<sup>20</sup>

Whether steps to verify accredited investor status are “reasonable” will be a determination by the company in the context of the facts and circumstances of a transaction.<sup>21</sup> Among the factors to be considered are: (i) the nature of the purchaser and the type of accredited investor that the purchaser claims to be (e.g. some purchasers may be accredited investors based on their status alone, such as brokers, dealers, or investment companies registered under the federal securities laws), (ii) the amount and type of information that the company has about the purchaser, and (iii) the nature of the offering, such as the

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lifted.” Keith F. Higgins, Dir., Div. of Corp. Fin., Keynote Address at the 2014 Angel Capital Association Summit (Mar. 28, 2014), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370541320533#.VR2EXeHVqvx>, *archived at* <http://perma.cc/G5YT-2LQG>. Higgins goes on to say, “Although the verification method must be objectively reasonable, the principles-based method is intended to provide issuers with significant flexibility in deciding the steps needed to verify a person’s accredited investor status and to avoid a ‘one size fits all’ approach.” *Id.* Higgins speaks directly to those that are hesitant to use the approach:

These are all part of a deliberate effort by the Commission to provide issuers with an alternative to the clear but highly prescriptive list of verification methods included in the rule. In fact, it is ironic that this list of verification methods is being viewed by some as the primary way to verify a purchaser’s accredited investor status when, in fact, the Commission originally proposed the principles-based approach as the way issuers would comply with the rule’s verification requirement and added the list of specific verification methods only in response to address the concerns of commenters who wanted more certainty.

*Id.*

<sup>17</sup> 17 C.F.R. § 230.506(b) (2014).

<sup>18</sup> *See* 17 C.F.R. § 230.506(c) (2014).

<sup>19</sup> *Id.*

<sup>20</sup> 17 C.F.R. § 230.506(c)(2)(ii).

<sup>21</sup> 17 C.F.R. § 230.506(c)(2)(ii)(d).

manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.<sup>22</sup>

In its adopting release, the SEC states that it does not believe that a check-the-box questionnaire, absent other information, will be sufficient to demonstrate that the issuer of the securities has taken reasonable steps to verify the accredited investor status of the investor.<sup>23</sup>

In addition to the principles-based approach described above, the SEC also provided four specific non-exclusive methods of verifying accredited investor status for natural persons: (i) on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year; (ii) using net worth, reviewing one or more of the following documents dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: (a) for assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and (b) for liabilities: a consumer report from at least one of the nationwide consumer reporting agencies; (iii) obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor: (a) a registered broker-dealer; (b) an investment adviser registered with the SEC; (c) a licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or (d) a certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office; or

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<sup>22</sup> 17 C.F.R. § 230.506(c)(2)(ii).

<sup>23</sup> Eliminating the Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44771, 44780 (July 24, 2013) (“We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.”)

(iv) with respect to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to the effectiveness of the rules and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.<sup>24</sup>

In practice, anecdotal evidence, suggests that method (iii) above is among the more commonly used methods of verifying that an investor is accredited.

Online platforms allow issuers to sell their securities to crowd, but nowhere in the JOBS Act does it shift the burden of complying with the registration requirements of the Securities Act from the issuer to the platform. The issuer still either has to register its securities for sale or find an exemption from registration. Using a platform, which permits general solicitation does not relieve the issuer of its obligation to take reasonable steps to verify that its investors are accredited investors. The obligation of the issuer of the securities to take reasonable steps to verify the accredited investor status of the investor is further discussed in Part IV, and sales to unaccredited investors, below.

### **B. General Solicitation<sup>25</sup>**

The SEC has not defined general solicitation, but instead in Rule 502(c) gives examples of what constitutes general solicitation, including (i) “[a]ny advertisement, article, notice or other communication published in any newspapers, magazine, or similar media or broadcast over television or radio; and (ii) [a]ny seminar or meeting [where] attendees have been invited by any general solicitation or general advertising.”<sup>26</sup>

Without careful attention to compliance with the securities laws, online solicitations for the offer and sale of securities may be deemed a general solicitation.

Private offerings have been conducted online for several decades now, and in certain circumstances the SEC has blessed the

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<sup>24</sup> 17 C.F.R. § 230.506(c)(2)(ii).

<sup>25</sup> For ease of reference, in this article, I refer to “general solicitation and general advertising” as general solicitation.

<sup>26</sup> 17 C.F.R. § 230.502(c) (2014). Demo days and pitch events, long operating somewhat with a blind eye to the potential for general solicitation have been receiving new scrutiny from practitioners and commentators in the wake of the passage of the JOBS Act. *See, e.g.,* Jacquelyn Lumb, *SEC Hosts forum on Small Business Capital Formation*, SEC FILINGS INSIGHT, Dec. 12, 2013, at 1.



arrangement.<sup>27</sup> The Divisions of Corporation Finance and Market Regulation gave no action relief to a registered broker-dealer and its affiliate, IPONET, that had planned to invite previously unknown prospective investors to complete a questionnaire posted on IPONET's web site "as a means of building a customer base and data base of accredited and sophisticated investors"<sup>28</sup> for the broker-dealer. After the affiliated broker-dealer determined that a prospective investor was "accredited" or "sophisticated" within the meaning of Regulation D, then a password-restricted web page permitting access to private offerings would become available to the investor.<sup>29</sup> Further, the prospective investor could only purchase securities in offerings that were posted on the restricted website after the investor had been qualified by the broker-dealer as an accredited or sophisticated investor and had opened an account with the broker-dealer.<sup>30</sup> When discussing the IPONET No-Action Letter, the SEC indicated that the no-action relief was "based on an important and well-known principal . . . : a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the offerees."<sup>31</sup>

After IPONET, the SEC issued a series of No-Action letters, where it found that private offerings under then Rule 506 and now Rule 506(b) could be conducted using the internet provided that among other criteria: (i) website access was restricted to accredited investors only,<sup>32</sup> and (ii) the website registered as a broker or was affiliated with a broker<sup>33</sup> or the website was managed by nonprofits and/or educational institutions.<sup>34</sup> However, in certain circumstances the SEC was unwilling to grant relief. For example, where the pool of potential

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<sup>27</sup> See, e.g., IPONET, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996).

<sup>28</sup> *Id.* at 2.

<sup>29</sup> *Id.* at 2-3.

<sup>30</sup> *Id.* at 3.

<sup>31</sup> Use of Electronic Media, Exchange Act Release No. 42,728, Securities Act Release No. 7856, 65 Fed. Reg. 25,843 (Apr. 28, 2000).

<sup>32</sup> See, e.g., Lamp Technologies, Inc., SEC No-Action Letter, 1998 WL 278984 (May 29, 1998); Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL 282988 (May 29, 1997).

<sup>33</sup> See, e.g., Oil-n-Gas, Inc., SEC No-Action Letter, 2000 WL 1119244 (June 8, 2000) (relief not granted where Oil-n-Gas was not registered as a broker); IPONET, *supra* note 27 (registered broker supervised IPONET's activities).

<sup>34</sup> See, e.g., Angel Capital Elec. Network, SEC No-Action Letter, 1966 WL 636094 (Oct. 25, 1996).

investors to be solicited was to be pulled from a database, there was “an extremely high degree of confidence as to the financial and business sophistication and investment suitability” of the potential investors, and there was no cooling off period between verifying accredited investor status and offering securities, the SEC was unable to grant no action relief and provide the requested interpretive relief that there was not a general solicitation.<sup>35</sup>

In its 2000 guidance, SEC Interpretation: Use of Electronic Media,<sup>36</sup> the SEC addressed practices of portals directly. The SEC raised concerns about both the sites as being operated by non-broker-dealers and that the sites may be conducting general solicitations.<sup>37</sup> The SEC recognized that some portals are neither registered as a broker-dealer or affiliated with a broker-dealer and have “established web sites *that generally invite* prospective investors to qualify as accredited or sophisticated in order to participate in private offerings” on those web sites, on an access-restricted basis.<sup>38</sup> Moreover, some non-broker-dealer web sites permit prospective investors to self-certify themselves as “accredited or sophisticated merely by checking a box.”<sup>39</sup> These investors are not even required to complete questionnaires providing information necessary to form a reasonable belief regarding their accreditation or sophistication.<sup>40</sup>

In its guidance, the SEC indicated “[t]hese web sites, particularly those allowing for self-accreditation, raise significant concerns as to whether the offerings that they facilitate involve general solicitations.”<sup>41</sup> One method of making sure to not conduct a general solicitation is to establish the existence of a “pre-existing, substantive relationship.”<sup>42</sup> SEC staff interpretations of whether a “pre-existing, substantive relationship” exists have often been limited to procedures established by broker-dealers in connection with their customers.<sup>43</sup> The SEC reasons that this is because the traditional broker-dealer relation-

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<sup>35</sup> Agristar Global Networks, Ltd., SEC No-Action Letter, 2004 WL 299067 (Feb. 9, 2004).

<sup>36</sup> Use of Electronic Media, 65 Fed. Reg. at 25,843.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 25,852.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *See id.*

<sup>43</sup> For a well-developed discussion of the criteria for a “pre-existing substantive relationship” in this context, see Seth Chertok, *A Theoretical Assessment of Private Placements Under Rule 506*, 8 N.Y.U. J.L. & Bus. 77, 93-107 (2011).

ship requires “that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers.”<sup>44</sup> However, “the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case.”<sup>45</sup> The SEC acknowledges in its guidance that, “there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a ‘pre-existing, substantive relationship’ sufficient to avoid a ‘general solicitation.’”<sup>46</sup> The SEC does not elaborate on what the facts and circumstances might be where an online platform might not need to be registered as a broker-dealer.

Many platforms continue today to allow for or exclusively permit Rule 506(b) offerings to be conducted on their website. Given that many of these sites do not follow the IPONET line of No-Action Letters and rather operate by giving investors access to the website after they merely check a box indicating that they are accredited, with no cooling off period beyond the time it takes to get the access code from an email account, and do not register as brokers, it is likely that many of the offerings conducted on these sites would in fact be deemed to be general solicitations and thus not eligible for exemption from registration under Rule 506(b).

Furthermore, to the extent that the offering would be deemed to have been a general solicitation, the startup has the obligation of complying with the requirements of Rule 506(c), including taking the reasonable steps to verify that all of its purchasers are in fact accredited investors. If the startup has not taken such steps, it may have conducted an unregistered public offering of its securities.

If a startup sells its securities in an unregistered public offering without an exemption from registration, then the participants in the offering have the right to put the securities purchased back to the issuer of the securities.<sup>47</sup> The participants in the offering may recover the

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<sup>44</sup> Use of Electronic Media, 65 Fed. Reg. at 25,852

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Section 12(a)(1) of the Securities Act provides that any person who “offers or sells a security in violation of [S]ection 5” of the Securities Act is liable to the purchaser of the securities for “the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.” Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(1) (2012)

purchase price for the securities, plus interest, if the action is brought within one year in most cases.<sup>48</sup>

## ***II. Use of an Unregistered Finder or Broker***

Under Section 15 of the Securities Exchange Act of 1934, as amended, (the “Exchange Act”) most “brokers” must register with the SEC and join a “self-regulatory organization,” or SRO.<sup>49</sup> Section 3(4) of the Exchange Act defines “broker” broadly as: “any person engaged in the business of effecting transactions in securities for the account of others.”<sup>50</sup> Platforms that host offerings of startup securities may be acting as brokers.<sup>51</sup>

Who needs to register as a broker is a bit of a gray question with a facts and circumstances test, which is largely elaborated on in no-action letters.

According to the SEC, the following actions, among others, indicate need of the actor to register as a broker:

- Finding investors or customers for, making referrals to, or splitting commissions with registered broker-dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries; . . .
- *Finding investors for “issuers” (entities issuing securities), even in a “consultant” capacity;*
- *Engaging in, or finding investors for, venture capital or “angel” financings, including private placements; . . .*
- investment advisers and financial consultants; . . .
- *persons that operate or control electronic or other platforms to trade securities;*
- persons that market real-estate investment interests, such as tenancy-in-common interests, that are securities; . . .
- persons that act as “placement agents” for private placements of securities;

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<sup>48</sup> *Id.*; see also Securities Act of 1933 § 13, 15 U.S.C. § 77m (2012) (limiting the time to bring the action to one year).

<sup>49</sup> 15 U.S.C. § 78c (2012).

<sup>50</sup> *Id.*

<sup>51</sup> Bradford, *supra* note 6, at 52; see also, e.g., Progressive Technology Inc., SEC No-Action Letter, 2000 WL 1508655 (Oct. 11, 2000).

- persons that effect securities transactions for the account of others for a fee, even when those other people are friends or family members;
- persons that provide support services to registered broker-dealers; and
- persons that act as “independent contractors,” but are not “associated persons” of a broker-dealer (for information on “associated persons”).<sup>52</sup>

Many crowdfunding portals have the hallmarks of acting as a broker, in that they solicit or find investors for issuers, often for a fee, provide certain ancillary services, and may permit the offering and sale of securities on the portal’s website. Prior to the passage of the JOBS Act, the SEC gave limited relief to online platforms which permitted securities to be offered on a website, when the platform itself did not register as a broker.<sup>53</sup>

#### **A. Are Online Securities Offering Platforms Brokers?<sup>54</sup>**

A facts and circumstances determination, in all likelihood, creates a need for many online platforms to register as a broker.<sup>55</sup>

The JOBS Act provides limited relief from the requirement to register as a broker under the federal securities laws, but does not address the state securities laws.<sup>56</sup>

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<sup>52</sup> *Guide to Broker-Dealer Registration, Division of Trading and Markets, SEC. & EXCH. COMM’N* (Apr. 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm>, archived at <http://perma.cc/ZM2M-E7TQ> (emphasis added).

<sup>53</sup> See, e.g., IPONET, *supra* note 27 (relief granted when affiliated with a broker); Angel Capital Elec. Network, *supra* note 34 (granting relief where the website was to be operated by non-profits and universities). *But see* Progressive Technology Inc., *supra* note 51 (SEC refused to grant relief when the portal was neither a broker nor affiliated with a broker).

<sup>54</sup> An additional question not addressed in this article is whether online securities offering platforms need to register as investment advisers under the Investment Advisers Act or applicable state laws. Bradford considers this and determines, “[c]rowdfunding sites might also be investment advisers within the meaning of the Investment Advisers Act of 1940.” Bradford, *supra* note 10, at 67.

<sup>55</sup> *Id.* at 60 (“[C]rowdfunding sites typically do more than just bring entrepreneurs together with potential investors. They solicit investors and are actively involved in the resulting transactions. This, coupled with transaction-based compensation, puts them at serious risk of being treated as brokers.”).

Title II of the JOBS Act provides an exemption from the requirements to register as a broker under the federal securities laws for offerings conducted in accordance with Rule 506 of Regulation D if “(A) that person maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means; (B) that person or any person associated with that person co-invests in such securities; or (C) that person or any person associated with that person provides ancillary services with respect to such securities.”<sup>57</sup>

Provided however, such exemption only applies if: “(A) such person and each person associated with that person *receives no compensation in connection with the purchase or sale of such security*; (B) such person and each person associated with that person does not have possession of customer funds or securities in connection with the purchase or sale of such security; and (C) such person is not subject to a statutory disqualification... and does not have any person associated with that person subject to such a statutory disqualification.”<sup>58</sup>

After the passage of the JOBS Act, some thought that the restriction on compensation “*no compensation in connection with the purchase or sale of such security*” was intended to address transaction based compensation, but the SEC clarified its position in that “[t]he staff interprets the term ‘compensation’ broadly, to include any direct or indirect economic benefit to the person or any of its associated persons. At the same time, we recognize that Congress expressly permitted co-investment in the securities offered on the platform or mechanism. We do not believe that profits associated with these investments would be impermissible compensation for purposes of Securities Act Section 4(b).”<sup>59</sup> Further, the SEC stated, “[a]s a practical matter, we believe that the prohibition on compensation makes it

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<sup>56</sup> Some areas of securities regulation, however, have been explicitly preempted by federal law. See 15 U.S.C. § 77r (2012).

<sup>57</sup> 15 U.S.C. § 77d(b)(1) (2012).

<sup>58</sup> 15 U.S.C. § 77d(b)(2) (2012) (emphasis added).

<sup>59</sup> *Frequently Asked Questions about the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, SEC. & EXCH. COMM’N (Feb. 5, 2013), <https://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm>, archived at <https://perma.cc/H4W2-P9GY>.

unlikely that a person outside the venture capital area would be able to rely on the exemption from broker-dealer registration.”<sup>60</sup>

After the passage of the JOBS Act, the SEC issued two no-action letters addressing whether certain platforms needed to register as brokers. Interestingly, these platforms were conducting rule 506(b) offering on their platform, but the SEC did not address whether it would consider such offerings to be general solicitations.

### **B. FundersClub Inc. and FundersClub Management LLC No-Action Letter<sup>61</sup>**

In a no-action letter from March 26, 2013, the SEC granted no-action relief to FundersClub Inc. (“*FC Inc.*”) and FundersClub Management (“*FC Management*”), allowing the companies to act as online platforms while allowing potential investors to indirectly invest in startup companies without having to register as broker-dealers.<sup>62</sup> The decision was based, in large part, on the structure of FC Inc. and its subsidiaries and the roles that each entity did and did not play in the transaction.<sup>63</sup>

FC Management is a wholly owned subsidiary of FC Inc. FC Management, in turn, has a number of wholly owned subsidiaries which are investment funds (“*Funds*”).<sup>64</sup> Each of these Funds holds shares of one or more startup companies. The investment process goes as follows: FC Inc. will enter into a non-binding agreement with a startup company, setting a “target amount of capital which FC Management will invest.”<sup>65</sup> The startup will provide FC Inc. with certain information

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<sup>60</sup> *Id.*

<sup>61</sup> FundersClub Inc. & FundersClub Mgmt. LLC, SEC No-Action Letter, 2013 WL 1229456 (Mar. 26, 2013).

<sup>62</sup> *Id.*

<sup>63</sup> *See id.* at \*10 (“FC Inc. and FC Management at no time possess investor funds or securities; the assets of the investment funds are held in custody accounts subject to Investment Advisers Act Rule 206(4)-2. Further, FC Inc. and FC Management do not hold themselves out as brokers. We believe that under the various factors set forth by the SEC Staff, FC Inc. and FC Management do not meet the tests of being (i) ‘engaged in the business’ of (ii) ‘effecting transactions’ in securities so as to require broker-dealer registration. Rather, FC Inc. and FC Management are venture capital fund advisers, and that regulatory scheme is how Congress and the SEC intended that they be regulated.”) (citations omitted).

<sup>64</sup> *Id.* at \*4-6.

<sup>65</sup> *Id.* at \*1.

about the company that FC Inc. will then make available online.<sup>66</sup> FundersClub members, all of whom must be accredited investors, can view this information online and, if they decide they want to invest in the startup, may submit non-binding indications of interest.<sup>67</sup> When a Fund reaches a certain level of interest, FC Inc. then “negotiates the final terms of the [investment] with the start-up company.”<sup>68</sup> Up until the investment fund closes, investors “can withdraw their indications of interest without penalty at any time.”<sup>69</sup> When an agreement is reached, “investors provide funds” into the investment fund, and the investment fund, in turn, purchases shares from the startup.<sup>70</sup>

In reaching its conclusion of no-action, the SEC focuses on a few key points that weigh in the favor of determining that FC Inc. need not register as a broker-dealer. First, all investors are accredited investors. Second, FC Inc. and FC Management are advisers to the Funds, which are venture capital funds under SEC rules.<sup>71</sup> Third, FC Inc. and FC Management do not receive any transaction-based compensation, rather, the compensation is a carried interest and consistent with traditional advisory and consulting compensation.<sup>72</sup> While there is a set amount of “administrative cost” that comes from the funds, this portion of investor contribution is used strictly to cover administrative costs, and any remainder is returned to investors.<sup>73</sup> FC Inc.’s main compensation comes in the form of “carried interest,” which means that after liquidation of the firm, funds are distributed (1) to cover remaining administrative expenses, (2) to repay investors’ capital contributions, and finally (3) to compensate FC Inc. with a set percentage of the profit (usually about twenty percent); the remainder of the profit is split pro rata among investors.<sup>74</sup> These factors heavily influenced the SEC decision in this no-action Letter.

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<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at \*2.

<sup>71</sup> *Id.* at \*10.

<sup>72</sup> *Id.* at \*9.

<sup>73</sup> *Id.* at \*5 n.5.

<sup>74</sup> *Id.* at \*7.



**C. AngelList LLC and AngelList Advisors LLC No-Action Letter<sup>75</sup>**

The AngelList No-Action Letter is substantially similar to the FundersClub No-Action Letter. Like FC Management, AngelList Advisors (“*AL Advisors*”) is a wholly owned subsidiary of AngelList LLC (“*AL LLC*”) and, in turn, creates wholly owned subsidiaries which invest in startup companies.<sup>76</sup> Angel investors invest in these subsidiaries. In this letter, AL Advisors proposed a plan in which it would create two different types of funds.<sup>77</sup> The first would be set up like the funds of FundersClub. In the second, a “Lead Angel” would take an active role in the startup companies, offering managerial or financial guidance and often working in tandem with the AL Advisors who, like FC Management, provide investment advice and administrative services to the companies. Based on the similar reasoning as in the FundersClub No-Action Letter, the SEC granted no-action relief to AngelList as a non-registered broker.<sup>78</sup> In addition, the SEC notes that AL Advisors will be a registered investment advisor, AL Advisors will disclose potential conflicts of interest that arise between AL Advisors and any lead angel in an angel advised deal, and neither AL Advisors nor any lead angel will handle any customer funds or securities.<sup>79</sup>

It is worth noting that in the case of each of the Funders Club and AngelList No-Action Letters, it is the online platform or a related entity that invests in the startup and the “crowd” invests in an entity formed for the purpose of investing in startups and managed by the platform or its affiliate. The relief that is granted in these two no-action Letters is very specific and does not apply to all online platforms.

**D. Issuer’s Exemption**

Some platforms posit that they are relying on the so-called issuer’s exemption. The issuer’s exemption relies on Rule 3a4-1 under the Exchange Act, which provides that an associated person of an issuer (such as officers, employees and directors of the issuer<sup>80</sup>) will not need to register as a broker, provided that, among other things, the

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<sup>75</sup> AngelList LLC, SEC No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013).

<sup>76</sup> *Id.* at \*1.

<sup>77</sup> *Id.* at \*2.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at \*3.

<sup>80</sup> 17 C.F.R. § 240.3a4-1(c)(1) (2014).

associated person “[i]s not compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities” and in many cases that “[t]he associated person does not participate in selling an offering of securities for any issuer more than once every 12 months.”<sup>81</sup>

Given that the portals are in the business of hosting issuers to sell the issuer’s securities on the platform and the compensation may be commission based, portals and those associated with them likely cannot rely on that exemption.

### **E. Finder’s Exemption**

Folklore suggests that there is a “finder’s” exemption, i.e., someone brings potential investors to an issuer and collects a fee, but is not involved in the securities transaction itself, then the finder is exempt from registration. This myth stems from the Paul Anka SEC No-Action Letter, where Paul Anka entered into an agreement with The Ottawa Senators Hockey Club Limited Partnership and Terrace Investments Limited, where Mr. Anka agreed to provide the Senators with the names of potential purchasers of units to be issued by the Senators and in exchange receive a finder’s fee of ten percent of the sales price of the units sold.<sup>82</sup> The SEC granted no-action relief, and noted that Mr. Anka had “a bona-fide, pre-existing business or personal relationship” with the potential investors, whom he believed to be accredited investors.<sup>83</sup> Further, Mr. Anka would not participate in a general solicitation related to the units, provide any advice relating to the financial advisability of the investment or handle the funds or securities.<sup>84</sup> Mr. Anka had not acted as a broker or finder in the past and had no intention to do so again in the future.<sup>85</sup> Despite what was a limited grant of no action relief, the SEC subsequently pulled back on the relief that it granted under the Paul Anka No-Action Letter.<sup>86</sup>

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<sup>81</sup> 17 C.F.R. § 240.3a4-1(a)(4)(ii)(C) (2014).

<sup>82</sup> Paul Anka, SEC No-Action Letter, 1991 WL 176891 (July 24, 1991).

<sup>83</sup> *Id.* at \*3.

<sup>84</sup> *Id.* at \*2.

<sup>85</sup> *Id.*

<sup>86</sup> See Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010); Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291 (June 4, 2002).

This very limited exemption led some to believe that those that receive commissions for introducing potential investors to issuers for a fee do not need to register as brokers.<sup>87</sup>

More recently in its denial of no-action relief, the SEC stated, “A person’s receipt of transaction-based compensation in connection with these activities is a hallmark of broker-dealer activity.”<sup>88</sup> According to the incoming letter, Electronic Magnetic Power Solutions, Inc. (“EMPS”) was to engage the law firm of Bromberg, Mackey & Wall, P.L.C. (“BMW”) to assist them in the acquisition of funding for financing to fund the EMPS operations and development.<sup>89</sup> A Referral Fee Agreement between BMW and EMPS was to reflect that BMW would be compensated upon the closing of the financing based upon a percentage of the amounts raised.<sup>90</sup>

In its denial of no-action relief, the Division of Markets and Trading of the SEC stated that it believed (i) that the “introduction to EMPS of only persons with a potential interest in investing in EMPS’s securities impl[ie]d that BMW anticipat[ed] both ‘pre-screening’ potential investors to determine their eligibility to purchase the securities, and ‘pre-selling’ EMPS’ s securities to gauge investors’ interest” and (ii) that, “the receipt of compensation directly tied to successful investments in EMPS’s securities by investors introduced to EMPS by BMW . . . would give BMW a ‘salesman’s stake’ in the proposed transactions and would create heightened incentive for BMW to engage in sales efforts.”<sup>91</sup> The staff of the Division of Markets and Trading determined that BMW’s “activities would require broker-dealer registration.”<sup>92</sup>

While there are consequences for failing to register and a broker when acting as such,<sup>93</sup> there are also consequences to engaging a broker who had failed to register as a broker.<sup>94</sup>

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<sup>87</sup> See, e.g., Brumberg, Mackey & Wall, P.L.C., 2010 WL 1976174 (seeking no action relief for being paid transaction-based compensation for making introductions to potential investors.).

<sup>88</sup> *Id.* at \*1.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at \*4-5

<sup>91</sup> *Id.* at \*2.

<sup>92</sup> *Id.*

<sup>93</sup> Failure to register as a broker-dealer can result in injunctive action, fines, and even criminal prosecution in the case of willful violation of the Securities Act. Securities Act of 1933 § 24, 15 U.S.C. § 77x (2012). An unregistered broker-dealer may also face penalties under state securities laws. See Willie R. Barnes, *Enforcement of State Securities Laws*, SJ062 ALI-ABA 289 (2004).

Under Section 29(b) of the Exchange Act, failure to comply with the Exchange Act by an issuer, gives its investors a “put” right, since it provides that contracts made in violation of the Exchange Act shall be void in respect of the “rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.”<sup>95</sup> In addition, many state securities laws, commonly referred to as “blue sky” laws, also provide a right of rescission to the buyer of securities sold by a finder that is not licensed under that state’s securities laws.<sup>96</sup>

Engaging a platform to essentially act as a broker that is not registered may mean that all of the investors who participated in the offering have a right to put the securities back to the company, which can have grave consequences to the issuer.

#### **F. In re Ranieri Partners LLC and Donald W Phillips<sup>97</sup>**

The Ranieri case demonstrates how a company can be held responsible for the actions of an unregistered broker when that company knows that the individual is not a registered broker and encourages or fails to prevent him or her from soliciting investors on behalf of the company. In Ranieri, the SEC charged William M. Stephens with “operating as an unregistered broker” on behalf of Ranieri Partners LLC “in violation of Section 15(a) of the Exchange Act.”<sup>98</sup> The SEC found that Stephens had violated the Act by personally contacting and meeting with potential investors, providing investors with confidential information, trying to convince at least one investor to invest with Ranieri Partners, and receiving compensation in the form of one

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Furthermore, even if a platform qualifies for the new SEC proposed Crowdfunding rules, it will be required to disclose its compensation arrangement. *See* Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,480 (proposed Nov. 5, 2013).

<sup>94</sup> *See In re Ranieri Partners LLC et al.*, Exchange Act Release No. 69091, 2013 WL 873219 (Mar. 8, 2013); Neogenix Oncology, Inc., Annual Report (Form 10-K) (July 12, 2012).

<sup>95</sup> 15 U.S.C. § 78cc(b) (2012).

<sup>96</sup> *See Hess v. I.R.E. Real Estate Income Fund, Ltd.*, 629 N.E.2d 520, 529-30 (Ill. App. Ct. 1993).

<sup>97</sup> *In re Ranieri Partners LLC et al.*, Exchange Act Release No. 69091, 2013 WL 873219 (Mar. 8, 2013).

<sup>98</sup> *Id.* at \*1.

percent of all capital commitments made by investors introduced by Stephens.<sup>99</sup>

Stephens was not the only one charged by the SEC, however. Ranieri Partners and Donald W. Phillips, a former Senior Managing Partner of Ranieri Partners, were charged with violations of Section 15(a) for knowing that Stephens was not a registered broker, and encouraging or failing to prevent him from improperly soliciting investors.<sup>100</sup> The SEC argued that the company was liable for failing “to adequately oversee Stephens’ activities,” as well as failing “to limit Stephens’ access to key documents.”<sup>101</sup> Not only was Ranieri Partners ordered to cease and desist these practices, but it was also assessed a penalty of \$375,000.<sup>102</sup> Phillips was ordered to pay a \$75,000 fine and was barred from acting in a supervisory capacity in the securities industry for nine months.<sup>103</sup>

### G. Neogenix Oncology Inc.

The story of Neogenix Oncology Inc. is a startup’s worst nightmare.<sup>104</sup> Neogenix was a development stage biotechnology company with a focus on developing and commercializing diagnostic and therapeutic products for the early detection and treatment of cancers, including pancreatic, colorectal, lung, cervical, ovarian, prostate.<sup>105</sup> The company was formed in December 2003,<sup>106</sup> and in order to fund itself,

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<sup>99</sup> *Id.* at \*2-5.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at \*5.

<sup>102</sup> *Id.* at \*6-7.

<sup>103</sup> *Id.* at \*7.

<sup>104</sup> While the story of Neogenix Oncology, Inc. is a cautionary tale for startups, Google Inc., found itself in a similar position during its initial public offering. Google Inc., Amendment No. 4 to Form S-1 Registration Statement (July 26, 2004) (“Shares issued and options granted under our stock plans exceeded limitations in federal and state securities laws, the result of which is that the holders of these shares and/or options have rescission rights that could require us to reacquire the shares and/or options for an aggregate repurchase price of up to \$25.9 million.”). Google offered to repurchase the shares and options subject to rescission rights, but none of the holders of such shares and options elected to have Google repurchase the shares or options. Google Inc., Annual Report Form 10-K (Mar. 30, 2015).

<sup>105</sup> Neogenix Oncology, Inc., General Form for Registration of Securities (Form 10) (April 30, 2010).

<sup>106</sup> *Id.*

Neogenix raised \$47.1 million through a series of private placements using unregistered brokers.<sup>107</sup> In 2006, Neogenix registered with the SEC disclosing the private placements and the use of unregistered finders in connection with such capital raising activities. In 2011, the SEC inquired into the activities.<sup>108</sup> The rescission rights of the investors became a problem for the accountants, who were unsure how to account for such a potential liability. The accountants and the SEC agreed on a method of addressing the potential liability in a footnote to the financial statements.

The company squarely addressed the concern in the risk factors included in its annual Report on Form 10-K for the fiscal year ended December 31, 2011:

*Certain shares of our common stock were sold through finders who were paid fees in spite of not being licensed as broker-dealers.*

The Company has concluded that finders' fees were paid to certain individuals who were not registered as broker-dealers or otherwise licensed under applicable state law. Accordingly, it is possible that at least some investors who purchased shares of common stock in transactions in which finders' fees were paid may have the right to rescind their purchases of shares, depending on applicable federal and state laws and subject to applicable defenses, if any. In addition, the Company may be subject to additional liability under state and/or federal laws in connection with the use of unlicensed broker-dealers. If the Company is forced to rescind a significant number of share purchases and/or pay substantial damages, it will impact the ability of the Company to continue operations; therefore management believes that there is substantial doubt about the Company's ability to continue as a going concern.<sup>109</sup>

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<sup>107</sup>Morris N. Simkin, Sandra Holtzman & David Schmidt, *A Tale of How Successfully Raising Capital Leads to Bankruptcy*, N.Y. L.J., Apr. 23, 2013, at 1.

<sup>108</sup>Letter from Philip M. Arlen, President & Chief Exec. Officer, Neogenix Oncology, Inc., to Neogenix Shareholders (Feb. 6, 2012).

<sup>109</sup>Neogenix Oncology, Inc., Annual Report (Form 10-K) 16 (July 12, 2012).

In the notes to the company's financial statements for the fiscal year ended 2011, the company's accountants EisnerAmper LLP, stated:

The Company has assessed the potential for rescission liability in accordance with the provisions of Accounting Standards Codification ("ASC") 450-20, Loss Contingencies. Under ASC 450-20, the Company is required to perform a probability assessment of the potential liability for rescission rights. Based on the information currently available to the Company, management has determined that it is reasonably possible that certain shareholders may have rescission rights related to common stock purchased for which finders' fees were paid. Management believes the range of potential liability for rescission by investors as of July 10, 2012 is approximately \$0 to \$31 million. As of July 10, 2012, the Company had received communications from shareholders making requests or claims for rescission of investments in the Company's common stock of approximately \$1.4 million. To the knowledge of the Company, no litigation against the Company has been initiated with respect to rescission of any shareholder's investment. Because the Company has not concluded that the liability for rescission is probable, no accrual has been made in the financial statements as of December 31, 2011. Management does not currently know when it will be able to reasonably determine the length of time investors who may have rescission rights will continue to have those rights.<sup>110</sup>

All this at exactly the same time as the company states,

*If we do not raise additional capital we will not be able to continue operations.*

To date, we have financed our operations principally through offerings of securities intended to be exempt from the registration requirements of the Securities Act. We do not have available cash or cash flow to

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<sup>110</sup> *Id.* at 23.

meet our anticipated working capital needs. We will require substantial additional funds in order to meet such needs, and we are investigating potential sources of funding. There can be no assurance that any such additional funding will be available to us. As a result, management believes that there is substantial doubt about the Company's ability to continue as a going concern. To date, we have been unable to identify potential investors or a source of potential equity investment. If additional funds are raised by issuing equity securities, such securities will likely be sold at a significantly reduced purchase price from the most recent offering, further dilution to existing stockholders may result, and future investors may be granted rights superior to those of existing stockholders. If adequate funds are not available, the Company will not be able to continue operations. We are currently evaluating potential strategic alternatives, including bankruptcy and a sale of assets.<sup>111</sup>

With this disclosure nestled in its risk factors and financial statements, Neogenix found itself unable to raise the capital it sought. Eventually, Neogenix was forced to file for bankruptcy under Chapter 11. Under the supervision of the United States Bankruptcy Court for the District of Maryland (Greenbelt Division), on September 24, 2012, the Neogenix completed the sale of substantially all of its assets to Precision Biologics.<sup>112</sup>

Under Section 29(b) of the Exchange Act, failure to comply with the Exchange Act by an issuer, gives its investors a “put” right, since it provides that contracts made in violation of the Exchange Act shall be void in respect of the “rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.”<sup>113</sup>

Startups need to carefully evaluate the structure of the online platform and any compensation paid to any online platform. The compensation may be a determining factor as to whether the SEC would determine that such platform would need to register as a broker.

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<sup>111</sup> *Id.* at 9.

<sup>112</sup> Neogenix Oncology, Inc., Current Report (Form 8-K) (Sept. 28, 2012).

<sup>113</sup> 15 U.S.C. § 78cc(b) (2012).



The consequences to the startup getting this wrong, as we have seen, could be catastrophic.

### **III. Sales to Unaccredited Investors**

Rule 506(b) allows for the sale of securities to up to 35 unaccredited investors<sup>114</sup> while Rule 506(c) does not permit any unaccredited investors to participate in such offering.<sup>115</sup> If an issuer of securities generally solicits to unaccredited investors without some other exemption from registration, since Rule 506(c) would be unavailable, the issuer would be deemed to have sold securities in violation of Section 5 of the Securities Act, pursuant to which it is unlawful to sell or offer to sell securities in intrastate commerce without an effective registration statement containing a prospectus that meets certain requirements under the securities laws.<sup>116</sup>

When selling securities online to unaccredited investors, startups need to first ensure that they are not conducting a general solicitation or general advertising. Once the startup is sure that the offering is safely within Rule 506(b) territory, if the securities will be offered and sold to unaccredited investors, then the startup must comply with the information delivery requirements applicable to Rule 506(b) offerings to unaccredited investors, which are somewhat akin to a registered offering.<sup>117</sup> Failure to comply with the information delivery requirements may lead to rescission rights under Section 12 of the Securities Act,<sup>118</sup> which as we have seen in the case of *Neogenix* may be catastrophic.<sup>119</sup>

This article does not address state crowdfunding statutes, Rule 147 promulgated under the Securities Act, or Regulation A+,<sup>120</sup> which under certain circumstances may permit crowdfunding of unaccredited investors.

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<sup>114</sup> 17 C.F.R. § 230.506(b)(2) (2014).

<sup>115</sup> 17 C.F.R. § 230.506(c) (2014).

<sup>116</sup> 15 U.S.C. § 77e (2012).

<sup>117</sup> 17 C.F.R. § 230.502(b) (2014).

<sup>118</sup> 15 U.S.C. 771 (2012).

<sup>119</sup> See *supra* notes 107-16 and accompanying text.

<sup>120</sup> Amendments for Small and Additional Issues Exemptions under the Securities Act, Securities Act Release No. 9741, Exchange Act Release No. 74578, 80 Fed. Reg. 21,806 (Apr. 20, 2015).

#### **IV. *Becoming a Bad Actor***

Not only can failing to comply with the securities laws mean cease and desist actions and penalties as in *Ranieri Partners* and rescission rights as depicted in *Neogenix Oncology*, but it may also mean becoming a “bad actor” under Rule 506(d) of Regulations D.<sup>121</sup>

If the issuer or any other person covered by Rule 506(d) (directors, executive officers, twenty percent beneficial owners) has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred on or after the effective date of the rule amendments, then the issuer may not rely on Rule 506 as an exemption from the registration requirements. In other words, as a result of failing to comply with the securities laws, the activity is such that it results in a disqualifying event under Rule 506(d), then, subject to the expiration of any applicable look-back period, the startup will no longer be able to raise capital via one of the most commonly used exemptions under the federal securities laws.

Among others, disqualifying events include, cease-and-desist orders within the past five years from violations and future violations of any scienter-based anti-fraud provision of the federal securities laws, including without limitation Section 5 of the Securities Act (Prohibitions Relating to Interstate Commerce and the Mails), Section 17(a)(1) of the Securities Act (Fraudulent Interstate Transactions), Section 10(b) of the Exchange Act and Rule 10b-5 (Regulation of the Use of Manipulative and Deceptive Devices), and Section 15(c)(1) of the Exchange Act (Registration and Regulation of Brokers and Dealers).<sup>122</sup>

Not complying with the securities laws intentionally, unintentionally, or with purposeful ignorance may have catastrophic effects on the ability of the startup to raise capital in the future whether because no one will invest in the company for fear of unknown liabilities or because the startup is actually precluded from relying on the one of the most common exemptions from registration.

#### **V. *Conclusion***

Failure to comply with the securities laws can have significant consequences to issuers of securities.

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<sup>121</sup> 17 C.F.R. § 230.506(d) (2014).

<sup>122</sup> *Id.*

Entrepreneurs need to understand that compliance with the securities laws in offerings of the startup company's securities is the responsibility of the startup. To the extent that a startup elects to use an offering platform that allows the startup to not comply with the securities laws, there may be significant consequences to the startup.

Startups should be cautious about the platforms that they engage to conduct their online offerings. They need to (i) be cognizant of whether the offering is being conducted under Rule 506(b), Rule 506(c), or another exemption, (ii) only sell to unaccredited investors if they understand which exemption they are relying on and otherwise satisfying the information delivery requirements, and (iii) make sure that to the extent that the platform is acting as a broker, then the platform is in fact registered as a broker.

The SEC may consider a notice filing for platforms, which would be publicly available requiring platforms to disclose, (i) what types of offerings are permitted on the platform, (ii) whether or not securities may be sold to unaccredited investors, (iii) method for verification of accredited investor status, (iv) whether or not they are registered as a broker, and (v) if not registered as a broker, identify which exemption from registration they are relying on. This information will help entrepreneurs do the due diligence that they need to do on crowdfunding portals before offering securities via the portal.

Crowdfunding offers startups access to capital, which previously was hard to imagine. Many of the concerns that have been raised by the SEC and elsewhere have been around investor protection. I would argue the companies need protection too, at least in the form of education and access to information, so as to make sure they don't inadvertently violate the securities laws and lose the access to capital that the JOBS Act was designed to offer.