CROWDFUNDING'S CULTURE OF NONCOMPLIANCE: AN EMPIRICAL ANALYSIS

by
Mercer Bullard[*]

The JOBS Act of 2012 launched a number of experiments in the regulation of securities offerings. The exemption it created that allows online equity crowdfunding offerings to retail investors garnered the most attention, in part due to widespread concerns regarding the potential for fraud and abuse. More than three years after the first crowdfunding offering, no empirical analysis of compliance has been conducted that would debunk or confirm critics' concerns. This Article plugs that gap by analyzing a sample of 362 crowdfunding offerings and evaluating compliance with some of crowdfunding regulation's simplest, most fundamental regulatory requirements. During the first 13 months of crowdfunding, almost half of issuers failed to file complete financial statements that met the applicable standard of review, barely one-quarter of issuers that were required to file two annual reports did so, less than 15% of issuers timely filed the final amount raised in their offering, and the only data point on Form C that was reviewed was, far more often than not, substantially inaccurate. Finally, the third-largest crowdfunding funding portal may be violating the prohibition against a funding portal's giving advice. In short, these findings reveal a deeply embedded culture of noncompliance. This Article is timely in light of the issuance of a concept release by the Securities and Exchange Commission that is intended to set the table for further liberalization of exempt offerings. Rather than supporting such changes, the findings set forth in this Article create doubt as to whether the crowdfunding experiment will even survive. This Article proposes a series of reforms that would address some of the above-mentioned noncompliance problems while both benefiting investors and reducing costs and burdens for issuers.

I. Introduction 900
II. Crowdfunding Regulation 903
  A. Financial Statements 904
  B. Progress Updates 906
  C. Annual Reports 906
  D. Advice and Recommendations by Intermediaries 908
III. Data and Data Set 910

[*] Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law. The author thanks commenters at the 2018 Consumer Financial Protection Workshop hosted by the Rutgers Law School Center for Corporate Law and Governance, and at a presentation to the faculty at Tulane Law School, including especially the insightful comments and suggestions provided by Ann Lipton, Michael M. Fleishman Associate Professor in Business Law and Entrepreneurship, Tulane Law School. The author also thanks Butler Snow for its generous financial support for faculty research.

- *A. Nonoperating Filers* ... 911
- *B. Successful and Unsuccessful Filers* ... 912
- *C. Types of Securities Offered* ... 914
  - *1. Contingent Interests* ... 915
  - *2. "D" is for Equity* ... 916
- IV. Reg CF Compliance ... 917
  - *A. Financial Statements* ... 917
    - *1. Availability of Rescission Right* ... 919
    - *2. Intermediary Oversight* ... 921
    - *3. Adjusted Requirements for Nonoperating Filers* ... 924
    - *4. Accounting Standards Based on Investor Commitments* ... 926
  - *B. Annual Reports* ... 930
    - *1. Annual Report Enforcement* ... 935
    - *2. Three Years of Annual Reports* ... 936
    - *3. Abridged Reporting* ... 937
    - *4. Termination Notice* ... 939
  - *C. Advice/Recommendation Prohibition* ... 939
    - *1. Revised Advice/Recommendation Standard* ... 944
    - *2. Universal Advice/Recommendation Prohibition* ... 944
    - *3. One Platform; One Voice* ... 944
  - *D. Progress Updates* ... 944
  - *E. Accuracy of Form C Financial Data* ... 946
- V. Conclusion ... 948

I. INTRODUCTION

When the JOBS Act of 2012 authorized unregistered online equity offerings to retail investors, known as "crowdfunding,"[1] many commentators predicted it would bring nothing but trouble. Some critics expected crowdfunding to be the "wild west" of capital formation where fraud would run rampant.[2] Others warned that crowdfunding would present "entrepreneurs with opportunities for self-dealing, excessive compensation, [and] misuse of corporate opportunities,"[3] or cautioned against "pump and dump" schemes and other abuses.[4] One skeptic contended that

---

[1] Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, §§ 301–05, 126 Stat. 306, 315–23 (2012) (codified as amended throughout 15 U.S.C. §§ 77–78 (2012)) (hereinafter JOBS Act). Crowdfunding was authorized in Title III of the JOBS Act, known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, or the CROWDFUND Act. *Id.* § 301, 126 Stat. at 315.

[2] *See* Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 521 (2014) ("[E]quity crowdfunding is effectively going to be a con game."); Zachary J. Griffin, Note, *Crowdfunding: Fleecing the American Masses*, 4 J.L. TECH. & INTERNET 375, 391 (2013); Jim Gallagher, *Crowdfunding to Bring 'Wild West' Investing*, ST. LOUIS POST-DISPATCH (Apr. 24, 2016), https://www.stltoday.com/business/local/crowdfunding-to-bring-wild-westinvesting/article_57c8cc00-cee5-5b65-9605-ffbb74b51be7.html.

[3] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 107 (2012).

[4] *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,474 (proposed Nov. 5, 2013) (to be codified throughout 17 C.F.R. pt. 200–49) ("we expect intermediaries to scrutinize any purchases by these

crowdfunding would fail no matter how well-behaved issuers were because most investors would lose their entire investment,[5] while others predicted that many investors would not benefit financially even if issuers were successful.[6] Some thought that issuers would find no one willing to distribute their securities because intermediaries would not be able to profit from distributing crowdfunded securities.[7] While there have been anecdotal hints of problems in crowdfunding,[8] no empirical research has been published that reveals whether and to what extent critics' fears have been realized.

This Article is the first to fill that gap. It analyzes a data set covering the first 13 months of crowdfunding offerings and measures issuers' compliance with crowdfunding rules. In short, crowdfunding appears to have become the regulatory mess than many predicted,[9] with issuers and intermediaries routinely failing to

---

individuals for 'red flags,' such as repeated investment commitments and cancellations, that would indicate that the purchase was designed to create an impression that the offering has reached, or will reach, its target amount."); Griffin, *supra* note 2, at 392–93 (discussing pump and dump scheme); Sherief Morsy, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, 79 BROOK. L. REV. 1373, 1382 (2014) (same); *see also* SlideBelts Inc., Offering Circular at 27 (Form 1-A) (Oct. 17, 2018) (under Regulation A offering, director disclosed purchase of $200,000 worth of SAFE notes in previous "Regulation Crowdfunding" offering), https://www.sec.gov/Archives/edgar/data/1700895/000114420418054259/tv504721_partiiandiii.htm.

5 *See* Dorff, *supra* note 2, at 496 (emphasis in original) ("The real problem with equity crowdfunding cannot be remedied by fine-tuning the disclosure obligations. The core issue has nothing to do with disclosure: it's that these investments are going to be *terrible*.").

6 Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe SAFE*, 102 VA. L. REV. ONLINE 168, 179–80 (2016); John S. Wroldsen, The Social Network *and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 615 (2013).

7 *See* Eric C. Chaffee, *Securities Regulation in Virtual Space*, 74 WASH. & LEE L. REV. 1387, 1432 (2017) ("[T]he exemption created by the CROWDFUND Act is so onerous to comply with that no software developer, platform owner, or user is likely going to take the time and expense to comply with it . . . ."); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1444 (2012) ("It is difficult to imagine that for offerings under $250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities.").

8 *See, e.g.*, Sara Hanks, *Regulation CF Annual Filing Season Starts Off Batting .200*, CROWDCHECK (Apr. 30, 2018), https://www.crowdcheck.com/blog/regulation-cf-annual-filing-season-starts-batting-200 ("Only 13 of those 61 companies to have filed a Form C-AR as of Friday night are compliant or even close to compliant."); *see also* Huiwen Leo, *Investor Alert 2: Has Your Company Provided You With Updates?*, CROWDCHECK (Apr. 20, 2018), https://www.crowdcheck.com/blog/investor-alert-2-has-your-company-provided-you-updates (of CF issuers that filed a Form C-U prior to May 1, 2017: "29.3% of them did not file a Form C-AR or post an annual report on their website, meaning approximately one in three investors did not receive any updates from the company they invested in."); Andrew Stephenson, *Compliance with Reg CF: Financial Statements Under Rule 201*, CROWDCHECK (Sept. 12, 2016), https://www.crowdcheck.com/blog/compliance-reg-cf-financial-statements-under-rule-201 (finding that "approximately 35% of Regulation CF issuers are conducting, or have conducted, offerings with non-compliant financial statements").

9 *Contra* Sherwood Neiss, *Regulation Crowdfunding Isn't the Mess Opponents Predicted*, VENTUREBEAT (July 31, 2016, 11:35 AM), https://venturebeat.com/2016/07/31/regulation-crowdfunding-isnt-the-mess-opponents-predicted/.

comply with the simplest, most fundamental requirements of crowdfunding regulation. In almost half of the first 362 crowdfunding offerings in the sample, the issuer failed to file at least one of the four required financial statements or obtain the required level review for their financial statements. Only 61% of issuers filed their mandatory initial annual report; only 37% filed it on time. Barely one quarter of issuers that were required to file two annual reports did so. Only 15% of successful issuers filed the required report on the final amount raised, most issuers' electronically-filed data included substantial deviations from the data in their financial statements, and one platform may be violating the prohibition against crowdfunding portals' providing advice. These findings demonstrate that crowdfunding, a mere 13 months after its inception, had developed a pervasive culture of noncompliance.

The most striking takeaway from these findings is that, even under a fairly liberal application of crowdfunding rules ("Reg CF"), there is a significant likelihood that a majority of crowdfunding offerings in the sample were not eligible to rely on the crowdfunding exemption. Investors in those offerings therefore may be entitled to rescission under Section 12(a)(1) of the Securities Act of 1933.[10] Intermediaries that have failed to ensure that issuers fulfill crowdfunding's most basic regulatory requirements bear significant responsibility for leaving them exposed to private liability. Congress required that crowdfunding offerings be conducted by registered intermediaries with the expectation that the participation of financial professionals would improve compliance. It appears that intermediaries have not served that purpose.

Crowdfunding's culture of noncompliance begs the question as to whether more extreme predictions of fraud, self-dealing, and ubiquitous failure have also been realized. On this front, relevant data are simply not available, partly because of issuers' noncompliance and partly due to inadequate reporting rules.[11] Annual reports provide the only source of information about issuers' post-offering conduct, but issuers routinely ignored that filing obligation. It is the promoters who may have absconded with offering proceeds, paid themselves exorbitant salaries, or run their firms into the ground, who are most likely to spurn annual reporting that might reveal misappropriation, misconduct, or failure. Neither regulators nor third parties can assess the results of the crowdfunding experiment if information on issuers' post-offering performance and conduct is unavailable.

Empirical data on the state of compliance in crowdfunding could not come at a better time. The Securities and Exchange Commission (the "Commission" or "SEC") has issued a concept release as a first step in liberalizing the regulation of unregistered securities offerings.[12] However, regulatory regimes in which

---

10 *See* 15 U.S.C. § 77*l*(a) (2012).

11 Dorff, *supra* note 2, at 508–09 (the "most important question surrounding equity crowdfunding is also the most neglected: how good will the investments be?" If performance were good, intermediaries "would be trumpeting it from the rooftops."). *But see* Andrew A. Schwartz, *The Nonfinancial Returns of Crowdfunding*, 34 REV. BANKING & FIN. L. 565, 575–80 (2015) (enumerating "six potential nonfinancial benefits of securities crowdfunding: Entertainment value; political expression; patron of the arts; altruism; community; and creativity").

12 *See* Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460 (June 26, 2019); Mark Schoeff, Jr., *SEC Exploring How to Give More Investors Access to Private Placements*, INVESTMENTNEWS (June 18, 2019), https://www.investmentnews.com/sec-exploring-

entrepreneurs and their intermediaries cannot follow the simplest rules are not well positioned for expansion. To bolster its case, the Commission published a companion staff report "on the impact of [crowdfunding rules] on capital formation and investor protection," which claims to include "a review of: (1) issuer and intermediary compliance . . . ."[13] While the report provides a substantial amount of useful data on crowdfunding, it does not include any data on compliance rates or other information on the level of issuer and intermediary compliance.

This Article plugs that hole by presenting findings on issuers' compliance with Reg CF's most basic requirements. It also uses these findings to identify ways to improve compliance and disclosure and reduce costs and burdens for issuers. For example, financial statements are of limited use to investors when a firm has no assets, liabilities, revenues, or expenses, which is the case for a large proportion of issuers. Disclosure requirements for these firms should be significantly curtailed. Issuers that seek to raise more than $100,000 must pay for an accountant to review their financial statements, even if they never raise a penny. This requirement should be triggered by the concrete commitment of funds by investors, not by the overly optimistic capital targets of issuers. Excessively burdensome rules do not excuse poor compliance but reducing burdens for issuers would undoubtedly improve it. Crowdfunding rules can work better for investors while also costing less for issuers.

This Article sets forth relevant elements of Reg CF in Part II. Part III describes the data set. Part IV discusses issuers' and intermediaries' compliance in the following areas, in each case followed by analysis and recommendations: financial statements, annual reports, investment advice and recommendations, progress updates, and data reliability. Part V concludes.

II. CROWDFUNDING REGULATION

Crowdfunding issuers register their offerings with the Commission by filing a fill-in-the-blank Form C that includes general information about the issuer and financial data for the issuer's current and preceding fiscal year.[14] This information is also required to be provided on the platform where the offering takes place.[15] Issuers must also file financial statements, the requirements for which are set forth below, along with other compliance standards that are evaluated in this Article.[16] In addition to Form C, issuers are required to file updates on the progress of their offerings.[17] If successful, they are required to report the final amount raised and file

---

how-to-give-more-investors-access-to-private-placements-80021; *see also* Fix Crowdfunding Act, H.R. 4855, 114th Cong. § 2(a)(2) (as passed by House, July 5, 2016).

13 U.S. SEC. & EXCH. COMM'N, REGULATION CROWDFUNDING 11 (2019) [hereinafter CROWDFUNDING REPORT].

14 *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, U.S. SEC. & EXCH. COMM'N (Apr. 5, 2017) [hereinafter *Issuer Compliance Guide*], https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm; *Form C Under the Securities Act of 1933*, U.S. SEC. & EXCH. COMM'N. (Apr. 2017), https://www.sec.gov/about/forms/formc.pdf.

15 *See Issuer Compliance Guide*, *supra* note 14.

16 *Id.*

17 *Id.*

at least one annual report.[18] Only intermediaries that are registered as funding portals or broker-dealers may conduct a crowdfunding offering, and offerings must be conducted exclusively on a single web-based platform.[19] Fund portals are prohibited from making recommendations or giving advice in connection with crowdfunding offerings.[20]

A. Financial Statements

Crowdfunding issuers' financial statements are subject to one of three standards depending on the maximum amount the issuer states that it will accept pursuant to the offering (its "maximum raise").[21] There are two different dollar amounts for each standard; one applied prior to April 12, 2017, the latter applied thereafter.[22] For simplicity, this Article usually refers only to the amounts that were applicable prior to April 12, 2017.

When the maximum raise is no more than $100,000, the issuer must provide: (1) the "total income, taxable income and total tax, or the equivalent line items," as reported on the issuer's federal tax return for the most recent year and (2) financial statements. Both the issuer's tax data and the financial statements must be certified by the issuer's principal executive officer ("Level 1").[23]

For a maximum raise in excess of $100,000, the issuer must provide financial statements that have been reviewed by an independent public accountant ("Level 2").[24] If the issuer has previously sold securities under Reg CF, it must file reviewed financial statements if its maximum raise is greater than $100,000 and no more than $500,000.[25]

If an issuer has previously sold securities in reliance on Reg CF, a maximum raise in excess of $500,000 requires financial statements that have been audited by an independent public accountant ("Level 3"). In other words, an issuer is never required to submit audited financial statements for a crowdfunding offering unless and until it has had a prior successful crowdfunding offering. Once an issuer has conducted a successful offering, its financial statements must be audited if it chooses a maximum raise in excess of $500,000.[26]

---

18 *Id.*

19 *Id.*

20 *See* JOBS Act of 2012, Pub. L. No. 112-106, § 304(b), 126 Stat. 322 (2012).

21 *See* 17 C.F.R § 227.201(t) (2019). Issuers also set a minimum amount for the offering that must be reached for any securities to be sold. *Id.* at § 227.201(g).

22 The JOBS Act requires the Commission to increase the dollar amounts every five years to reflect inflation. *See* JOBS Act, § 101(a), 126 Stat. at 307. Effective April 12, 2017, the Commission increased the dollar amounts pursuant to this requirement. *See* Inflation Adjustments and Other Technical Amendments Under Titles I and III of the Jobs Act, 82 Fed. Reg. 17,545 (April 12, 2017).

23 17 C.F.R. § 227.201(t)(1). The certification must include the statement: "the financial statements of [identify the issuer] included in this Form are true and complete in all material respects . . . ." *Id.* § 227.201(t) instr. 7.

24 *Id.* § 227.201(t)(2).

25 *Id.* § 227.201(t)(3).

26 As of April 12, 2017, the $100,000 and $500,000 limits were increased, respectively, to

In each case, the limit applies to the amount of any securities raised within the preceding 12 months under Reg CF.[27] For Level 1 and 2 offerings, financial statements meeting a higher standard must be provided if they are available.[28] All financial statements must include a balance sheet, income statement, statement of cash flows, statement of changes in shareholders' equity, and footnotes.[29]

For each Level, financial statements must cover the issuer's "most recent" and "prior" fiscal years.[30] These are misnomers, however, because issuers are not required to file financial statements for their most recent fiscal year if 120 days have not passed since that year's end.[31] In other words, an issuer with a calendar-year fiscal year ("calendar-year FY issuer")[32] that files for an offering from January 1 through April 30 of year three need not file financial statements for year two (its most recent fiscal year). In most cases, the issuer will choose to file financial statements for year one as its most recent fiscal year (actually its *prior* fiscal year) and year zero as its prior fiscal year (actually the year *prior* to its prior fiscal year). Thus, the financial statements labeled "most recent" may be up to 484 days old. However, if the offering remains open on April 30, the issuer would be required to file updated financial statements for year two at that time.

Thus, the financial statements for two calendar-year FY issuers that file on the same day may be for different years. Adding to this comparability problem, if an issuer was created after the first day in a fiscal year, then the financial statements for that year will represent less than 12 months. Another problem is that issuers sometimes interpret "most recent" fiscal year to mean "most recent" financial information. The issuers then populate the "most recent" fields with data as of the end of the last month covered by the financial statements. These discrepancies cannot be discerned from Form C. Investors and other third parties must hand-review the financial statements to determine which periods electronically filed data actually cover.

Filers are required to amend their filing in the event of a material change.[33] The Commission stated, not very helpfully, that such a change would include a "material

---

$107,000 and $535,000. *See* 17 C.F.R § 227.201(t). The maximum amount that may be raised under Reg CF in any 12-month period was increased from $1 million to $1.07 million. *See id.*

27 *Id.*

28 *Id.*

29 *Id.* § 227.201(t) instr. 3. The SEC staff takes the position that an issuer that begins an offering between its inception date and 120 days after the end of its fiscal year is permitted to provide a balance sheet as of its inception date and no other financial statements. *See Regulation Crowdfunding: Compliance and Disclosure Interpretations*, U.S. SEC. & EXCH. COMM'N (May 13, 2016), https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm (Rule 201: Disclosure Requirements, Question 201.01).

30 17 C.F.R. § 227.201(t) instr. 3.

31 *Id.* § 227.201(t) instr. 4.

32 CROWDFUNDING REPORT, *supra* note 13, at 28 n.69 ("almost all issuers during the considered period had a calendar fiscal year").

33 17 C.F.R. § 227.203(a)(2) (2019); *see* Crowdfunding, 80 Fed. Reg. 71,388, 71,418 (Nov. 16, 2015) ("information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether or not to purchase the securities.") (citing *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)).

change in the financial condition"[34] of the issuer. At a minimum, an issuer would have to file updated financial statements no later than the 120th day following the end of its fiscal year if they have not already been filed.

B. *Progress Updates*

Section 302(b) of the JOBS Act requires that filers file "regular updates regarding the progress of the issuer in meeting the target offering amount."[35] Reg CF provides that an issuer need not provide regular updates if the "intermediary's platform [makes available] frequent updates regarding the progress of the issuer in meeting the target offering amount."[36] If the issuer chooses to rely on its intermediary as a proxy, it is only required to file the final amount raised within five business days of the offering deadline.[37] If the issuer does not choose this option, it must file, in addition to the final amount, updates when 50% and 100% of the target offering amount is reached.[38]

C. *Annual Reports*

Reg CF requires that successful issuers file at least one annual report after a successful offering.[39] The report must include the same information required in the offering document except for: (1) offering terms and other offering-specific information; (2) risk factors; and (3) where the annual report can be found on the issuer's website.[40] Reg CF exempts an issuer from the annual report requirement after its first annual report if, *inter alia*, it has filed at least one annual report and has fewer than 300 holders of record.[41] An issuer may not conduct a crowdfunding offering

---

34 *Id.*

35 JOBS Act of 2012, Pub. L. No. 112-106, § 302(b), 126 Stat. 317 (2012).

36 17 C.F.R. § 227.203(a)(3)(iii).

37 *Id.*

38 *Id.* § 227.203(a)(3)(i).

39 The JOBS Act requires that an "issuer who offers *or* sells securities shall . . . not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate." JOBS Act § 302(b)(4), 126 Stat. at 317–18 (emphasis added). Reg CF's annual report requirement applies to an issuer that has "offered *and* sold securities." 17 C.F.R. § 227.202(a) (2019) (emphasis added). Thus, annual reports are required only once an offering has closed. Nonetheless some Filers filed annual reports prior to the closing of their initial offering, while others did not but believed they were required to. *See, e.g.*, Ohos, Inc., Annual Report (Form C-AR) (Apr. 30, 2018), https://www.sec.gov/Archives/edgar/data/1681286/000167025418000186/document_1.jpg ("The issuer failed to file a 2016 annual report.").

40 *See* 17 CFR § 227.202(a) (2019).

41 *Id.* § 227.202(b). An issuer also may suspend filing annual reports if: (1) it has filed at least three annual reports and has no more than $10 million in total assets, (2) becomes a reporting company, (3) all crowdfunding securities have been repurchased, or (4) it dissolves or liquidates under state law. *Id.*; *see also* CROWDFUNDING REPORT, *supra* note 13, at 29 n.72 (no crowdfunding issuers had become reporting companies as of the end of 2018). The suspension provision is independent of the provision of Reg CF requiring that the issuer file a termination notice, which raises the question of whether filing the notice is a condition of the suspension of reporting. 17 C.F.R. § 227.203(b)(3) (stating that an "issuer eligible to terminate its obligation to file annual

if it has not filed annual reports, as required, for both of the preceding two years, as required, but this prohibition does not apply if the issuer files "catch-up" reports as needed, as long they are filed before the offering.

Issuers must file an annual report "no later than 120 days after the end of the fiscal year covered by the report."[42] The "fiscal year covered by the report" is not specifically identified. If, for example, a calendar-year FY issuer initiated an offering on February 1 and completed the offering on April 29, would the annual report be due on April 30? Or would the report be due the following year?

The primary purpose of an annual report is to provide more recent information about the issuer to investors. It therefore would not make sense for it to apply to a year for which financial statements had already been provided. In the example immediately above, it would not make sense to file an annual report on April 30 if financial statements for the immediately preceding year had already been filed; the financial statements in the report would already have been filed. All material changes through April 29 would have been filed before the offering closed, so the annual report would provide no new information. If the issuer had fewer than 300 shareholders, it could terminate reporting on May 1, thereby eliminating any meaningful right to updated information. Thus, if financial statements have been provided, the first annual report would logically be due by April 30 of the *following* year.

If the same issuer had *not* filed updated financial statements before closing the offering, it would make sense for the first annual report to be due by the April 30 immediately following the closing because financial statements for the just-ended fiscal year would not previously have been provided to investors. Recall that the opening and closing of an offering in the first 120 days of year three would not have required filing financial statements for year two. If the issuer did not file an annual report by April 30 immediately after closing, investors would not receive year 2 financial statements until as late as the 120th day (April 30) of year four.

Thus, it makes the most sense for the annual report to be for the most recent fiscal year for which an issuer has not filed financial statements. Most issuers in the first 13 months of crowdfunding submitted annual reports that are consistent with this interpretation, and it is the interpretation applied in this Article for the purpose of determining compliance. However, some filers may have believed that they could file their annual report more than one year after their offering closed, even if they had never filed financial statements for the most recent fiscal year ending prior to the closing. Still others may have believed that filing financial statements in a follow-on offering obviated the need to file an annual report.

Nonetheless, this interpretation leads to awkward results. If an offering closes on April 29 without the issuer having submitted financial statements for the preceding fiscal year, then the annual report would be due the next day, on April 30. It would contain no new post-offering material information, and the issuer could

reports" must file termination notice); *Issuer Compliance Guide*, *supra* note 14 ("Any issuer terminating its annual reporting obligations is required to file notice on Form C-TR reporting that it will no longer provide annual reports pursuant to the requirements of Regulation Crowdfunding."). *But see* CROWDFUNDING REPORT, *supra* note 13, at 29 n.72 ("Some issuers that fail to file annual reports might be eligible to terminate reporting but might have failed to file a Form C-TR.").

42 17 C.F.R. § 227.202(a).

immediately terminate reporting. If the financial statements have been filed, then the first annual report would not be due until April 30 of the following year. In these two instances, calendar-year FY issuers that close in the first four months of a year would have different deadlines for submitting their first annual report depending on whether they had updated their financial statements during their offering.

The financial statements included in an annual report need only be certified by the CEO, regardless of the size of the issuer's maximum raise or amount of securities sold (although accountant-reviewed or audited financial statements, if available, must be provided).[43] This means that an issuer with an offering that is subject to review or audit has an incentive to end the offering before having to update its financial statements (i.e., for the calendar-year FY issuer, before April 30) in order to avoid that accounting expense. By closing before the 120th day after the end of a fiscal year, an issuer still has to provide updated financial statements in its annual report, but they need only be CEO-certified.

D. Advice and Recommendations by Intermediaries

The JOBS Act requires that all crowdfunding offerings be conducted by a registered broker-dealer or funding portal. The Act defines "funding portal" as a person acting as an intermediary in a crowdfunding offering that does not, among other things, "offer investment advice or recommendations."[44] As a practical matter, the advice/recommendation may also apply to registered broker-dealers. The Financial Industry Regulatory Authority ("FINRA") has issued guidance that casts doubt on whether a broker-dealer could provide advice or recommendations on a crowdfunding platform in compliance with its suitability obligations.[45]

The advice/recommendation prohibition is one of the more difficult regulatory issues in Reg CF. Intermediaries have a natural interest in screening firms that they accept for their platforms, which means that the appearance of a firm on the intermediary's platform necessarily constitutes a weak form of recommendation.

---

[43] *See id.*

[44] JOBS Act of 2012, Pub. L. No. 112-106, § 304(b), 126 Stat. 322 (2012).

[45] *2019 Annual Risk Monitoring and Examination Priorities Letter*, FIN. INDUS. REGULATORY AUTH. (Jan. 22, 2019), https://www.finra.org/rules-guidance/communications-firms/2019-annual-risk-monitoring-and-examination-priorities-letter ("FINRA is concerned that some member firms assert they are not selling or recommending securities when involved with online distribution platforms despite evidence to the contrary"); *see also* Tracey Longo, *FINRA to Target Online Sales Practices of Broker-Dealers*, FIN. ADVISOR MAG. (Jan. 22, 2019), https://www.fa-mag.com/news/finra-to-target-online-sales-practices-of-broker-dealers-42893.html. Broker-dealers are required to ensure that all recommendations are "suitable," that is, appropriate for customers in light of their specific financial situation. *See Rules & Guidance, 2111. Suitability*, FIN. INDUS. REGULATORY AUTH. (May 1, 2014), https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111; *see also Funding Portal Rules, 200. Funding Portal Conduct*, FIN. INDUS. REGULATORY AUTH. (Jan. 29, 2016), https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200 (requiring funding portals to "observe high standards of commercial honor and just and equitable principles of trade"). At least one lawyer-commentator has suggested that a broker-dealer online platform necessarily requires suitability-level due diligence. *See* David M. Freedman, *Distinguishing Crowdfunding Portals and Broker-Dealer Platforms Under Title III*, FIN. POISE (April 4, 2016) ("Broker-dealers are subject to strict standards of due diligence"). Notwithstanding, this requirement is technically triggered only when a recommendation is made.

The difficulty lies in drawing a practical line between this form of recommendation, which helps to minimize the risk of fraudulent offerings,[46] and qualitative judgments about offerings that constitute implicit or explicit investment recommendations.

Reg CF addresses this issue through a safe harbor that permits a portal to "[d]etermine whether and under what terms to allow an issuer to offer and sell securities in reliance on section 4(a)(6) . . . through its platform; provided that a funding portal otherwise complies with" Reg CF.[47] Thus, portals can deny access to prospective issuers based on the advisability of investing in the issuer,[48] but it is another question whether a portal can *promote* issuers on the basis of their having met the portal's qualitative screens.

Reg CF seems to prohibit portals from promoting issuers based on qualitative criteria because it would violate the advice/recommendation prohibition, but this is not entirely without doubt. One problem is that Reg CF provides examples of *permitted* activities rather than clarifying what activities are prohibited. The unavailability of the safe harbor does not mean that a portal has violated the advice/recommendation prohibition.

Reg CF is also problematic because it sets forth three safe harbors that are inconsistent as to what criteria a portal may use in promoting specific issuers. The safe harbors allow portals to "highlight offerings"[49] on the portal's platform, provide "search functions,"[50] and advertise the existence of the portal and identify issuers—in each case on the basis of objective criteria.[51] Each safe harbor includes its own list of permissible criteria, which are essentially identical to the following:

> The criteria may include, among other things, the type of securities being offered (for example, common stock, preferred stock or debt securities); the geographic location of the issuer; the industry or business segment of the issuer; the number or amount of investment commitments made, progress in meeting the issuer's target offering amount or, if applicable, the maximum offering amount; and the minimum or maximum investment amount . . . .[52]

The difficulty lies in determining whether "objective criteria" may include qualitative criteria that are based on an assessment, for example, of an issuer's business plan, management or overall prospects. The safe harbors for highlighting offerings and advertising portals/identifying issuers apply essentially the following condition: "The criteria are reasonably designed to identify a broad selection of issuers offering securities through the funding portal's platform, and are applied consistently to all potential issuers and offerings . . ."[53]

---

46 *See* CROWDFUNDING REPORT, *supra* note 13, at 49.

47 17 C.F.R. § 227.402(b)(1).

48 *See* Crowdfunding, 80 Fed. Reg. 71,388, 71,463 (Nov. 16, 2015) ("we are providing funding portals with broad discretion to determine whether and under what circumstances to allow an issuer to offer and sell securities through its platform").

49 17 C.F.R. § 227.402(b)(2).

50 *Id.* § 227.402(b)(3).

51 *Id.* § 227.402(b)(9).

52 *Id.* § 227.402(b)(2)(ii).

53 *Id.* § 227.402(b)(9)(i). The highlighting offerings safe harbor adds the condition that the criteria be "clearly displayed on the funding portal's platform." *Id.* § 227.402(b)(2)(i).

The search function safe harbor does not include this proviso.[54] Although it is arguably implied by the term "objective criteria," the question of why it was included in two safe harbors but not the third remains.

The highlighting offerings safe harbor appends the following to its list of permissible criteria: "provided that the funding portal may not highlight an issuer or offering based on the advisability of investing in the issuer or its offering."[55] This seems to prohibit the use of qualitative criteria. However, the advertising/identifying safe harbor extends this proviso as follows: "The criteria may not include, among other things, the advisability of investing in the issuer or its offering, *or an assessment of any characteristic of the issuer, its business plan, its key management or risks associated with an investment*."[56]

By adding criteria to the advisability of investing in the issuer—*i.e.*, any assessment of an issuer's "characteristics," business plan or key management, or of the risks of investing in the issuer—this proviso implies that advisability criteria do *not* necessarily include all qualitative factors. Perhaps offerings *can* be highlighted on the basis of an issuer's business plan or key management.

The search function does not even include the proscription against advisability criteria, which could mean that a portal's platform could allow investors to search for the issuer with, for example, the best business plan and management team. This would be logically inconsistent with the other two safe harbors,[57] but judges will be inclined to construe such ambiguities against the regulators responsible for creating them. These interpretive questions are directly implicated *infra* in Part IV(C)'s discussion of the "vetting" of issuers conducted by an actual portal.

III. DATA AND DATA SET

The analysis in this Article is based on the inaugural class of crowdfunding issuers in the United States. The data set comprises the first 362 offerings initiated under Reg CF from the effective date for filing under Reg CF (May 16, 2016) through June 15, 2017, or 13 months (the "Sample" and "Sample period").[58] The Sample includes withdrawn offerings unless the withdrawal resulted from an inadvertent filing of Form C. This reflects filings subsequent to the Sample period through at least July 13, 2019 (the "cut-off date"). During the Sample period, 347 separate firms ("Filers") initiated at least one offering; 15 initiated a second

[54] *Id.* § 227.402(b)(3).

[55] *Id.* § 227.402(b)(2)(ii).

[56] *Id.* § 227.402(b)(3)(ii) (emphasis added).

[57] *See* Crowdfunding, 80 Fed. Reg. 71,388, 71,463 (Nov. 16, 2015) ("funding portal must avoid any appearance that it is giving investment advice or recommendations or that the funding portal believes its offerings are investment worthy").

[58] Sixteen offerings that were shut down as a result of a FINRA enforcement action are excluded. *See* Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent (No. 201651563901) from Gary Shao, Managing Dir., UFP, LLC to Dept. of Enforcement, FINRA (Nov. 25, 2016) [hereinafter UFP Letter], https://www.finra.org/sites/default/files/fda_documents/2016051563901_FDA_JG411996.pdf. (expelling registered funding portal). The Sample also excludes six Forms C that were filed inadvertently and do not represent separate offerings.

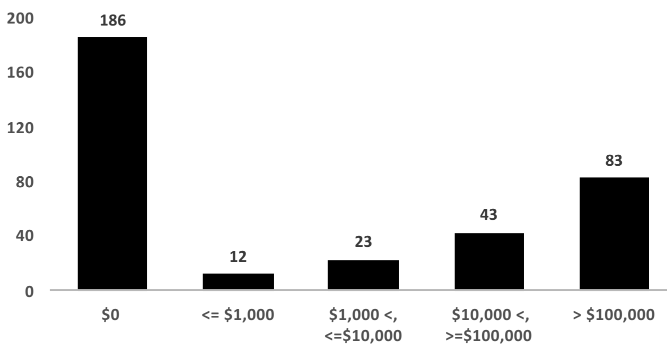
offering.[59] Many Filers initiated additional offerings subsequent to the end of the Sample period.

A. Nonoperating Filers

The Sample's most noteworthy characteristic is the large proportion of firms with essentially no operating history. One quarter of Filers have less than $1,000 in assets and no cash. More than half have no revenue. For 60 Filers, every financial data point is zero; the combined total of all financial values for another 46 Filers is less than $1,000.

Figure 1 shows the distribution of Filers' most recent fiscal year revenues for each initial offering.[60] The majority of offerings were conducted by Filers with zero revenues, which is partly explained by their youth. Sixty-seven Filers submitted their initial Form C less than 100 days after forming, while 135 filed within one year. A substantial majority were formed within two years of initiating an offering.[61] Although crowdfunding is primarily a place for young firms, the Sample includes a healthy number of small businesses with a steady revenue stream. Twenty-three percent of Filers reported revenues in excess of $100,000 in their most recent fiscal year, which, as noted, often represents data that is up to 484 days stale. At the time that Filers initiated their offerings, it is likely that a larger percentage had more than this amount in revenues.

Figure 1: Revenues



[59] A Small Business Administration staffer studied samples for the SBA Study which covered 326 issuers that conducted 343 offerings from May 16, 2016, through May 16, 2017, including 17 follow-on offerings. *See* Lindsay M. Abate, *One Year of Equity Crowdfunding: Initial Market Developments and Trends*, U.S. SMALL BUS. ADMIN. OFF. ADVOC. ECON. RES. SERIES 2 (Mar. 29, 2018), https://cdn.advocacy.sba.gov/wp-content/uploads/2018/03/28180000/Crowdfunding_Issue_Brief_2018.pdf. The discrepancy in follow-on offerings between our numbers and the SBA numbers may be the result of the SBA Study's including Form C filings that are excluded from this analysis because they were inadvertent and did not represent actual offerings. *See id.* at n.6 (number of filings based on number of Forms C filed).

[60] The data discussed herein often cover only initial offerings because the characteristics of follow-on offerings are likely to be inherently different in many respects.

[61] *Cf.* Abate, *supra* note 59, at 2, 6 (43% and 88% of issuers were up to 1-year and 5-years old, respectively; chart showing distribution of ages of issuers).

B. *Successful and Unsuccessful Filers*

Of the 362 offerings in the Sample, 196 were successful for a success rate of 54%. Nine of these successes were follow-on offerings. Of the 196 successful Filers, seven were successful in two offerings (none had a third offering during the Sample period). Thus, 189 out of 349 Filers (54%) had at least one successful offering.[62]

In most cases, the total amount raised can only be estimated. The most reliable source of amounts raised is the annual report, but annual reports often were not filed or did not include the final amount raised. When not available in an annual report, final amounts are derived from Filers' Form C-Us, which generally report an amount raised within a few days of the filing date, but that amount is usually inaccurate. When neither source is available, the total amount raised is derived from crowdfunding platforms, which are generally less reliable than the annual reports and Forms C-U, but are consistently fairly close to the final amount.

With these caveats in mind, the 196 successful offerings raised a total of $55,635,058, for an average of $283,852 per offering and a median of $169,850.[63] Figure 2 shows the distribution of amounts raised. Small offerings dominate, with 29% of offerings raising no more than $100,000, and 60% raising no more than $200,000. Only 29% raised more than $300,000, and only 14% more than $500,000.[64] Crowdfunding issuers are overwhelmingly firms that raise far less, for example, than the amount that would require audited financial statements.

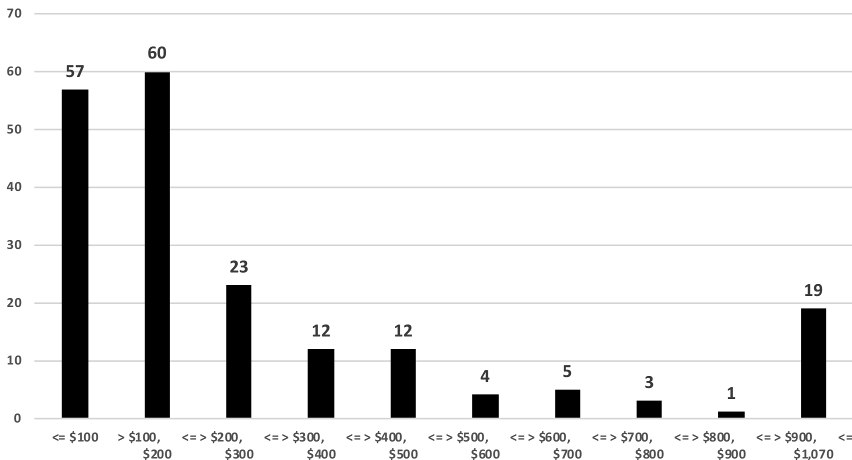
---

62 This figure includes all successful offerings, regardless of whether a Form C-U was filed that reported the final amount raised. *Cf. id.* at 9 (118 Forms C-U filed for 343 offerings, for success rate of at least 34%).

63 *Cf.* CROWDFUNDING REPORT, *supra* note 13, at 15 tbl.1 (average and median raise of $208,400 and $107,367, respectively, noting that this is a "lower bound"). It appears that the SEC staff relied solely on final amounts reported on Forms C-U and did not consider amounts reported in annual reports or on platforms. *Id.* at 15 n.40, 17 n.49. The staff found that issuers raised $108.2 million over 31 months, compared with an industry estimate of $194 million. *Id.* at 15 n.40; *see also* Abate, *supra* note 59, at 9 (finding, for crowdfunding offerings from May 16, 2016, through May 16, 2017, issuers raised more than $30 million in 105 offerings with an average (median) Form C-U reported raise of $289,000 ($170,000)).

64 Although some have lobbied to raise the exemption limit to $5 million, *see, e.g.*, U.S. DEP'T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 41 (2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf, these data support the view that the JOBS Act, written for $1 million offerings, should have adopted a more streamlined approach and set a much lower limit. *See* Cohn, *supra* note 7, at 1438; *cf.* Chaffee, *supra* note 7, at 1455 (arguing that all offerings conducted in "virtual space" should be exempt under the "context otherwise requires" of Section 4 of the Securities Act of 1933).

Figure 2: Amount Raised ($000)



An issuer cannot raise more than $1 million under Reg CF in any 12-month period,[65] but this limit was infrequently a constraint, with only 19 offerings (5%) reaching that amount.[66] Even this group was not constrained by the limit, as at least nine were engaging or had engaged in a Reg A and/or Reg D offering, and at least seven of those had obtained additional funding through these avenues.[67] These Filers may have conducted additional unreported offerings, as Filers often conducted Reg D filings without filing the required Form D.[68]

Some have argued that issuers that need to raise more than $1 million will eschew a crowdfunding offering and conduct a Rule 506 offering instead.[69] However,

65 17 C.F.R. § 227.100(a)(1) (2019).

66 This total includes an offering that raised $1,069,999 of the applicable $1,070,000 limit and another that raised $999,979.50 of the applicable $1,000,000 limit. *See* CROWDFUNDING REPORT, *supra* note 13, at 15 (over first 31 months of crowdfunding, 29 offerings raised the maximum allowed; only 3 issuers raised more than an aggregated $1.07 million during that period).

67 Reg D is an exemption from registration for securities sold in a nonpublic offering or an offering in which only accredited investors make investments. 17 C.F.R. §§ 230.500–.508 (2019). Issuers that rely on the Reg are required to file Form D with the SEC. *Id.* § 230.503. Reg A is an exemption from registration for public offerings of up to $20 million or $50 million, depending on certain offering criteria. *Id.* §§ 230.251–.263.

68 *See, e.g.*, Offering Statement (Form C) (Sep. 21, 2016), https://www.sec.gov/Archives/edgar/data/1674525/000166516016000092/if_materials.pdf (attached exhibits reporting four successful Reg D offerings from 2014 to 2016 for which no Forms D were filed); *see also* CROWDFUNDING REPORT, *supra* note 13, at 18 n.52, 36 (244 of 1,246 issuers (20%) filed at least one Form D up to the end of 2018).

69 Abate, *supra* note 59, at 13 (stating that "SEC may want to consider raising the amount that an individual sophisticated or high net worth investor can invest in crowdfunding transactions in a single year, since this could potentially increase the total amount of capital available to firms in this market" while also noting that additional research on this issue is needed). Rule 506(b) generally permits private offerings of an unlimited amount to an unlimited number of wealthy investors ("accredited investors") plus up to 35 nonaccredited investors who are provided with a registration-statement-like disclosure document. *See* 17 C.F.R. § 230.506(b). Rule 506(c) generally

some Filers not only conducted offerings under both exemptions, but also did so in a joint Reg CF-Rule 506(c) offering on the same platform.[70] Rather than the exemptions offering mutually exclusive options, they create synergies that are likely to generate increased total investment when combined. A crowdfunding offering strengthens a Rule 506(c) offering by creating an additional avenue by which to access accredited investors. Conversely, a Rule 506(c) offering benefits a crowdfunding offering by siphoning off investors that might otherwise cause the crowdfunding offering limit to be exceeded or the number of non-accredited investors to trigger registration as a reporting company.

C. *Types of Securities Offered*

Filers offered a wide variety of financial instruments.[71] Figure 3 shows the distribution of instruments based on Form C filings. The terms of the securities offered demonstrate the influence of intermediaries. Securities offered through a single intermediary generally have identical boilerplate and term structure. It appears that issuers choose a framework for a particular type of security and make changes to only a limited set of terms.[72] For example, many revenue participation interests vary only by the frequency of payment, percentage of revenue paid, multiple of the investment amount paid and the term. Professor Jack Wroldsen has written an excellent analysis of the specific terms of crowdfunding securities offered in the first month after Reg CF became effective.[73] His discussion is generally applicable to the securities offered by Filers in the Sample.

---

permits public offerings of an unlimited amount to an unlimited number of accredited investors. *See id.* § 230.506(c).

[70] *See, e.g.*, Corsica Innovations Inc., Annual Report (Form C-AR) at 19 (Nov. 14, 2019), https://www.sec.gov/Archives/edgar/data/1687516/000168751619000003/Corsica2019car_11.14.pdf (reporting combined proceeds of offerings); Kylie.ai, Inc., Annual Report (Exhibit A to Form C-AR) at 10 (Apr. 30, 2018), https://www.sec.gov/Archives/edgar/data/1702419/000170241918000001/kylieformcar.pdf (also reporting combined proceeds of offerings); *see also* CROWDFUNDING REPORT, *supra* note 13, at 39 (one portal reported that every offering included at least one accredited investor; on average, accredited investors accounted for 9% of investors and 40% of funds raised).

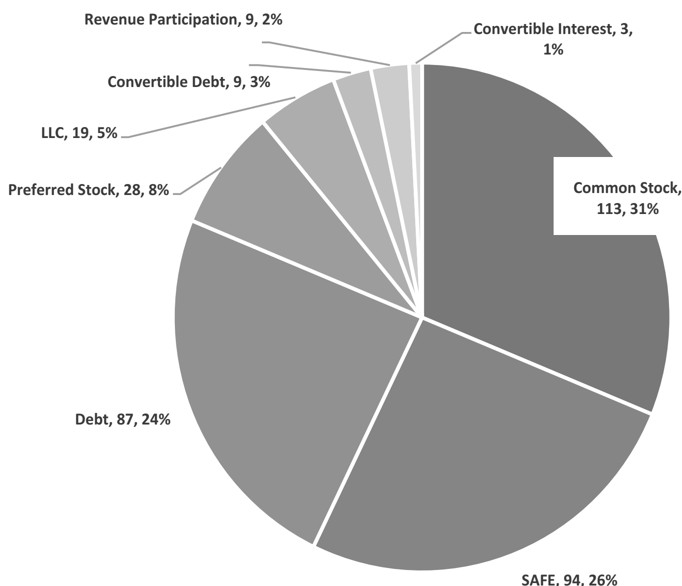
[71] *See* Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543, 576–79 (2017).

[72] *See id.* at 544 (intermediaries "profoundly influence crowdfunding contracting practices by forging the standardized channels through which crowdfunding investments flow"). Intermediaries' provision of standardized formation documents runs the risk of their engaging in the unauthorized practice of law. *See* Jeff Thomas, *Equity Crowdfunding Portals Should Join and Enhance the Crowd by Providing Venture Formation Resources*, 42 NOVA L. REV. 375, 392–95 (2018). Assisting issuers in drafting offering documents raises the same issue, particularly in light of the conflict that arises when an intermediary also invests in the offering.

[73] Wroldsen, *supra* note 71, at 546.

1) Contingent Interests

Three types of crowdfunding securities call for further discussion here because of their contingent nature. About one-quarter of Filers offered a simple agreement for future equity, or "SAFE," which is a version of an instrument used in venture capital deals.[74] A SAFE generally grants the holder the right to receive nonvoting preferred shares if the issuer subsequently raises capital in a preferred stock offering.[75] Another contingent interest, "crowd notes," are a type of convertible security that is typically exchanged for equity on the occurrence of an eligible financing event.[76] As with SAFEs, the equity received is typically nonvoting preferred stock. Finally, revenue participation interests promise to pay holders a percent of revenues until they have been paid up to a multiple of the investment amount.



These three types of securities share the disadvantages that they are nonvoting and lack the information rights that are typical for common shareholders. Their holders have no right to know, for example, if the contingency that triggers their right to receive equity has occurred. As discussed *infra* at Part IV(C), this is an important consideration in light of the frequency with which issuers do not file annual reports.

74 The SAFE is said to have been created by the startup accelerator Y Combinator. *See id.* at 556; Green & Coyle, *supra* note 6, at 171.

75 Wroldsen, *supra* note 71, at 555–56.

76 Crowd notes are similar to the Keep It Simply Security ("KISS"), except that crowd notes often do not have a maturity date. *See id.* at 556–57.

2) "D" is for Equity

Form C provides for two fields for the type of security offered. The first is for the type of security, which may include "Other." The second provides for the filer to "Specify" the type. Most categories provide a reasonably accurate reflection of the type of securities offered, such as common stock and preferred stock. Filers that offered SAFEs typically entered "Other" in the first field and "SAFE" or something similar in the "Specify" field. Filers offering LLC equity interests were less consistent in their use of the primary and "Specify" fields, but the nature of the interest was usually discernable from those entries.

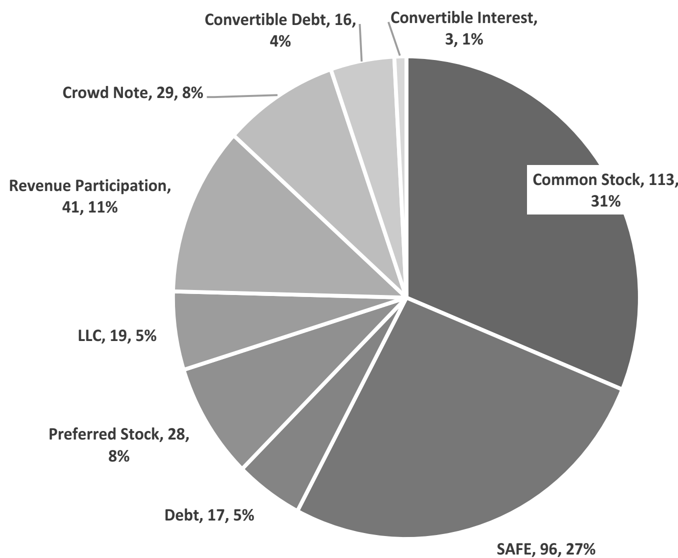
In contrast, Filers that entered "Debt" in the first field and entered "Debt" again in the "Specify" field or left it blank offered a grab bag of instruments that often are more akin to equity.[77] Of the Sample's 87 "Debt" offerings, only 17 (20%) involved were instruments with terms most commonly associated with debt: a promise to repay principal at the end of a fixed term and interest at a fixed rate at fixed intervals.[78] Thirty-seven percent of "Debt" securities were a form of revenue participation interest where investors were promised a percentage of gross revenues (most often 5%) until the investor had received a multiple of the investment amount (most often two). Most had no term, which makes them more akin to equity than debt because there is no fixed repayment obligation. So-called "crowd notes," which are complex convertible securities where conversion and payment rights are entirely contingent, comprise 33% of the "Debt" group.

Figure 4 shows the distribution of financial instruments after breaking out the "Debt" group into its separate constituents and counting only conventional promissory notes as debt. These data show that Form C's "Debt" is potentially misleading. Form C should be amended to more accurately reflect the securities offered by creating default options such as revenue participation interests, term loans, and convertible securities. Instructions in the Form should define the essential characteristics of each category.

---

[77] *Cf.* CROWDFUNDING REPORT, *supra* note 13, at 19 n.53 ("Debt is comprised of straight and convertible debt. Analysis of XML data from Form C does not allow a granular breakdown of debt security types.").

[78] The small number of notes may reflect competition from online lending platforms. *See generally* Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 ILL. L. REV. 217, 236–38 (2015).



IV. REG CF COMPLIANCE

A. *Financial Statements*

The average Filer did not comply with Reg CF's primary accounting requirements. Reg CF imposes three accounting requirements that are simple, objective and easily satisfied: (1) filers must submit financial statements for their two most recent fiscal years, (2) the financial statements must include a balance sheet, income statement, statement of cash flows, and a statement of changes in shareholders' equity, and (3) the financial statements must be, for a first-time filer, certified by the CEO or reviewed by an accountant.[79] Almost half of Filers failed to satisfy one or more of these requirements.[80]

These findings are based on a liberal standard. Late filings are generally treated as compliant. Each financial statement is assumed to be what it purports to be,

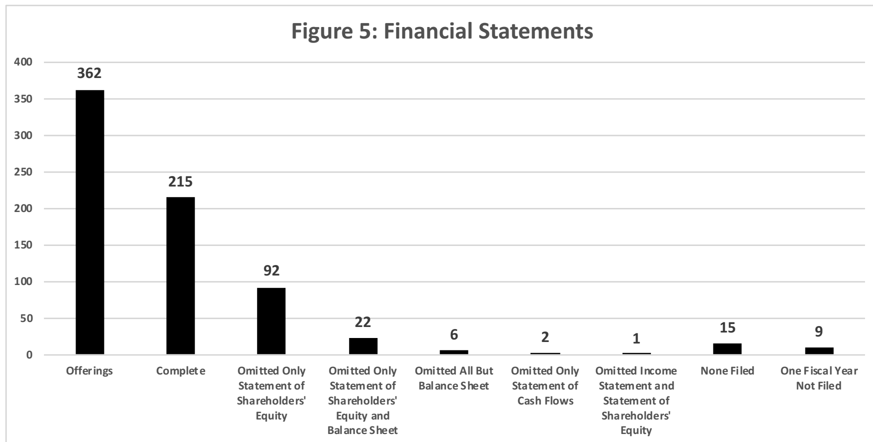
---

[79] *See supra* notes 14, 29, 43 and accompanying text.

[80] The SEC staff reviewed "issuer and intermediary compliance" for the CROWDFUNDING REPORT, *supra* note 13, at 11, but it provides no data on compliance with financial statement requirements. *See id.* at 28, n.68 (citing "differences among issuers' compliance;" "[s]taff observations have identified certain instances where issuers appear not to have provided compliant financial statement disclosures, have failed to file or timely file required annual reports, or have failed to file progress updates."). *Cf. id.* at 33 ("FINRA staff believed the funding portals were only in partial compliance").

regardless of missing or incorrect information.[81] Financial statements were deemed to satisfy the applicable standard of review if that level of review was applied to any financial statement, even if the review did not cover all financial statements. Filings were not reviewed to determine whether updated financial statements were filed as required in the course of the offering. A stricter standard for compliance would result in materially lower compliance rates.[82]

By any measure, Filers had a low level of compliance. Filers submitted complete financial statements that met the applicable review standard in only 201 of 362 offerings (56%). Complete financial statements were filed in 215 offerings (59%), as shown in Figure 5. This total includes 15 Filers that never submitted any financial statements and nine Filers that failed to file any financial statements for at least one required fiscal year. In 92 cases, only the statement of changes in shareholders' equity was left out. Twenty-two offerings did not include the statement of changes in shareholders' equity or the statement of cash flows. In six cases, only a balance sheet was provided.



Fifteen percent of financial statements did not meet the applicable review standard. Accountant review is associated with a slightly higher rate of completeness. Of the 208 offerings that included an accountant review, the financial statements were complete in 132 cases (63%). Financial statements were certified by the CEO as complete in 95 offerings, 56 (59%) of which were complete.[83] The completeness of financial statements for successful offerings was not different, but a higher percentage (89%) met the applicable review standard.[84]

---

81 For example, the presentation of the value of shareholders' equity at the beginning and end of a period was accepted as a statement of changes in shareholders' equity, even if no information about the number of shares issued was included.

82 *Cf.* Stephenson, *supra* note 8.

83 Note that these data cover financial statements that were actually accountant-reviewed or CEO-certified, not the financial statements to which each of those standards applied under Reg CF.

84 This analysis assumes that a FINRA Hearing Panel's ("the Panel") claim that the financial statement requirements do not apply to companies with no operating history is incorrect. *See* DreamFunded Marketplace, LLC, No. 2017053428201 (Fin. Indus. Regulatory Auth. June 5,

Filers' poor record in meeting the financial statement requirements casts doubt on the future of crowdfunding. These compliance failures are the kind of "unethical non-disclosure" that the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act was intended to deter.[85] Filers' overall 56% rate of compliance under a very liberal standard shows that neither Filers nor intermediaries are confirming that even the simplest, most objective filing requirements have been satisfied. It is not clear why an intermediary would permit any offering to go forward without having conducted a ministerial, check-the-box review of Reg CF's most fundamental requirements.

The harm of noncompliance is not merely the inadequate and legally insufficient disclosure provided to investors; noncompliant Filers also gain an advantage over compliant Filers. Compliant Filers incur greater costs, bear greater burdens and assume greater disclosure risk than noncompliant Filers. They expose financial information to public scrutiny that they might otherwise prefer to remain confidential. The only disadvantage to noncompliant Filers is the liability. While SEC inaction on this front suggests that SEC enforcement risk is near zero, noncompliant Filers and the intermediaries that host their offerings may have significant exposure to private liability and state enforcement actions.

1) Availability of Rescission Right

The most striking aspect of Filers' noncompliance rate is that investors in up to half of crowdfunding offerings may be entitled to rescission under Section 12(a)(1) of the Securities Act.[86] Under that private right of action, rescission is available to investors who purchase securities in an unregistered offering if no exemption from registration is available.[87] The nature of crowdfunding is such that, if the crowdfunding exemption is not available,[88] the only exemption that an offering set up for crowdfunding could satisfy is the crowdfunding exemption, and the

2019) (hereinafter DreamFunded) (disciplinary proceeding decision). The Panel claimed that Reg CF implies that financial statements are not required for nonoperating companies. *Id.* at 122. The Panel cited no authority in support of its assertion, which is facially implausible and misunderstands the function and content of financial statements. Issuers' financial statements must comply with Generally Accepted Accounting Principles ("GAAP"), which includes no blanket exception for non-operating companies. Nor does any SEC guidance reference such an exception.

85 *See* Cohn, *supra* note 7, at 1438 n.17.

86 Crowdfunding investors may have a private right of action under the Securities Act Section 12(a)(2) as well, but that provision requires, *inter alia*, proof that the loss was caused by a material misstatement or omission (among other difficulties, such as the possible requirement of individual proof of reliance). *See* 15 U.S.C. § 77*l*(a)(2) (2012). Issuer failures will most often be traceable to fundamental causes—e.g., ill-conceived business concept, economic downturn, managerial incompetence or cash flow problems—where it is difficult to show that a specific, materially misleading representation or omission (including, even, unfiled financial statements) caused the loss. *See* Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L.J. 177, 203 (2013); Morsy, *supra* note 4, at 1385–90.

87 *See* 15 U.S.C. § 77*l*(a)(2) (2012).

88 In contrast, a private offering under Rule 506(b) that fails to satisfy that exemption's requirements often may qualify, as a fallback option, for the registration exemption under Section 4(a)(2) of the Securities Act. *See id.* § 77d(a)(2); 17 C.F.R. § 230.506(b) (2019).

accounting failures described above in many—perhaps all—cases would render the exemption unavailable.[89]

Section 12(a)(1) is a strict liability provision in the sense that it does not require proof, for example, of a material misstatement or omission.[90] But whether noncompliance with a term of Reg CF vitiates the exemption is, itself, a kind of materiality question. Insignificant deviations from the conditions of an exemption will not sustain a Section 12(a)(1) claim. Certain deviations related to financial statement requirements may be considered insignificant, but there is a strong likelihood that a court would view a total failure to file *any* financial statements, for example, as significant noncompliance that made the crowdfunding exemption unavailable.

The accounting failures discussed in Part II(A) likely would not fit within safe harbor for insignificant Reg CF noncompliance. The safe harbor absolves an issuer if the "failure to comply [is] insignificant with respect to the offering as a whole," the issuer made a "good faith and reasonable attempt" to comply with Reg CF, and, if the failure resulted from an intermediary's noncompliance with Reg CF, the issuer did not know about the noncompliance.[91] The safe harbor would likely not be available for the accounting noncompliance because the Filer would not be able to demonstrate both that the failure was insignificant and that it made a "good faith and reasonable attempt" to comply. The Commission has stated that "a deviation from certain fundamental requirements in the rules, such as a failure to adhere to the aggregate offering limit under Rule 100(a)(1), presumptively would not be an insignificant deviation that would allow reliance on this safe harbor."[92] Filing complete, appropriately reviewed financial statements would likely also qualify as such a "fundamental requirement."

An aggravating factor for some Filers is that the CEO certified that the "financial statements of [identify the issuer] included in this Form are true and complete in all material respects."[93] If one or more of the four required financial statements is not provided to investors, then the CEO has falsely certified their completeness. An accountant review does not provide cover for a Filer because a review does not confirm the completeness of the financial statements for Reg CF purposes.

In defending a Section 12(a)(1) claim, a nonoperating Filer that had literally no financial information or material footnote revelations to report might argue that its failure to file financial statements should not affect the availability of the crowdfunding exemption.[94] As noted, Section 12(a)(1) liability generally should attach

89 At least one Filer may already have been subject to a rescission claim. *See* Annual Report (Exhibit A of Form C-AR) (Apr. 30, 2018), https://www.sec.gov/Archives/edgar/data/1700829/000170082918000001/formcar2.pdf ("Additionally, the Company rescinded a $50,000 SAFE agreement with no valuation cap or minimum equity financing that was issued in 2016 and returned $50,000 to the investor.").

90 Securities Act of 1933 § 12(a)(2) (codified as 15 U.S.C. § 77*l*(a)(1) (2012)).

91 17 C.F.R. § 227.502(a) (2019).

92 Crowdfunding, 80 Fed. Reg. 71,388, 71,475 (Nov. 16, 2015).

93 17 C.F.R § 227.201(t) instr. 7. *But see* DreamFunded, *supra* note 84, at 122 (finding that CEO certification that financial statements are complete and accurate is consistent with no financial statements having been filed).

94 *See* DreamFunded, *supra* note 84, at 122 (FINRA hearing panel finding that nonoperating issuers are not required to file financial statements).

regardless of, for example, the substantive materiality of omitted financial statements. But the Commission has stated in connection with the safe harbor that: "whether a deviation from the requirements [of Reg CF] would be significant to the offering as a whole will depend on the facts and circumstances of the offering and the deviation."[95] A court might take this approach in evaluating whether accounting noncompliance vitiated the crowdfunding exemption for nonoperating Filers, which would protect a significant number. Courts may be inclined to set a low bar for Filers that have no experience with or expertise in securities offerings. In contrast, courts may set a high bar for intermediaries that, as registered securities professionals, should have a thorough understanding of crowdfunding's regulatory structure and requirements.

2) Intermediary Oversight

Filers' frequent failure to comply with requirements related to financial statements is not so surprising. They may have little or no experience with financial statements, and they may rely on intermediaries to catch filing problems. In contrast, intermediaries have no such excuse. Intermediaries are FINRA-regulated firms for which ensuring issuers' compliance with basic, simple Reg CF requirements should be second nature. They are repeat players that are expected to have expertise in both financial statements and compliance systems. The intermediary requirement was added to the JOBS Act precisely in order to provide greater assurance of reasonable compliance by filers.[96]

Intermediaries' failure to monitor Filers' noncompliance with accounting requirements may reflect the low standard imposed on them by Reg CF. Section 302(b) of the JOBS Act requires that an intermediary "take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, including obtaining a background and securities enforcement regulatory history check . . . ."[97] The plain meaning of this provision is that intermediaries are expected to serve a compliance function.[98] Consistent with that interpretation, Rule 301(a) of Reg CF requires that an intermediary have a "reasonable basis for believing that" an issuer conducting an offering on the intermediary's platform "complies with the requirements of Section 4A(b) of the [Securities] Act . . . and the related requirements of" Reg CF.[99]

---

95 Crowdfunding, 80 Fed. Reg. at 71,475.

96 *See Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcommittee on TARP, Fin. Svcs. & Bailouts of Pub. & Private Programs, Committee on Oversight & Gov't Reform*, 112th Cong. 75–77 (Sept. 15, 2011) (Statement of Mercer Bullard, Associate Prof. of Law, U. of Miss.) (recommending the House crowdfunding bill be amended to require participation of a regulated intermediary for the protection of investors); Cohn, *supra* note 7, at 1439 ("The imposition of the intermediary requirement was motivated by the concern . . . that a regulated intermediary is necessary to limit the potential for fraudulent or otherwise abusive offerings.").

97 JOBS Act of 2012, Pub. L. No. 112-106, § 302(b), 126 Stat. 316 (2012).

98 Heminway, *supra* note 86, at 194–95 (interpreting provision to require that intermediaries "perform due diligence and consolidate information flow" similar to underwriter in a public offering; Congress conferred "certifying functions" on intermediaries "force[d]" on them more directly than same role is forced on underwriters by the Securities Act of 1933).

99 17 C.F.R. § 227.301(a) (2019).

However, Reg CF provides that, "[i]n satisfying [the reasonable basis] requirement, an intermediary may rely on the representations of the issuer concerning compliance with these requirements unless the intermediary has reason to question the reliability of those representations."[100] The "reasonable basis" and "reliance on representations" standards are essentially contradictory. Simply asking an issuer whether it has complied with applicable JOBS Act provisions and Reg CF is not a "basis" for belief in any meaningful sense. The term "reasonable basis" implies a factual evaluation of compliance rather than a mere assertion by the issuer whose compliance is at issue. A representation by an issuer is not a "measure" of the issuer's compliance. A "measure" of compliance would include, for example, determining whether a filer actually filed financial statements, the financial statements had been reviewed by an accountant, or that all four financial statements were included.

In discussing the JOBS Act's "take measures" provision, the Commission focused almost exclusively on background checks,[101] apparently choosing to rely, for example, on an intermediary's "concern for the reputational integrity of its platform" to ensure compliance with other requirements.[102] Intermediaries' record on ensuring that Filers comply with accounting requirements shows that the SEC's reliance on "reputational intermediaries" is a poor substitute for enforcement.[103] One intermediary states that it "has not taken steps to verify the adequacy, accuracy, or completeness of the information"[104] regarding offerings made through its platform. The "measures" required by Congress are precisely the "steps" disavowed by the intermediary.

Rule 301 may create a disincentive for intermediaries to ensure that basic filing requirements are met. Reg CF requires that an intermediary deny platform access to an issuer if the intermediary:

> [h]as a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. In satisfying this requirement, an intermediary must deny access if it reasonably believes that it is unable to adequately or effectively assess the risk of fraud of the issuer or its potential offering.[105]

The phrasing of this requirement may create a disincentive to conduct due diligence that might uncover facts that create a "reasonable basis for believing that the issuer" is a fraud risk, as illustrated in the FINRA enforcement action discussed *infra*.

Reg CF contradicts the purpose of requiring that crowdfunding offerings be conducted through an intermediary, which requirement was added to the original bill by the Senate to ensure that persons with expertise in crowdfunding regulation

---

100 *Id.*

101 *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,461–65, 66,531 (proposed Nov. 5, 2013) (to be codified throughout 17 C.F.R. pt. 200–49); *see also* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 605 (2015) (JOBS Act "only requires funding portals to do one type of due diligence on the companies that wish to list with them: background checks").

102 Crowdfunding, 78 Fed. Reg. at 66,463.

103 *See* Heminway, *supra* note 86, at 185–87.

104 *Disclaimer*, SPORTBLX, https://sportblx.com/disclaimer/ (last visited June 29, 2020).

105 17 C.F.R. § 227.301(c)(2).

would be responsible for ensuring basic compliance.[106] Rule 301(a) effectively strips intermediaries of their primary *raison d'etre*. An intermediary should be required to take steps to ensure that specific requirements for offering materials are satisfied, including the filing of complete financial statements that meet the applicable standard of review.[107]

In a recent enforcement action, FINRA appears to have applied precisely this standard and rejected the proposition that intermediaries can rely solely on an issuer's claim that it has filed required documents.[108] The enforcement action also shows that FINRA staff are closely scrutinizing crowdfunding filings. Although the enforcement action sends somewhat mixed signals, it is clear that portals are required to review issuer filings at least to the extent necessary, for example, to confirm that financial statements are included.

In its decision, the FINRA Hearing Panel stated that an intermediary "is not required to conduct due diligence . . . to obtain [a] reasonable basis" for purposes of Rule 301(a).[109] Yet it found that Rule 301's requirement that access be denied to an issuer that presents the potential for fraud means that an intermediary, "after giving access to its platform,"[110]

> has some responsibility for reviewing the issuer's postings on its platform, because Funding Portal Rule 200(c)(2)(A)(i) prohibits a funding portal from distributing or making available on its website any communication that includes "a false, exaggerated, unwarranted, promissory, or misleading statement or claim."[111]

Under this standard, the Panel found that the portal had a reasonable basis for believing that certain issuers posed a fraud threat. Although the Panel stated that a portal has no separate "general obligation to analyze and evaluate an issuer's financial statements,"[112] it made it clear that a portal has an obligation to "review" these materials[113] and strongly implied that such a review was necessary to be able to form

---

106 *See supra* note 96.

107 *See* CROWDFUNDING REPORT, *supra* note 13, at 29 ("A potential check on issuer noncompliance is the intermediary through which the crowdfunding offering is conducted."); *cf.* JOBS Act of 2012, Pub. L. No. 112-106, § 302(b), 126 Stat. 316 (2012) (intermediaries must ensure offering proceeds are distributed to issuer only if target amount is reached).

108 *See* DreamFunded, *supra* note 84, at 112–13; *see also* FIN. INDUS. REG. AUTH., DISCIPLINARY AND OTHER FINRA ACTIONS 16 (May 2019), https://www.finra.org/sites/default/files/publication_file/Disciplinary_Actions_May_2019.pdf (expelling funding portal for failure to pay annual assessment); FIN. INDUS. REG. AUTH., DISCIPLINARY AND OTHER FINRA ACTIONS 21 (Apr. 2019), https://www.finra.org/sites/default/files/publication_file/Disciplinary_Actions_April_2019.pdf (expelling portal for not providing information); UFP Letter, *supra* note 58.

109 DreamFunded, *supra* note 84, at 32.

110 *Id.* at 33.

111 *Id.*

112 *Id.* at 112.

113 *Id.* at 132 (portal's failure "to implement policies and procedures reasonably designed to achieve compliance . . . derives from the failure to establish written policies and procedures to review issuer filings").

a "reasonable basis" under Rule 301.[114]

The Panel separately rejected claims that the portal had to deny access because of "errors and gaps" because it has no duty to "probe those representations."[115] But it also stated that "an accumulation of errors and gaps in a Form C might be sufficient"[116] to require denial of access, which implies that a portal must review filings to the extent necessary to catch such an "accumulation."[117] At a minimum, it believed that the portal must "look at" an issuer's Form C and deny access if it uncovers facially inadequate compliance.[118]

Notwithstanding diligent efforts by FINRA examiners and enforcement officials, Filers' noncompliance as documented above suggests that intermediaries are not meeting their legal obligations. It is very likely that every crowdfunding intermediary has permitted offerings that, under the Panel's standard, would require denying access to one or more issuers.

3) Adjusted Requirements for Nonoperating Filers

As noted, a large percentage of Filers are nonoperating firms with essentially no financial data to report,[119] which begs the question of why they are required to file financial statements, much less to obtain an outside accountant's review. Footnotes often revealed no useful information about these Filers, especially when little time has elapsed between the end of the period covered by the financial statements and the date the footnotes were prepared.

At the same time that financial statements provide little useful information about nonoperating issuers, they fail to provide critical information regarding an issuer's capital structure, which will often be the most important information that investors need. Potential investors should pay close attention to a nonoperating filer's capitalization because initial capital contributions may be the issuer's only assets and source of liquidity. The amount an issuer receives in return for an initial contribution is generally the sole concrete indicator of the value of what investors are purchasing and their rights in liquidation.

A nonoperating issuer may be capitalized with contributions from founders just prior to the start of an offering. One hundred percent of an issuer's assets at the time of filing therefore may comprise founders' recent contributions, but this information is likely to be omitted from the financial statements because the capitalization occurs after both the end of the most recent fiscal year and the date the financial statements were prepared. In this event, the only disclosure of the capitalization will appear, if at all, in a non-standardized, narrative format in various sections of Form C.

To illustrate, one nonoperating Filer initiated its offering after issuing 2.7

---

114 *Id.* at 133–34 ("It is apparent from his testimony that [the portal's CEO] adopted no systematic review of the issuers' disclosures in order to formulate a reasonable basis for believing them in compliance with their legal and regulatory duties.").

115 *Id.* at 123.

116 *Id.*

117 *Id.*

118 *See id.* at 123, n.596 ("because [the portal's CEO] did not even look at the company's Form C, Respondents had no basis for believing Company A was in compliance.").

119 *See supra* notes 60–61 and accompanying text.

million common shares to its founder for $270. Its financial statements included no financial information other than this initial capitalization. The Filer proposed to issue 83,330 common shares for $1 million, from which it expected to receive approximately $926,000 after offering expenses. It appears that there was no change in the Filer's financial condition between the date of the financial statements and the date of the offering, which means that the Filer would have had shareholders' equity of about $926,000 after the offering. If the Filer liquidated, the founder would receive about $898,000 (having contributed $270), while the crowdfunding shareholders would receive about $28,000 (having contributed $1 million).

In this offering, the Filer's initial capitalization was critical information, but it is hard to derive it from the required disclosure documents. The Filer does not provide its valuation for the firm, explaining instead that "[w]e have not undertaken any efforts to produce a valuation of the company. The price of the common stock merely reflects the opinion of the CEO and management . . . as to what a fair value would be."[120] Based on the Filer's post-offering capitalization, it appears that it has been valued at approximately $30 million, but this figure is not disclosed. Valuation is such an uncertain concept that a simple, standardized, pre-money valuation methodology should be required, such as a valuation that is based on shares outstanding (e.g., the $30 million figure provided above) or a multiple of discounted future revenues or earnings.[121]

Reg CF does not require clear disclosure of an issuer's pre-offering capitalization; nor can investors easily determine its post-offering capitalization. Investors usually must piece together information from the offering materials' discussion of valuation, dilution, financial condition and the type of securities offered to understand what they would own if they made an investment. Additionally, the financial statements may be so stale as to make it impossible for an investor to estimate what an investment might be worth.[122]

---

[120] Offering Circular (Form C) (Sept. 12, 2016), https://www.sec.gov/Archives/edgar/data/1683872/000166516016000089/sondors_materials_page1.pdf; Form C (Exhibit A) (May 16, 2016), https://www.sec.gov/Archives/edgar/data/1674207/000164460016000134/exhibita_mffire.pdf ("Any valuation at this stage is pure speculation."); *cf.* UFP Letter, *supra* note 58, at 4 (expelling registered funding portal in part based on violation of Funding Portal Rule 200(c)(3) prohibiting false or misleading statements because portal "knew that [thirteen issuers'] valuations were arbitrary and baseless."); Offering Statement (Form C) (Jan. 17, 2017), https://www.sec.gov/Archives/edgar/data/1674439/000167443917000001/NextRXOSandC1.pdf (citing seven factors used for valuation; valuation based on weighting of 5 different valuation methods).

[121] *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 938–39 (2011) (discussing importance of standardization for efficient equity crowdfunding).

[122] *See, e.g.*, ComHear, Inc., Offering Memorandum (Exhibit A to Form C) (Apr. 5, 2017), https://www.sec.gov/Archives/edgar/data/1561299/000164460017000050/ComhearOM.pdf and Financial Statements (Exhibit B to Form C) (Dec. 31, 2015), https://www.sec.gov/Archives/edgar/data/1561299/000164460017000050/ComhearFinancials.pdf (offering initiated with 460-day stale financial statements); Juhi LLC, Offering Memorandum (Exhibit A to Form C) (Mar. 13, 2017), https://www.sec.gov/Archives/edgar/data/1699828/000164460017000028/JuhiOMFinal.pdf and Financial Statements (Exhibit B to Form C) (Dec. 31, 2015), https://www.sec.gov/Archives/edgar/data/1699828/000164460017000028/JuhiFinancials.pdf (offering initiated on March 13, 2017 with 437-day stale financial statements and closed on May

Issuers should be required to include financial statements for their most recently ended fiscal year in their initial offering materials, regardless of whether 120 days have passed since the end of the year. When a company is subject to an ongoing obligation to produce financial statements, it is reasonable to allow 120 days to prepare financial statements for the immediately preceding fiscal year because the company does not control the timing of the disclosure. The end of the fiscal year arrives, and the disclosure clock starts ticking. But this is not the case for crowdfunding issuers. The deadline for filing initial financial statements is a function of the filing date, which the issuer controls. If an issuer needs more time to prepare financial statements, it can delay its offering until its financial statements have been prepared. This delay would be least burdensome for a nonoperating issuer, which has virtually no information to gather. Currently, Reg CF allows an issuer to use its control over the timing of an offering to avoid disclosure of financial statements covering up to 16 months prior to the offering. For updated financial statements filed in the course of an offering, issuers would have up to 120 days after the end of the fiscal year to file.

The costs and burdens of filing financial statements can also be reduced. Rather than file financial statements, a nonoperating issuer's CEO could certify that the issuer: (1) had not engaged in any operations as of the date of the offering, and (2) as of the end of the most recent fiscal year, had no revenues and no more than $1,000 in total assets, liabilities or shareholders' equity.[123] The CEO could also certify a capitalization table that is current as of the date of the offering and includes the issuer's current and post-offering pro forma capitalization. When contingent securities are offered, the pro-forma capitalization would be provided on a post-offering and post-conversion basis.

This revised approach would have significant advantages for nonoperating issuers. It would delay—and, where an offering never gained traction, eliminate—the costs and burdens of preparing financial statements for the issuers that were least able to afford them. At the same time, investors would receive more current disclosure of the most critical financial information to consider before investing in a nonoperating filer: its capital structure as of the date of the offering.

4) Accounting Standards Based on Investor Commitments

The costs and burdens of financial statement requirements could be further reduced by delinking the standard of review from the issuer's maximum raise. One reason that the Commission linked the review standard to the maximum raise is that the more that is raised in an offering, the greater the potential loss to investors.[124]

1, 2017).

123 A potentially distorting effect of this approach is that founders might put off capitalizing an issuer that had no other assets until after the initial filing in order to avoid triggering a higher standard of review. However, this incentive would be mitigated by the requirement that an issuer amend its offering materials to reflect a material change in the issuer's financial condition. Additionally, an offering for an issuer to which founders have committed capital presumably would be more attractive to investors, *ceteris paribus*.

124 Section 3(b) of the Securities Act provides the statutory authority under which the Commission could have created a non-legislated crowdfunding regime. *See* 15 U.S.C. § 77c(b) (2012) (authorizing exemption if Commission finds that registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited

It also assumed that issuers that sought to raise more could more easily afford the cost of an accountant review.[125] Neither assumption is consistent with the empirical evidence.

The amount sought by issuers bears little relationship to the capacity of an issuer to pay for an accountant. As discussed below, Filers with substantial assets frequently sought no more than $100,000, while Filers with zero or close to zero assets routinely sought to raise $1,000,000. However, many Filers that could afford an accountant review avoided that requirement by tactically setting their maximum raise at $100,000. Many asset-poor Filers incurred the cost of a review solely because they sought more than $100,000.

The amount sought by Filers had little to do with the amount raised. Filers sought more than $100,000 in 71% of their initial offerings, but only 38% raised more than that amount. In 46% of initial offerings, Filers sought $1 million; yet only 5% raised that amount.

Filers often chose their maximum raise based on the trigger for accountant-reviewed financial statements. Figure 6 shows the distribution of the initial maximum raise amounts set by Filers.[126] Filers in 97 of 347 initial offerings (28%) set their maximum raise at or just below the amount that would require an accountant review of their financial statements (the "$100,000 group").[127] Another 32 Filers (9%) appear to have set their maximum raise at just below the amount that they incorrectly believed would trigger an audit.[128] The largest group—74 Filers—set their maximum amount at or just below the crowdfunding limit of $1 million.

The extreme concentration of maximum raises at or just below $100,000 strongly suggests that a large number of Filers chose their maximum raise in order to avoid an accountant review. Filers demonstrated an inclination to set their maximum raise at a multiple of $100,000 or a midpoint,[129] but this preference cannot explain the size of the $100,000 group. Their choice likely reflects the balancing of the burdens, cost and potential delay of, and potential scrutiny resulting from, an accountant review, against the likelihood of raising more than $100,000.

---

character of the public offering.").

125 *See* Crowdfunding, 80 Fed. Reg. 71,388, 71,418 (Nov. 16, 2015) (explaining the audit exemption for first-time issuers: "for issuers undertaking a first-time crowdfunding offering of more than $500,000 but not more than $1 million, the benefits of requiring audited financial statements are not likely to justify the costs.").

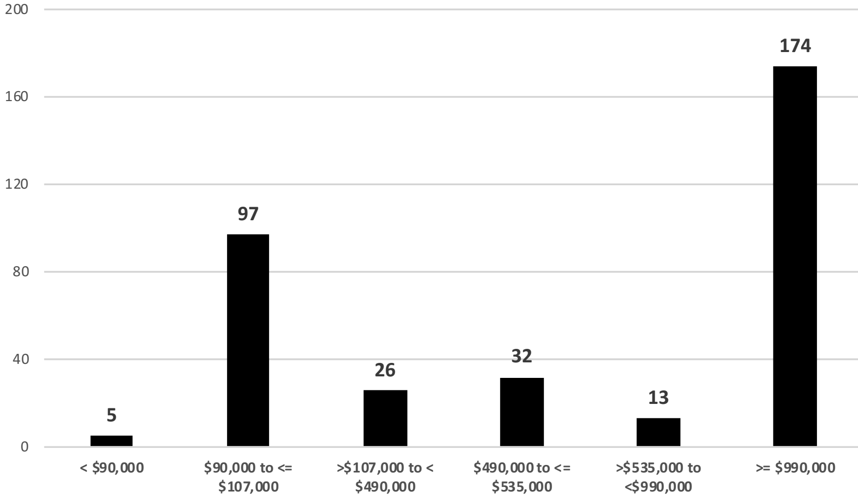
126 This analysis focuses on initial offerings because the maximum raise in follow-on offerings can be distorted by the outcome of a prior offering.

127 As a reminder, this Article generally refers to the $100,000, $500,000 and $1,000,000 offering amounts to include the updated limits of $107,000, $535,000 and $1,070,000, as appropriate. *See supra* note 26. Thus, maximum raises at or close to an amount comprise those ranging from $90,000 to $107,000, $490,000 to $535,000, and $990,000 or greater. The number of Filers that set their maximum raise at exactly the amount of the applicable limit is 80 at $100,000, 3 at $107,000, 30 at $500,000, and 158 at $1 million.

128 In fact, an audit may be triggered for an offering only if the filer has previously issued crowdfunding securities. *See supra* note 26 and accompanying text.

129 Eighty-five percent of Filers chose one of the following amounts (frequency) in their initial offering: $100,000 (80), $200,000 (4), $250,000 (2), $300,000 (5), $400,000 (4), $500,000 (30), $600,000 (3), $750,000 (6), $800,000 (1), $900,000 (1), $1,000,000 (158).

Figure 6: Distribution of Maximum Raise



If an issuer's maximum raise were a good proxy for its ability to pay for an accountant, then, *ceteris paribus*, cash-poor Filers would be over-represented, and cash-rich Filers would be under-represented, in the $100,000 group. In fact, Filers that reported holding no cash at the end of their most recent fiscal year accounted for 30% of the $100,000 group—only one percentage point higher than their proportion of the total population at 29%. At least one survey found that accounting costs averaged $3,289, yet 70 of the 99 Filers that held zero cash set their maximum raise at more than $100,000, despite their apparently being in a poor position to pay for an accountant review.

Conversely, a significant number of Filers that were better able to afford an accountant review took advantage of the opportunity to submit only CEO-certified financial statements. Thirty-six of the 97 Filers with a maximum raise at or just below $100,000 held more than $100,000 in assets; ten held more than $500,000 in assets; nine held more than $100,000 in cash; 23 held more than $25,000 in cash. For example, one Filer that sought to raise $100,000 reported $1,625,200 in assets and $29,079 in cash and raised more than $1.7 million in Reg D offerings in the five years preceding the Reg CF offering.

All other things being equal, a zero-cash Filer that seeks more than $100,000—thereby triggering the accountant review requirement—should be more likely to seek to raise $1 million, the maximum allowed in their initial offering. The reason is that, by raising more in an initial offering, when audited financial statements are never required, an issuer can reduce the risk of triggering an audit in a follow-on offering, i.e., it can reduce the risk that it will need to raise more than $500,000 in a follow-on offering. This risk is greater for issuers that are less able to pay for an audit.

A zero-cash Filer therefore has a stronger incentive to game the rules by seeking to raise $1 million when it otherwise might seek less—a mirror image of its distorted incentive to seek to raise $100,000 when it otherwise would seek more. However, the percentage of Filers with zero cash that preferred a $1 million maximum raise

was *lower* than for Filers with a non-zero cash position. Sixty percent of zero-cash Filers that sought more than $100,000 chose a $1 million maximum raise compared to seventy-four percent of non-zero-cash Filers.

The data are consistent with (but by no means prove) the view that accountant-review avoidance is not a function of a Filer's ability to pay for an accountant. Rather, the bunching at a maximum raise of $100,000 more likely reflects a strategic decision not to waste money on an accountant when the Filer was not likely to raise enough funds above $100,000 to require that it hire one.[130] As market participants told the SEC staff, "many new companies are not able to bear [Reg CF] costs given the uncertainty regarding whether they would raise capital successfully."[131] If the level of accounting standards required in an offering is to be based on the cost to issuers, it should be tied to the issuer's assets or cash, not its maximum raise.[132]

A second reason that the Commission based the financial statement standard on the maximum raise is that the maximum raise reflects the potential loss to investors. However, the amount of an issuer's maximum raise is a poor predictor of the potential loss. In 174 of the 347 initial offerings in the Sample, the Filer set its initial maximum raise at or close to $1 million. Seventy-nine of those offerings failed. Another 14 raised no more than $100,000, which means that more than half of Filers would not have needed to pay for an accountant review if they had sought no more than $100,000 from the outset. Another 50 Filers raised between $100,000 and $500,000, which, for a follow-on offering, would require only an accountant review (although some Filers might not have sought $1 million if doing so would have required audited financial statements).[133] Only 25 offerings—16% —raised more than the $500,000 that could require audited financials. By this measure, the $1 million maximum raise trigger predicts the potential loss to investors only 16% of the time.

The amount of an offering's investor commitments would more accurately represent the potential loss to investors than the maximum raise while also eliminating wasteful strategic behavior. For example, under current law an issuer that cannot afford an accountant review will seek no more than $100,000, even if it could raise more if there is significant interest in the offering. Currently, if an issuer needs to raise more than $100,000, it has an incentive to seek far more than it needs in order to reduce the likelihood of having to provide audited financial statements in a follow-on offering.[134] These incentives likely lead to issuers raising more or less

---

130 This assumes that the motivation for bunching is cost rather than the risk of an accountant review's uncovering opportunistic behavior. An analogous form of bunching occurs when public companies manipulate their public float so as to avoid triggering heightened accounting standards. *See, e.g.*, Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices*, 65 J. FIN. 1163, 1172–74 (2010).

131 CROWDFUNDING REPORT, *supra* note 13, at 30; *see also* Crowdfunding, 80 Fed. Reg. 71,388, 71,413 (Nov. 16, 2015) (for Reg CF issuers, "the benefits of requiring audited financial statements are not likely to justify the costs").

132 Similar recommendations were made pursuant to rulemaking. *See* Crowdfunding, 80 Fed. Reg. at 71,411–12.

133 *Id.* at 71,414 (citing commenter's claim that an accountant review is only 60 percent of the cost of an audit).

134 It is self-evident that under-funding as a result of choosing a $100,000 maximum raise

than they otherwise would in order to game the financial statement standard.

Basing the financial statement standard on the amount of investor commitments would also reduce costs and burdens for issuers. Issuers would not incur the cost of an accountant if they never received commitment in excess of $100,000. The Reg CF requirement that issuers provide updates on the progress of an offering provides an efficient means by which ongoing commitments by investors can be monitored. When commitments exceed $100,000, the issuer would file accountant-reviewed financial statements (or audited for more than $500,000 in commitments). If commitments were the trigger for the higher financial standard, the issuer could, from the initial filing, fix its maximum raise at the amount it actually sought and possibly avoid having to obtain investor recommitments if the updated financial statements do not constitute a material change.

If filed investment commitments were the trigger for financial statement standards, issuers would not have to pay for an accountant review or audit without knowing whether it will raise enough funds to make the offering worthwhile. Every offering would begin with CEO-certified financial statements. When an offering failed, the issuer could cancel it without having incurred any accountant costs. Issuers would likely set the maximum raise at the amount they would ideally raise and explain the use of proceeds for the full amount. The data cited above suggests that many issuers might seek to raise more if doing so did not automatically trigger a higher standard of review or raise less than $1 million if doing so would have no effect on the standard applied in a follow-on offering.

B. *Annual Reports*

Most Filers did not comply with Reg CF's annual report requirement. As discussed below, only one quarter of Filers that were required to file two annual reports did so. Their compliance level would likely be lower if the third annual report were included and substantially lower if a strict definition of "compliance" were applied.[135] Many annual reports were filed but materially incomplete.

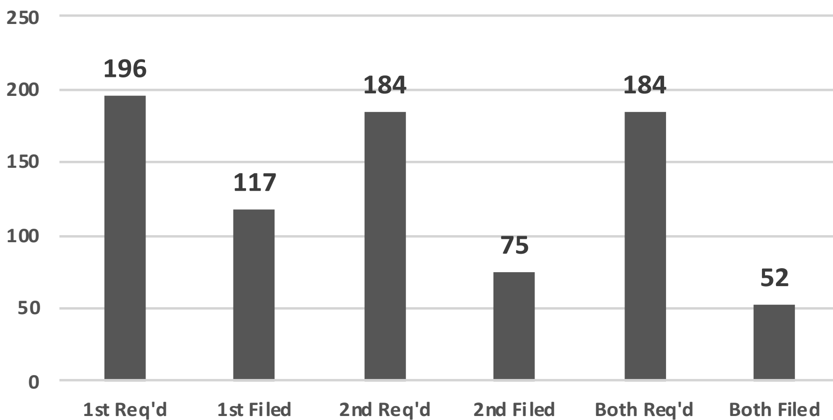
---

could increase the likelihood of failure due to insufficient funds. In the donative crowdfunding space (e.g., Kickstarter), *over-funding* has been found to be correlated with a higher failure rate. Tanya M. Marcum & Eden S. Blair, *Over- and Under-Funding: Crowdfunding Concerns of the Parties Involved*, 16 DEPAUL BUS. & COMM. L.J. 1, 17–18 (2017) ("receiving too much funding may make it harder to pursue the project than getting just the right amount").

[135] *Cf.* Hanks, *supra* note 8 (treating compliance as requiring that all financial statements be filed and comply with GAAP, a signature is included, and information is not missing (e.g., risk factors or list of directors)).

As shown in Figure 7, only 61% of the 196 successful Filers submitted their first annual report.[136] Only 41% of Filers that were required to submit a second annual report did so. The compliance rate for Filers that were required to file both reports was 28%.[137] Although some noncompliant Filers may have failed prior to the deadline for an annual report, the SEC staff "did not find indications of bankruptcy proceedings among issuers that reported completed crowdfunding offerings in 2016–2017 with no subsequent EDGAR filing activity in 2018."[138] The staff observed that some bankruptcies were likely to have occurred, however, citing a Labor Department estimate that the one-year survival rate for private firms in 2013 was 80%.[139]

Figure 7: Annual Report Compliance



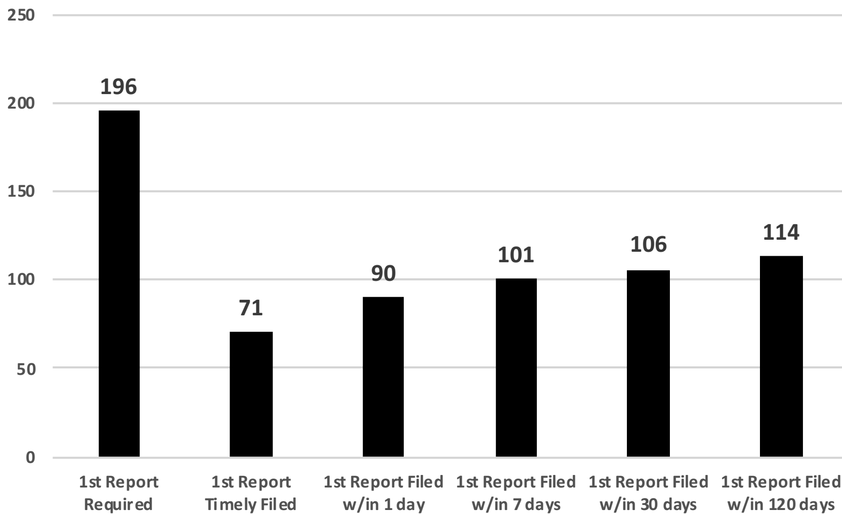
---

136 As discussed above, *supra* notes 39–43 and accompanying text, this analysis assumes that, if an offering concluded without having filed financial statements for the most recent fiscal year, it was required to file its first annual report for that fiscal year.

137 These data treat four nominal filings of a first annual report and two nominal filings of a second annual report as not having been filed. These Filers submitted only Form C with most or almost all required information missing, and no financial statements included. *See, e.g.*, Annual Report (Form C-AR) (Apr. 30, 2018), https://www.sec.gov/Archives/edgar/data/1690631/000169063118000002/updatefinancials2017.pdf. Annual reports that were missing other information were treated as compliant.

138 CROWDFUNDING REPORT, *supra* note 13, at 45.

139 *Id.* at 45–46 (citing *Survival of Private Sector Establishments by Opening Year*, U.S. BUREAU OF LABOR STATISTICS, https://www.bls.gov/bdm/us_age_naics_00_table7.txt (last visited May 18, 2020)); *cf.* Crowdfunding, 80 Fed. Reg. 71,388, 71,488–89 (Nov. 16, 2015) (citing studies on failure rates); Scott A. Shane, *Failure Is a Constant in Entrepreneurship*, N.Y. TIMES: YOU'RE THE BOSS (Jul. 15, 2009 5:00 PM), http://boss.blogs.nytimes.com/2009/07/15/failure-is-a-constant-in-entrepreneurship/ (showing 1-year survival rate as approximately 80%; "[a]ccording to U.S. Census data, only 48.8[%] of the new establishments started between 1977 and 2000 were alive at age five"). The UK's Alternative Investment Market ("AIM") is often compared to the U.S. crowdfunding market. *See generally* Ibrahim, *supra* note 101. AIM listings have experienced a negative return overall and in about one-third of IPOs investors lost at least 95% of their investment. *See* Claer Barrett, *AIM—20 Years of a Few Winners and Many Losers*, FIN. TIMES (June 18, 2015), https://www.ft.com/content/ea2bd724-140c-11e5-abda-00144feabdc0.



The data in Figure 7 above assume late-filed annual reports to be compliant regardless of whether they were timely filed. As shown in Figure 8, only 71 of 196 successful Filers (36%) filed their first annual report on time. Another 19 filed within one day of the deadline, bringing the one-day compliance rate to 46%. By comparison, one study found that the one-day compliance rate for reporting company 10-K and 10-Q filings was 99%.[140] Only 55% of all successful Filers filed within 30 days of the deadline.

Although the Crowdfunding Report purported to assess "issuer and intermediary compliance,"[141] it is silent on the level of annual report noncompliance. Nonetheless, various data points in the Report, combined with data collected for the Sample, allows for a very rough estimate of compliance with the first annual report requirement.[142] The staff's sample included 519 successful offerings, and the staff found that 252 annual reports were filed by issuers by the end of 2018.[143] Assuming that the distribution of successful offerings was the same as the distribution of all offerings in 2016, 2017 and 2018,[144] there would have been approximately 275

140 Samer Khalil et al., *Bond Market Reaction to Untimely Filings of 10-K and 10-Q Reports* 9, 29 (Oct. 23, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3038837.

141 CROWDFUNDING REPORT, *supra* note 13, at 27.

142 The part of the Report that discusses the financial performance of issuers reveals that "[a]pproximately two-thirds of issuers that reported completing a crowdfunding offering in 2016–2017 made at least one filing on EDGAR in 2018." *Id.* at 44–45. An estimate of annual report compliance could be derived from this data, but it would be far less reliable than the estimate provided below.

143 *Id.* at 15 tbl.1, 28 n.69 (519 successful issuers filed an annual report; 20 filed a termination notice).

144 *Id.* at 14 (292 (22%), 557 (41%), and 502 (37%) offerings filed in, respectively, 2016, 2017 and 2018). It should be noted that these are offerings initiated, whereas successful offerings have been completed. A typical offering will be completed in about four months, which means that this approach almost certainly overestimates the number of successful offerings in 2016 and very likely overestimates the number of successful offerings in 2017.

successful offerings in 2016 and 2017 where at least one annual report would have been required to be filed before the end of 2018. In the Sample, 38% of annual reports that were filed were second reports. Assuming that the same proportion is approximately accurate for the 252 annual reports filed by issuers in the staff's sample, about 157 would have been first annual reports, which would mean that the compliance rate for the first annual report filing requirement would have been approximately 57%, which is very close to the 60% rate for the Sample.

Filers are prohibited from conducting a follow-on offering without first catching up on annual reports, but this rule was sometimes ignored in law or in spirit. One Filer that had never filed an annual report conducted two successful offerings in the interim.[145] Another conducted three successful offerings without ever having filed an annual report.[146] Others initiated a second offering without having filed the required annual reports.[147] Some Filers appear to have consciously (and legally) sought to avoid filing an annual report by conducting a follow-on offering that ended in the month before their second report was due, and then failed to file that report.[148] This strategy allowed the Filers to raise additional capital without having to file financial statements for their most recently ended fiscal year.

Some Filers were not required to file a second annual report because they terminated their filing obligation.[149] Reg CF allows termination if, *inter alia*, an issuer

145 *See* Magnabid, Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1699829 (showing Forms C filed on Mar. 12, 2018 and June 13, 2018, along with Progress Updates, but no Form C-AR Annual Report) (last visited Mar. 4, 2020).

146 *See* PlantSnap, Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1699476 (Form C filed Mar. 17, 2017, Form C filed Nov. 6, 2017, and Form C filed Mar. 20, 2018; third offering closed April 30, 2018, first annual report filed Sep. 6, 2019) (last visited May 20, 2020).

147 *See* CHRGR Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1702784 (second offering 16 days after missing deadline to file second annual report) (last visited May 18, 2020); FenSens, Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1695816 (second offering initiated eight months after second annual report due that was never filed) (last visited May 18, 2020).

148 *See, e.g.*, Charron Favreau LLC, EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1698872 (second Form C filed Feb. 19, 2019, no subsequent annual report filed until Apr. 24, 2020) (last visited May 18, 2020); VirZoom, Inc., Amended Offering Statement (Form C/A), https://www.sec.gov/Archives/edgar/data/1639511/000167025419000234/document_1.jpg (filed Apr. 19, 2019 with a Apr. 30, 2019 offering deadline); GeoOrbital Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0001706908&owner=exclude&count=40 (Dec. 11, 2018 deadline) (last visited June 29, 2020); Happy Tax Franchising, LLC, EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1690781 (Annual Report filed Oct. 25, 2017) (last visited June 29, 2020); *see also* Los Angeles SuperStars, Inc., EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1706788 (conducting follow-on offering without ever filing an annual report for prior offering) (last visited May 18, 2020).

149 This compliance analysis assumes that a termination notice must have been filed prior to the date the report was due for the issuer to be eligible to terminate. If this is not the case, the annual report compliance rate would be higher because some Filers that filed neither a second annual report nor a termination notice would have been eligible to terminate, most likely due to having filed their first report and having no more than 300 shareholders. The annual report

has filed at least one annual report and has fewer than 300 holders of record. A termination notice was filed in 15 offerings.[150] Four were not effective because the notice was filed after the second annual report was due. Three did not qualify for this exclusion because the Filer did not file its first annual report, but they were treated as effective for this analysis because the Filer could have been eligible to terminate for other reasons. The issuer is required to file the termination notice within five business days after becoming eligible, but there is no way to evaluate the timeliness of a notice because the notice does not indicate the issuer's number of shareholders. Nor does it require disclosure of the basis for termination.[151]

It is possible to estimate roughly the potential effect of the termination option. The number of investors was available for 151 of 196 successful offerings conducted by 148 Filers.[152] Most Filers had only a handful of other investors at the time of their offering, so assuming that a Filer did not add a significant number of shareholders after the initial offering, the number of investors in the initial offering can be used to create a rough estimate of the number of Filers that had fewer than 300 shareholders after an offering and therefore were eligible to terminate their reporting obligation. Ninety-two Filers had fewer than 290 investors in their crowdfunding offering or offerings. This means that, allowing for up to ten other shareholders, about 61% could have terminated immediately after their offering closed assuming that they filed their first annual report.[153]

For the 11 Filers assumed to have filed an effective termination notice, the number of investors was available and did not exceed 290 in eight cases. That leaves 84 of 148 Filers that could have terminated but did not, assuming that each filed its first annual report. Of this group of 84, 36 filed a second report and 48 did not. Thus, only approximately 10% of Filers that could have terminated exercised that option. Thirty-one Filers that did not file a second report had more than 290 shareholders.

Routine noncompliance with the annual report requirement calls for significant reforms, both to strengthen compliance and make the annual report more useful

compliance rate would not necessarily be substantially higher because many Filers counted as failing to file a required second annual report did not file their first report or had more than 300 shareholders. Even if 20% of Filers failed in their first year they might not have dissolved "under state law." *See supra* note 139. However, for each additional compliant Filer, there would be an instance of noncompliance with the termination notice. Annual report and termination notice filings are a kind of zero-sum set.

150 *Cf.* CROWDFUNDING REPORT, *supra* note 13, at 28 n.69 (through the end of 2018, 252 annual reports and 20 termination notices were filed).

151 Reporting can also be terminated if an issuer has (1) repurchased or paid in full all outstanding CF securities, (2) dissolved, or (3) become a reporting company (although the latter would be obvious due to SEC filings under the 1934 Act on EDGAR).

152 One Filer provided the name of every investor in its offering in its annual report. Ohos, Inc., Annual Report (Form C-AR) (Apr. 30, 2018) https://www.sec.gov/Archives/edgar/data/1681286/000167025418000186/document_3.jpg.

153 This does not include Filers that became eligible to terminate for other reasons, such as dissolution under state law. CROWDFUNDING REPORT, *supra* note 13, at 45 (in search of bankruptcy filings, "we did not find indications of bankruptcy proceedings among issuers that reported completed crowdfunding offerings in 2016–2017 with no subsequent EDGAR filing activity in 2018").

for investors, while also making the report less burdensome for filers by limiting the information required to what investors need to know. This challenge is greater than for offering materials because the intermediary relationship with the issuer will usually have ended, although intermediaries could be made responsible for permitting follow-on offerings where catch-up annual reports have not been filed.

1) Annual Report Enforcement

A possible cause of Filers' disregard of their annual report obligations may be the SEC's indifference. The Commission took no public steps to enforce annual report obligations. Nor is there evidence that they made efforts behind the scenes to promote compliance during the Sample period. In fact, noncompliance *increased* slightly during this period, with the two-report compliance rate falling from 29% to 27% from first 173 to the last 174 initial offerings. It is possible, however, that the rate of compliance has changed since July 2017.

In the absence of any meaningful enforcement risk, issuers have little incentive to file annual reports. Nor does Reg CF create any incentive to file. An issuer cannot make a follow-on offering unless it is current as to its two most recent reports, but it can remove this impediment simply by filing catch-up reports. If it has skipped three reports, the third never needs to be made up. Although written as a punitive measure, issuers may interpret the catch-up provision as a signal that they need not pay attention to the annual report requirement unless and until they conduct a follow-on offering.

The low level of annual report compliance demonstrates that issuers need stronger incentives to comply. Issuers that fail to submit an annual report could be prohibited from conducting a follow-on offering until one year after all required reports had been filed. When an issuer files a new Form C, EDGAR could automatically determine whether the issuer has previously issued crowdfunding securities and, if so, whether its annual reports have been timely filed. Form C would be rejected if the issuer had not filed a required annual report, or if less than one year had passed after it had filed a late annual report. Additionally, intermediaries should be held responsible for offerings conducted in violation of annual report catch-up requirements.

To the extent the SEC's non-enforcement of annual report requirements reflects scarce resources, it could improve compliance through inexpensive, automatic monitoring of EDGAR filings. Filers whose annual report deadline was approaching could be sent automatic email reminders, followed by more stern warnings that require a response if a timely report was not filed. If a report is not submitted within 30 days, any pending crowdfunding offering by the issuer should be automatically cancelled. If these methods do not improve compliance, the Commission could bring an exemplary enforcement action and/or issue a Report of Investigation under Section 21(a) of the Exchange Act.[154] FINRA could require that intermediary procedures include additional processes to ensure annual report catch-up

[154] *See, e.g.*, SEC. & EXCH. COMM'N, No. 84429, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING CERTAIN CYBER-RELATED FRAUDS PERPETRATED AGAINST PUBLIC COMPANIES AND RELATED INTERNAL ACCOUNTING CONTROLS REQUIREMENTS (Oct. 16, 2018), https://www.sec.gov/litigation/investreport/34-84429.pdf.

compliance and amend its rules to specifically prohibit portals and broker-dealers from hosting a crowdfunding offering unless and until they have confirmed that the issuer has submitted all required annual reports and that the reports are complete in all material respects.

2) Three Years of Annual Reports

As noted, it appears likely that a majority of crowdfunding issuers are eligible to terminate reporting after their initial report. Thus, if every issuer took advantage of the termination option, and many likely would if the annual report requirement were enforced, investors in more than half of offerings would receive only one annual report. The termination option essentially eviscerates investors' right to monitor their investments for a reasonable time after a public offering.

The Commission based the 300-shareholder termination option partly on the similar right of a public company to deregister once it has fewer than 300 shareholders.[155] But that situation is not analogous. Public companies rarely deregister after having issued only one annual report.[156] They often have a multi-year record on which investors in the initial public offering ("IPO") can evaluate their investment and protect their rights.[157] Firm survival rates may be higher in the first few years after an IPO because IPO proceeds provide a buffer for newly public firms.[158]

In contrast, Reg CF allows crowdfunding issuers—apparently, a substantial majority of them—to conduct a public offering and go dark only *one day* after the offering is completed.[159] In the Sample, more than half of successful Filers had fewer than 290 shareholders after their offering. The termination right does not reflect the dramatic change in circumstances that normally precedes a public company's deregistration. Rather, it makes the annual report obligation the exception rather than the norm.

First-time issuers that sell securities with contingent rights, such as SAFEs, crowd notes, convertible securities and revenue participation interests, should be required to provide three years of reports to ensure that investors receive information necessary for them to determine whether issuers are honoring their obligations. The owner of a revenue participation interest who is entitled to a monthly share of revenues needs a certified accounting of the amount of the issuer's revenues. Owners of convertible securities and crowd notes need to know whether conversion events have occurred. SAFE holders need to know whether a financing event that triggers their right to equity has occurred. Reg CF gives them no

---

155 *See* Crowdfunding, 80 Fed. Reg. 71,388, 71,421 (Nov. 16, 2015) ("300 shareholder threshold reflected in Rule 202(b)(2) is consistent with the threshold used to determine whether an Exchange Act reporting company is eligible to suspend its Section 15(d)").

156 Less than five percent of firms failed within one year of their U.S. IPO from 1985 through 2006, and more than 80% survived at least three years. Utpal Bhattacharya et al., *Firm Mortality and Natal Financial Care*, 50 J. FIN. & QUANTITATIVE ANALYSIS 61, 71 tbl.1 (2015).

157 *See id.*

158 *See* Madeleine I. G. Daepp et al., *The Mortality of Companies*, 12 J.R. SOC. INTERFACE 1, 3 (2015).

159 For example, a calendar-year FY filer that completes an offering to 250 shareholders on April 30 without having filed financial statements for the preceding fiscal year would be required to file its annual report no later than May 1. It could terminate reporting the same day.

enforceable right to the information they need to protect their rights.

Surviving companies with outstanding crowdfunding securities should not be allowed to go dark soon after conducting what is, in almost every case, their IPO. Almost no crowdfunding issuers have previously conducted a public offering prior to their initial offering. After an issuer first takes advantage of the public securities market, it should be required to provide at least minimal information for at least three years. This burden could be reduced by applying only to an issuer's initial crowdfunding offering.

Furthermore, an annual report covering a fiscal year that ended fewer than 121 days prior to the closing date of the offering should not be counted toward the minimum number of annual reports. The primary purpose of an annual report is to allow investors to monitor their investments. A report that can be issued as little as one day after an offering closes provides no information about the post-offering financial situation of the issuer. Rather, it provides information about the issuer's past, including financial statements for the preceding fiscal year that investors should have been able to consider before making the investment.

The logical accompaniment to this reform would be to eliminate the requirement for an annual report for the fiscal year immediately preceding their offering year. Instead, issuers would be required to provide CEO-certified financial statements for that fiscal year no later than 120 days after it ends, which could be CEO-certified if post-offering. Other information in the annual report would not be useful to investors so soon after an offering closes, so it would be omitted from this filing. The issuer's first annual report then would not be due until 120 days after the end of the fiscal year in which the offering ends.

3) Abridged Reporting

Reg CF annual reports can be substantially abridged, as they require more information than investors need. Requiring annual reports for public companies is partly justified on the ground that investors continue to make investment decisions on the basis of the reports. In contrast, crowdfunding interests are restricted securities for which no market exists one year following an offering and virtually no market is likely to exist thereafter.[160] There is little, if any, need for annual reports to enable investors to make investment decisions about the crowdfunding securities that they own. Reducing the requirements for annual reports would reduce costs and burdens for issuers, lead to greater compliance, and reduce overlap with other filings.

Most annual reports submitted by Filers were cluttered with information that is not required, such as risk factors and offering terms.[161] Many Filers simply file their Form C with updated financial statements and little else. These reports usually refer to the already completed offering in the future tense, as if the filing is an

---

[160] CROWDFUNDING REPORT, *supra* note 13, at 21 n.56 ("secondary trading market for crowdfunding securities was generally non-existent.").

[161] *See, e.g.*, Napa Valley Limoncello Co., LLC, Annual Report (Form CA-R) (Nov 30. 2018), https://www.sec.gov/Archives/edgar/data/1557286/000155728618000001/formcar-2.pdf (18 of 41 pages devoted to risk factors); Daplie, Inc., Annual Report (Form C-AR), (Oct. 30, 2017) https://www.sec.gov/Archives/edgar/data/1674374/000144586617001492/FormC_AR.pdf (14 of 77 pages devoted to risk factors).

offering document rather than a report. One reason for bloated annual reports is that Form C is also used for annual reports (Form C-AR). Many Form C-AR items are not related to investors' ability to protect their interests, such as details about officers, directors and 20% beneficial owners; the description of the business and business plan; the number of employees; and material factors that make an investment in the issuer "speculative or risky."[162]

At the same time that superfluous information is required, the report omits important information, such as compensation received by the intermediary in an offering.[163] Form C-AR does not make it sufficiently clear that disclosure of the amount raised in previous offerings must be separately provided for each exemption. Filers routinely combined the number of securities and amount raised under Reg CF and Rule 506(c), notwithstanding that they are separate exemptions and usually securities with different terms.[164]

What crowdfunding investors need most in an annual report is information that relates to their rights as investors. As noted above, the owners of contingent interests, such as convertible securities, crowd notes and SAFEs, need to know if the contingencies on which payment or issuance of equity are based have occurred. Determining whether contingent rights have been triggered and, if so, unraveling the resulting obligations of an issuer are complex tasks, and issuer obligations may be difficult to enforce, which makes it imperative that investors in these instruments have the information they need to protect themselves. Under Reg CF, in most cases investors may receive this information for only one year. In cases where an annual report is filed immediately after an offering closes, they are not entitled to receive *any* of this information because it is essentially backward looking. And it is the issuers who are most likely to short-change investors that will benefit most from not being required to provide any information about their post-offering financial situation.

In contrast, when an issuer sells conventional promissory notes that have no provisions that imply an ability to monitor the issuer (e.g., events of default based on financial ratios), there is a reasonable argument for eliminating the annual report requirement. Note holders have a specific contractual right to periodic interest payments. They will necessarily know if an issuer fails to make a payment, and the breach is straightforward and relatively easy to enforce.

In many cases, investors need only receive financial statements. That information goes a long way toward protecting investors, but in some cases it will not be sufficient. For example, financial statements are generally inadequate as a vehicle for informing investors in crowd notes and SAFEs about events that may have triggered rights attached to those securities. If an issuer sells such complex securities, it should be responsible, in addition to filing financial statements, for clearly disclosing the status of investors' rights in its annual report, a standard that currently is not met in offering documents, much less the annual report. If issuers choose to offer

---

162 *E.g.*, 17 C.F.R § 227.201(f).

163 This information must be disclosed in Form C. *See id.* § 227.201(o).

164 *See, e.g.*, Corsica Innovations, Inc., Annual Report (Form C-AR) (April 30, 2018) (reporting combined proceeds of offerings) https://www.sec.gov/Archives/edgar/data/1687516/000168751618000001/corsicaformcar.pdf.

crowdfunding securities with terms that extend beyond the deadline for the third annual report, the reporting obligation should continue as long as any securities remain outstanding.

4) Termination Notice

Reg CF's lax approach to termination notices may account for the small number of issuers that take advantage of this option. An issuer loses nothing if it does not file the termination notice before its annual report filing deadline because the Commission has indicated that it will give effect to a termination notice, regardless of when it is filed, for purposes of applying the annual report catch-up provision. An issuer can file a termination notice for an annual report due almost two years earlier (while Reg CF purports to require filing within five days of the issuer's eligibility to terminate) and be relieved of having to file any catch-up report before conducting a follow-on offering.[165] The termination notice thereby operates retroactively, in effect, to terminate reporting.

If the termination option is retained, issuers should be permitted to file it at any time during the fiscal year to which it applies, rather than within five days, provided that the issuer is eligible to terminate at the time the notice is filed. A termination notice should not apply retroactively for any purpose. Investors are entitled to know whether the non-filing of an annual report is due to an issuer's becoming eligible to terminate, noncompliance, or some other reason. Investors can then make an informed decision about whether to exercise information or contractual rights that they may have before such claims become time-barred. The termination notice should disclose the basis of the termination and the CEO should certify the relevant facts, such as the number of the issuer's shareholders and its total assets.

C. Advice/Recommendation Prohibition

As discussed above, Reg CF seems to prohibit portals from highlighting issuers based on qualitative criteria because this would violate the advice/recommendation prohibition.[166] The vast majority of offerings fit well within the contours of permissible vetting. However, one platform, the third most popular intermediary in the Sample, appears to advertise its "vetting" of offerings on the basis of the kind of qualitative factors that may cross the line.

The portal's homepage loads with the large-font statement: "Invest in highly vetted startups."[167] This statement then alternates with a variation that inserts a type of company in bold face after the words "highly vetted,"[168] (e.g., "Invest in highly vetted robotic startups," "Invest in highly vetted fintech startups"). Each is footnoted to the following text:

> SeedInvest's due diligence process is no guarantee of success or future results. All investors should carefully review each investment opportunity and cancel

---

165 An issuer would not be prohibited from making a subsequent Reg CF offering if it was "delinquent in the progress update or termination of reporting requirements," Crowdfunding, 80 Fed. Reg. 71,388, 71,398 (Nov. 16, 2015).

166 *See supra* Part II(D).

167 SEEDINVEST, www.seedinvest.com (last visited May 18, 2020).

168 *Id.*

> their subscription within the allotted time-frame if they do not feel comfortable making any specific investment based on their own DD. Learn more about due diligence in the SeedInvest Academy . . . and our vetting process in our FAQs.[169]

In the substantive text, the home page includes the following text under the header "Vetted Startup Investments:" "[i]n the past we've accepted just ~1% of startups that apply. The startups listed must all successfully pass our comprehensive due diligence process."[170] Further down the homepage, the following text appears adjacent to an image and a link to a New York Times article about the portal: "SeedInvest is different. We feature only highly vetted investment opportunities."[171] The latter sentence is footnoted to the same footnote quoted above that begins: "SeedInvest's due diligence process . . . ."

The due diligence process to which the foregoing footnotes refer apply a number of criteria under the heading "Business Due Diligence."[172] The Business Due Diligence section states that "research and due diligence" is conducted:

> on each company before it is able to accept investments on the SeedInvest platform in order to determine: (1) its viability as an investment opportunity and (2) the key risks associated with that opportunity. [Registered broker-dealers] North Capital and SI Securities take a dynamic, multi-faceted approach to evaluating individual offerings, recognizing that a standard scorecard model cannot be applied to the unique situations many startup companies face.[173]

This statement is followed by a list of factors to which "[p]articular focus is paid," including, among others: "[d]emonstrated traction (e.g. revenue, pre-sales, purchase orders, signed contracts, media coverage, awards, etc.)," "Growth Strategy," "Addressable market (e.g. size, growth, penetration, etc.)," "Competitive landscape and industry dynamics," and "Exit opportunities."[174]

The portal's vetting process appears contrary to the SEC's position that portals may not "make statements or otherwise represent that the offerings listed on its platform are safer or better investments than those listed on other platforms."[175] It is likely that FINRA would take this position in light of a 2019 enforcement action

---

[169] *Id.*

[170] *Id.*

[171] *Id.* (linking to Nathaniel Popper, *Doubts Arise as Investors Flock to Crowdfunded Start-Ups*, N.Y. TIMES (Jan. 24, 2017), https://www.nytimes.com/2017/01/24/business/dealbook/crowdfunding-fraud-investing-startups.html).

[172] Two other categories of vetting due diligence factors are included: "Legal and Confirmatory Due Diligence provided by Crowdcheck" and "review of Transaction Documents by Outside Legal Counsel." This due diligence generally comprises confirmation of factual information and legal compliance, which appears to be consistent with SEC guidance. As noted, the Commission has stated that a portal would not provide investment advice or make a recommendation if it screens potential filers because of "a reasonable basis for believing that there is a potential for fraud or other investor protection concerns." Crowdfunding, 80 Fed. Reg. 71,388, 71,436 n.698 (Nov. 16, 2015); *see also id.* at 71,461–62.

[173] *Frequently Asked Questions*, SEEDINVEST, www.seedinvest.com/faqs (last visited Apr. 15, 2020).

[174] *Id.*

[175] Crowdfunding, 80 Fed. Reg. 71,388, 71,463 (Nov. 16, 2015).

in which it expelled a funding portal partly because FINRA found that public claims made on its website that offerings were intensively vetted were false and misleading.[176] As to a separate video, the Hearing Panel stated:

> The video showing the offer to invest in Company C also might violate the JOBS Act and a Crowdfunding Rule prohibiting a funding portal from making recommendations or soliciting transactions. Potential investors could reasonably perceive Fernandez's announced investment as an endorsement or recommendation of an investment in Company C, which would encourage them to make an investment in Company C, too.[177]

The Panel did not expressly indicate whether this position applied to the defendant's vetting claims, but its analysis implies that it would.

The portal seems to have considered this possibility and accordingly included various disclaimers on its site. The above quoted statement "We feature only highly vetted investment opportunities" is footnoted to the following:

> Seedinvest's selection criteria does [sic] not suggest higher quality investment opportunities nor does it imply that investors will generate positive returns in investment opportunities on SeedInvest. Learn more about due diligence in the SeedInvest Academy . . . and our vetting process in our FAQs.[178]

This disclaimer seems likely to be unavailing. If the evaluation of the due diligence business factors listed above is not conducted for purposes of identifying "higher quality" investments, it is not clear what purpose it serves.

The portal appears to take the position that the vetting applies only to offerings under other exemptions. The site's FAQs for investors include a section entitled "What does 'Vetted' mean?" that includes the following:

> All Regulation D and A+ offerings marked as "Vetted" have successfully gone through our complete due diligence process, which includes internal business due diligence and outsourced legal and confirmatory due diligence. Such investment opportunities are offered via SI Securities or NCPS, each a registered broker-dealer. Investment opportunities offered under Regulation CF have not been fully vetted and are offered via SI Portal, a registered funding-portal. Such investment opportunities have gone through a screening process with SI Portal and legal due diligence by an independent third-party.[179]

The site does not provide any explanation as to the difference between "vetted" and "fully vetted." In any case, the various business factors that the portal considers as part of the "screening process" apply to crowdfunding offerings, and it is those

---

[176] *See* DreamFunded, *supra* note 84, at 117–19. In a separate section of the Panel's decision, it noted that the portal CEO "interposed" himself between issuers and investors and "invited investors to rely on his judgment," and concluded with the statement: "A funding portal is supposed to be a communications center, not an advice-giver." *Id.* at 45 n.171.

[177] *Id.* at 24; *see also id.* at 6 ("The video seemed potentially inconsistent with the prohibition against a funding portal making investment recommendations."). These statements were made in the context of a posted video's representations that the CEO and portal had and would invest in issuers.

[178] SEEDINVEST, www.seedinvest.com (last visited Apr. 15, 2020).

[179] *Frequently Asked Questions*, SEEDINVEST, www.seedinvest.com/faqs (last visited Apr. 15, 2020) (emphasis added).

criteria that appear to be qualitative advice.

It appears that Reg CF offerings were not reviewed by the portal's internal investment committee in 2018:

> In the case of an offering under Regulation D or A, the findings of the foregoing review are presented to an internal investment committee comprised of senior executives of SI Securities or NCPS, which may approve, reject, or require additional information for the offering. Upon approval by the investment committee an offering can be listed as "Vetted" and can begin accepting investments online.[180]

One difficulty with the foregoing is that Reg CF offerings are specifically "listed" as "Vetted." On the portal's platform, each offering is highlighted in its own rectangular box in which the term "vetting" appears just two spaces after "Rule 506(c) and Reg CF" (e.g., "Rule 506(c) and Reg CF Vetted").[181] The term "Vetted" modifies both offerings.

Even if the Reg CF offering were not specifically listed as "vetted," an investor would believe that it had been if the Reg D (Rule 506(c)) offering was vetted because any vetting of the latter offering would necessarily apply to the former because it is the same issuer. The offerings are functionally so intertwined that the vetting would be viewed as applying to both offerings.

For example, the offering webpage shows the amount raised to date as the sum of the Rule 506(c) and Reg CF commitments, as if each dollar was going to the same investment. The webpage describes the offering as a "Side by Side offering," which is defined "as a deal that is raising capital under two offering types. This Side by Side offering is raising under Regulation CF and Rule 506(c) of Regulation D."[182] The webpage identifies the key terms of the securities (e.g., term, interest rate, conversion discount, and valuation cap) as being the same for both offerings.[183] The webpage identifies some of the differences between the offerings (e.g., the $1,070,000 raise limit under Reg CF, and the limited voting rights of "non-Major Purchasers," the holding of certain securities under one holder of record), but none goes to any difference in due diligence.[184]

---

[180] *Id.* (emphasis added) (webpage as of Dec. 30, 2018, on file with author).

[181] *See Live Startups*, SEEDINVEST, https://www.seedinvest.com/offerings (last visited May 18, 2020).

[182] *See, e.g.*, Cellar Stash Offering Page, SEEDINVEST, https://www.seedinvest.com/cellarstash/series.a (last visited June 5, 2020). *See generally* J.D. Alois, *SeedInvest Lists First Reg CF / Reg D Side-by-Side Crowdfunding Offer*, CROWDFUND INSIDER (Nov. 14, 2016, 1:27 PM), https://www.crowdfundinsider.com/2016/11/92496-seedinvest-lists-first-reg-cf-reg-d-side-side-crowdfunding-offer/.

[183] *See Live Startups*, SEEDINVEST, https://www.seedinvest.com/offerings (last visited May 18, 2020).

[184] Joint offerings in which a funding portal participates raise the issue of whether the portal is complying with the JOBS Act's definition of a portal, which is a "person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, *solely pursuant to section 4(6) [sic] of the Securities Act of 1933*." JOBS Act of 2012, Pub. L. No. 112-106, § 304(b), 126 Stat. 322 (2012) (emphasis added). Portals may take the position that they are engaged "solely" in selling securities under Section 4(a)(6) even when a non-crowdfunding offering is conducted on their platform on the ground that not everything on a platform is

This example illustrates some of the interpretive problems created by the advice/recommendation safe harbor.[185] The portal may contend that only the safe harbor for search functions specifically includes the kind of criteria applied in its due diligence process, which implies that applying the same criteria in highlighting issuers is permissible. It may argue that it is a registered broker-dealer that is doing the vetting, with the portal posting the vetting claim only because the Commission requires that crowdfunding offerings be conducted on an online platform.[186] Alternatively, it may assert that, while crowdfunding offerings must be made exclusively on such platforms, the platforms need not host only crowdfunding offerings. If a broker-dealer cannot claim that offerings made under other exemptions are vetted, the effect would be to create a de facto prohibition against an issuer's making both offerings on the same platform.

The portal would not be alone in asserting or implying that a portal can disclaim statements on its platform and attribute them to an affiliate. The largest crowdfunding portal states that it "operates sections" of its platforms "where some Regulation Crowdfunding offerings are made," while another entity "operates sections of [the platform] where some Regulation D and A offerings are made."[187] The second largest portal claims that it is responsible only for the parts of its platform that relate to Reg CF offerings and states that its Reg A and D offerings are "made through" a separate entity.[188] These disclaimers are likely intended to clarify that the portal is involved solely in crowdfunding offerings as required under the JOBS Act.[189] But in these cases, unlike the portal discussed above, there is no express disclaiming of statements about an issuer that is conducting a joint offering on the platform.

Portal platforms routinely host offerings under Reg CF, Reg D and Reg A, and in some cases offerings under multiple exemptions are made concurrently. Reg CF is not clear as to whether a portal can disclaim statements made on its platform. Nor is it clear regarding the rules governing the qualitative highlighting of certain issuers or all issuers making offerings on the platform. Finally, the disparate treatment of registered broker-dealers and portals as to advice and recommendations may be consistent with the regulated activities in which each entity may engage, but this does not make sense in the impersonal supermarkets that crowdfunding platforms have become. These and other problems with the advice/recommendation prohibition militate for substantial changes to Reg CF.

---

necessarily attributable to a portal that uses the platform. However, it is not clear how this position can be maintained when narrative material for a crowdfunding offering and an offering made under offering exemptions are intertwined and the offerings are made through a common offering memorandum. Although the Commission has indicated that concurrent Reg CF/Rule 506(c) offerings are permissible, *see* Crowdfunding, 80 Fed. Reg. 71,388, 71,392 (Nov. 16, 2015), it has not specifically addressed the question of whether a joint offering may be conducted on a portal's platform.

185 *See supra* Part II(D).

186 However, as a practical matter FINRA may take the position that an online offering by a broker-dealer will necessarily constitute a recommendation. *See supra* note 44–45.

187 *See* WEFUNDER, https://wefunder.com (last visited May 11, 2020).

188 *See* STARTENGINE, www.startengine.com (last visited May 11, 2020).

189 *See supra* note 184.

1) Revised Advice/Recommendation Standard

The Commission should clearly define the contours of the advice/recommendation prohibition. As discussed in Part II(D), Rule 402(c)'s three safe harbors are confusing and inconsistent. The Commission should convert the safe harbors to a conduct standard that prohibits portals from separately identifying, highlighting, advertising, or otherwise featuring specific issuers, including through a user-directed search function, unless the portal receives no related special compensation and the only factors used to identify the issuer are objective criteria that are: reasonably designed to highlight a broad selection of issuers on the platform, applied consistently to all potential issuers and offerings, and prominently disclosed where used.

The term "objective criteria" should be defined as: (1) including the type of security, issuer's geographic location and industry or business segment, target and maximum amount, and number and amount of investment commitments and progress made toward the target and maximum offering amounts, and (2) excluding any criteria that reflect a qualitative assessment of the issuer, such as an assessment of its risk profile, business plan, key management or competitive environment.

2) Universal Advice/Recommendation Prohibition

All crowdfunding platforms, including broker platforms, should be prohibited from giving advice or making recommendations. While it is true that broker-dealers are permitted to recommend securities that they underwrite, the underwriter and broker-dealer functions in that context normally are separate. The offering document itself—the registration statement—is not the vehicle for the recommendation. A broker-dealer's analysts may provide a qualitative evaluation of an offering, but not as part of the registration statement through which an issuer is presented to investors. In contrast, an issuer's platform webpage is not a vehicle for an issuer's offering memorandum, it *is* the offering memorandum. Permitting facts and opinions of a third party to be interwoven with facts and opinions presented by an issuer violates the critical distinction between statements *by* an issuer and statements *about* an issuer.

3) One Platform; One Voice

Finally, the Commission should establish that responsibility for communications on a single platform cannot be allocated based on legalistic distinctions. A crowdfunding platform should be responsible for all communications about a crowdfunding issuer. Without such a rule, restrictions on communications by portals are meaningless when an issuer conducts more than one offering. Communications that offend Reg CF can simply be assigned to a different entity. It is absurd to pretend that a platform's characterizations of an issuer for purposes of one offering are not necessarily applicable to the same issuer for purposes of another offering conducted in the same platform.

D. Progress Updates

Few Filers filed progress updates during the course of the offering, presumably because they relied on the intermediary to post regular updates on the offering's

progress.[190] In fact, every platform in the Sample provided this service to the Filer and appeared to satisfy Reg CF's partial exemption from the JOBS Act progress update mandate.[191] However, Filers timely filed the correct final amount in no more than 15% of successful offerings. For a large majority of these compliant filings, the amount filed is assumed to be correct only because no annual report was filed or the amount was not reported in an annual report, which meant that the claimed amount could not be confirmed. It is likely that only a handful of the 15% group actually submitted compliant filings.

Filers must submit the final amount sold "no later than five business days after the offering deadline."[192] Filers filed at least one progress update in 167 of the 196 successful offerings—an 85% compliance rate—but only 84 (50%) of these were timely filed. Filers' Form C-U filings indicate that they rarely know the final amount sold within that time period.[193] Twenty-two Forms C-U were followed by an update, and, of the final Forms C-U that included a final amount, 64 (43%) indicated that the amount was "approximate" or a "best estimate," or that final orders were "still being processed."[194] In most cases, the final amount reported did not match these interim estimates.[195] Seventeen Forms C-U did not provide a final amount, indicating instead only that it was the "end of the offering."[196] Approximately half of Forms C-U were timely filed.

---

190 CROWDFUNDING REPORT, *supra* note 13, at 15 n.40 ("Almost all issuers rely on the intermediary to fulfill the requirement of providing interim progress updates and only file a final progress update.").

191 *See* 17 C.F.R. § 227.203(a)(3) (2019).

192 Crowdfunding, 80 Fed. Reg. 71,388, 71,417 (Nov. 16, 2015).

193 *See, e.g.*, Brewer's Table—East Austin LLC, EDGAR SEARCH RESULTS, https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=1676480 (August 2016 Progress Update Form C-U reports $396,500 raised, while April 2017 Annual Report shows $300,000 raised) (last visited June 29, 2020).

194 *See, e.g.*, Avua Corp., Progress Update (Form C-U) (May 25, 2018), https://www.sec.gov/Archives/edgar/data/1705545/000167025418000278/primary_doc.xml ("Payments are still being processed; final number is yet to be determined."); madeBOS, Inc., Progress Update (Form C-U) (Dec. 22, 2017), https://www.sec.gov/Archives/edgar/data/1705954/000170595417000003/primary_doc.xml (issuer "raised approximately $86,552"); MF Fire, Inc., Progress Update (Form C-U) (Aug. 29, 2016) https://www.sec.gov/Archives/edgar/data/1674207/000164460016000185/primary_doc.xml ("best estimate"). If a Filer's annual report confirmed that its estimate in Form C-U was accurate and the Form was timely filed, the filing was deemed to be compliant.

195 CROWDFUNDING REPORT, *supra* note 13, at 15 n.40 (discussing discrepancies between final amounts reported on Form C-U and "industry statistics"). Some Filers reported a "final amount" in Form C-U only to change the amount in a subsequent filing. *See, e.g.*, SlideBelts, Inc., Progress Update (Form C-U) (July 17, 2017), https://www.sec.gov/Archives/edgar/data/1700895/000166516017000275/primary_doc.xml ("amount of securities sold at the close of the offering is $927,500.00") and SlideBelts, Inc., Progress Update (Form C-U) (Nov. 22, 2017), https://www.sec.gov/Archives/edgar/data/1700895/000166516017000621/primary_doc.xml ("amount of securities sold at the close of the offering is $1,069,982.96").

196 *E.g.*, Sidekick Tech., Progress Update (Form C-U) (July 7, 2017), https://www.sec.gov/Archives/edgar/data/1703835/000166919117000083/primary_doc.xml; *cf.* Abate, *supra* note 59, at 9 (for offerings initiated from May 16, 2016 through May 16, 2017, 118 Forms C-U filed as of August 16, 2017; 13 stated only that the offering had ended).

The final amount filing requirement is unworkable, and the filing is unusable. After an offering closes, the issuer must reconcile investor commitments and evaluate late cancellations. Offerings that are conducted concurrently with a Reg D offering must separate investors between the two based on their preference and their accredited investor status. The five-day requirement is unduly burdensome and, in practice, results in the dissemination of inaccurate information. Moreover, the update is provided in textual form, rather than a data entry, which means that the reported amount sold can only be collected by hand. At a minimum, the Commission should require that filers report, as a dollar amount in a numerical data field, the *final* amount sold within a more reasonable period after the offering closes (e.g., 30 days).

E. *Accuracy of Form C Financial Data*

The transfer of information from issuers' financial statements to Form C creates a risk of error that was amply illustrated in the Sample. The cleaning and prepping of CF data for the analysis in this Article uncovered persistent errors in the short-term debt reported on Form C. Thirty-four offerings had Form C data that raised issues of accuracy, such as negative cash or cost of goods sold or missing entries.

For this group of Filers, the short-term debt in Form C is different from the financial statement amount in 22 cases (65%). It appears that it is the Form C data, not the financial statements, that are incorrect. In most cases, total current liabilities are entered on Form C rather than only short-term debt, which strongly suggests that the error resulted from transposing the wrong information from the financial statements to Form C. However, these findings are not necessarily representative of the Sample, because the selected offerings were already identified as having potential data issues.

To better evaluate whether short-term debt reporting is a systemic problem, 37 offerings were randomly selected (excluding the first group of 34). In that group, the Form C short-term debt entry is incorrect in 22 offerings, representing 38 separate mismatches. The short-term debt amounts are correct for both years in only 11 offerings;[197] in the four remaining offerings no financial statement was filed against which the Form C data could be compared. In three cases of correct short-term debt amounts, the Filer reported zero values for all entries because it was formed after the end of the most recent fiscal year,[198] meaning that only 8 of the 11 Filers that had correct short-term debt Form C data actually had financial data to match. After excluding the seven offerings with no data to match or no financial statements filed, 22 of 27 offerings (81%) reported incorrect short-term debt.

The short-term debt errors are nontrivial in amount, with an average error of $121,000. The Form C short-term debt should have been zero in 21 cases. In the 17 remaining cases, the size of the error averages more than 11 times the correct

---

[197] The group of 11 includes a case where no financial statement was filed for the prior fiscal year, but the short-term debt figures matched for the most recent fiscal year.

[198] In some cases, Filers that were formed after the most recent fiscal year end nonetheless included their most recent financial data in their Form C filing. These cases were treated as matches if the short-term debt figures matched.

amount. To put these data in context, for 37 errors where the Filer holds cash, the amount of the error is, on average, more than six times cash. In 11 cases, the error results in cash being less than short-term debt when it should have exceeded that amount. Thus, the error often materially affected the apparent ability of the Filer to pay off short-term debt.[199]

There is no evidence that Filers intended to mislead investors,[200] but the finding that short-term debt is far more likely to be wrong than right is concerning. The remarkably high incidence of errors suggests that intermediaries are failing to conduct the most rudimentary checks of Filers' information.

Short-term debt errors may also be attributable to problems with Form C. The Form asks for cash and accounts receivable—the principal components of current assets—and short-term debt. Oddly, it does not ask for accounts payable or for total current assets and liabilities. These are important data for purposes of calculating an issuer's working capital, which measures an issuer's ability to pay its bills as they come due. Form C provides parts, but not the whole, in other contexts as well. For example, it includes total assets, but not total liabilities or shareholders' equity. Similar to the inclusion of accounts receivable but not accounts payable, the Form provides cost of goods sold and taxes, but not the other principal components of expenses: marketing, overhead, research and development, and interest.

These quirks may explain inaccurate short-term debt data. Filers may assume that Form C would not ask for accounts receivable without also asking for accounts payable and including accounts payable with short-term debt would be one way to create this expected symmetry. Alternatively, Filers may believe that short-term debt means short-term liabilities. The substitution of short-term "notes" or "loans" in place of "debt" might solve the problem, as most of the examined Filers' balance sheets showed short-term debt under one of these alternative names.

Although most investors are likely to rely on an issuer's financial statements rather than the financial data in Form C, it is important that investors be able to rely on the latter data source. More sophisticated investors may prefer to analyze digital information that can be automatically downloaded and analyzed, and they may consider formally filed information to be more reliable. The Commission has a responsibility to ensure that it and third parties can meaningfully evaluate the operation of offering exemptions. This analysis considered the accuracy of only one data point in Filer's financial information and found that it is far more likely to be materially inaccurate than not. When coupled with incomplete financial statements, unfiled annual reports, inaccurate final raise amounts and highly vetted offerings, materially incorrect financial data completes a picture of a deeply embedded culture of noncompliance.

---

199 The effect of a given amount of short-term debt on a filer's financial health will generally be greater than the effect of an equal amount of other liabilities. Short-term debt is normally a far less flexible obligation than, for example, accounts payable, with default often triggering onerous consequences.

200 If the errors were intended to mislead investors, Form C might be expected to understate short-term debt and thereby give the Filer the appearance of being financially stronger. However, in the 38 separate instances of mismatched data in the second group, Form C understated debt in only two (by a combined total of $123.58) and overstated debt in 36 (by an average of $121,000).

V. CONCLUSION

During the first 13 months of crowdfunding offerings, compliance with the simplest, most fundamental crowdfunding requirements was extremely low. Complete financial statements that met the applicable review standard were filed in barely half of offerings. Fifteen Filers never submitted financial statements. To be compliant under the standard applied in this analysis, Filers needed only (1) file four financial statements for each applicable fiscal year (2) that were, as appropriate, certified by the CEO or reviewed by an accountant. If the financial statements were subject to a more demanding, substantive compliance standard, a much smaller fraction would be deemed to have been compliant.

Filers' compliance with the annual report requirement was also analyzed under a very liberal standard. Filers needed only to file a document that would be facially acceptable as an annual report. The vast majority of Filers would have been required to file only one such report if they had filed a termination notice. Yet barely one-quarter of Filers that were required to file two annual reports managed to do so; barely one-third filed their first report on time. If these filings were subject to any level of substantive review, only a tiny fraction would likely be found to be in compliance with Reg CF. For example, of the 117 first annual reports filed, 24 (21%) failed the requirement to disclose the final amount raised. Far more often than not, the amount of short-term debt in Form C filings was materially inaccurate.

Although Filers are the primary violators, responsibility lies primarily with intermediaries and regulators. The dismal level of compliance reflects an abdication of oversight responsibility by intermediaries. Regulators allowed a nascent offering exemption, one that had been predicted by some to lead to systematic problems, to evolve without the heightened monitoring that is critical for a newborn. The unsurprising result is that a culture of noncompliance developed, thereby putting the entire crowdfunding experiment at risk.

Reg CF also bears much of the responsibility for crowdfunding's noncompliance culture. This is not the fault of the Commission, which should be commended for creating a reasonably well-designed initial regulatory structure. The crowdfunding experiment has exposed ways in which Reg CF is overly burdensome and costly, but these shortcomings were not necessarily foreseeable. Reg CF has provided a workable structure within which lessons learned can be applied and the rules tightened in some respects and liberalized in other respects. On the whole, crowdfunding can provide better protection for investors while also imposing reduced costs and burdens on issuers.

However, it is not clear that empirical analysis will actually motivate future rulemaking by the Commission. The SEC's Crowdfunding Report purports to address crowdfunding "issuer and intermediary compliance,"[201] but it is strangely devoid of actual data or other information on whether issuers or intermediaries are actually complying with the law. The most striking aspect of the SEC's Concept Release and Crowdfunding Report is their repeated admissions that the Commission simply lacks important information, much of which is necessary to engage in intelligent, informed rulemaking. Various outside entities have recommended

---

201 CROWDFUNDING REPORT, *supra* note 13, at 27.

liberalizing Reg CF without having conducted any meaningful evaluation of crowd-funding compliance.[202] The Commission should eschew such an information-free approach to regulation and, instead, heed the lessons of experience.

[202] *See, e.g.*, Letter from U.S. Senators Mike Crapo, Richard Shelby, Patrick Toomey, Tim Scott, Ben Sasse, Tom Cotton, M. Michael Rounds, David Perdue, Thom Tillis, John Kennedy, Martha McSally, Jerry Moran and Kevin Cramer to Jay Clayton, Chairman, Sec. & Exch. Comm'n (July 18, 2019) (encouraging Commission to, *inter alia*, "remove impediments to access to capital"); A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS, *supra* note 64; U.S. SEC. & EXCH. COMM'N., 2017 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION 21–24 (2018), https://www.sec.gov/files/gbfor36.pdf; *see also* Fix Crowdfunding Act, H.R. 4855, 114th Cong. § 2(a)(2) (as passed by House, July 5, 2016).