

**A JOB CREATOR OR AN INVESTOR PERIL?: A  
TEXAS PRACTITIONER’S GUIDE TO THE  
CROWDFUNDING EXEMPTION UNDER TITLE III  
OF THE JOBS ACT**

Comment

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## I. A NEW TYPE OF INVESTOR

John Smith has an eighth-grade education and is currently unemployed.<sup>1</sup> Recently, while John was searching the internet looking for a new way to make money, he came across a website that intrigued him—Crowdfunder.<sup>2</sup> Unsure what the term “crowdfunding” meant, John did a quick Google search for the definition; from Wikipedia, John learned that crowdfunding was a “collective effort of individuals who network and pool their money, usually via the Internet, to support efforts initiated by other people or organizations.”<sup>3</sup> Fascinated with this new concept, John clicked on the “Crowdfunder” link, and he was redirected to the website. As John began browsing the site, the following text scrolled across the main page in bold font: “President Barack Obama signed the Jumpstart Our Business Startups Act (JOBS Act) on April 5, 2012, Legalizing Equity-Based Crowdfunding/Get the Jumpstart On Others To Make More Money Now.”<sup>4</sup> John believed that if President Obama authorized this new form of investing, it had to be legitimate, so he decided to click on a pop-up advertisement for “Friendsbook,” the newest social media phenomenon.

When he clicked on the advertisement, the only thing that appeared on his screen was a brief overview of the company, which described Friendsbook as the “Facebook Killer.” John thought he had struck gold; he thought he would never have to find a job because he had heard about numerous individuals who made a lot of money with Facebook. Sensing that he should seize this opportunity, John decided to invest his money and become a shareholder in Friendsbook. John paid \$2,500 and requested that Crowdfunder process his payment immediately. That \$2,500 was the last of John’s savings, but he knew the investment would make him rich in the long run. The next day, John wanted to learn a little bit more about crowdfunding, so he performed another Google search. During the search, John learned that the part of the JOBS Act relating to crowdfunding had not yet been approved by the Securities and Exchange Commission (SEC); therefore, it was illegal for Friendsbook to use the Crowdfunder website to sell an equity interest in its company.<sup>5</sup> The following morning, John sought legal advice from a practitioner to recover his \$2,500.

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1. John Smith is a fictional character, and his story illustrates some of the current investor-protection issues that could arise with crowdfunding.

2. See CROWDFUNDER, <http://www.crowdfunder.com/> (last visited Sept. 10, 2013).

3. *Crowdfunding*, WIKIPEDIA, [http://en.wikipedia.org/wiki/Crowd\\_funding](http://en.wikipedia.org/wiki/Crowd_funding) (last visited Jan. 12, 2013).

4. See President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), transcript available at <http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing>.

5. See Mary L. Schapiro, Chairman of the U.S. Sec. & Exch. Comm’n, *Testimony Concerning the “JOBS ACT in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC”*, SEC. & EXCHANGE COMMISSION (June 28, 2012), <http://www.sec.gov/news/testimony/2012/ts062812mls.htm> (noting that Title III is not effective until the final rules are put into place by the SEC).

On April 5, 2012, just days after Congress passed the JOBS Act, President Obama signed it into law.<sup>6</sup> Supporters of the JOBS Act anticipated that it would be a boon for entrepreneurs and small businesses by making it easier for them to gain access to capital.<sup>7</sup> The JOBS Act amends various sections of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act), among other things.<sup>8</sup> Some sections of the JOBS Act, however, such as Title III, were not self-effectuating; thus, per congressional mandate, the SEC had to implement final rules for the crowdfunding exemption before Title III of the JOBS Act would take effect.<sup>9</sup> The SEC, however, failed to meet Congress's Title III implementation deadline, so many startups and small businesses have yet to reap the projected benefits of this section of the JOBS Act.<sup>10</sup>

Apart from the SEC's failure to issue crowdfunding regulations within the mandated period, SEC officials, investor protection groups, and other Title III skeptics continue to voice concerns about the crowdfunding exemption.<sup>11</sup> While there are inherent risks associated with any startup company, the overarching concern with the crowdfunding model is that it opens the door to a wholly unfamiliar set of investor-protection problems.<sup>12</sup> Because Title III exempts crowdfunded securities from the SEC's registration requirements and permits members of the general public to invest in startup companies through an online funding portal, this exemption, in essence, allows relatively unsophisticated individuals to invest in risky startup ventures.<sup>13</sup> The lack of knowledge and shortage of financial sophistication of the "crowd" places an inordinate number of average Americans, like John Smith, at risk of depleting

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6. See, e.g., Jonathan B. Wilson & Dianne L. Trenholm, *LexisNexis Emerging Issue Analysis, Crowdfunding Under the JOBS Act: The Bottom Line Impact on Private Equity Issuers and Market Intermediaries*, 2012 EMERGING ISSUES 6302; *JOBS Act to Ease Capital Formation for Public and Private Companies and Reduce Regulatory Burdens on Emerging Growth Companies*, MINTZ LEVIN (Apr. 5, 2012), <http://www.mintz.com/newsletter/2012/advisories/1770-0312-nat-sec> [hereinafter *JOBS Act to Ease Capital Formation*].

7. See Wilson & Trenholm, *supra* note 6.

8. See JOBS Act, Pub. L. No. 112-60, 126 Stat. 306 (2012).

9. See, e.g., *JOBS Act to Ease Capital Formation*, *supra* note 6; Schapiro, *supra* note 5 (explaining that the SEC was also required to adopt final rules for Title I, Title II, Title IV, and Title V of the JOBS Act). While Title I, Title II, Title IV, and Title V of the JOBS Act all encourage the funding of small businesses by changing certain SEC regulations, they are outside the scope of this Comment. See Schapiro, *supra* note 5.

10. See Marcia Kaplan, *Equity Crowdfunding Stalls*, PRAC. ECOMMERCE (Jan. 25, 2013), <http://www.practicalecommerce.com/articles/3887-Equity-Crowdfunding-Stalls> (explaining that the SEC had 270 days to implement the regulations for crowdfunding, but did not meet its deadline); see also *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last updated June 10, 2013) (indicating that the SEC is charged with implementing rules that seek to balance capital formation and investor protection).

11. See *JOBS Act to Ease Capital Formation*, *supra* note 6; Kaplan, *supra* note 10 (emphasizing that between the SEC's failure to implement regulations by the mandated deadline and the recent resignations of several top SEC officials, including SEC Chairman Mary Schapiro, the crowdfunding exemption will likely remain in limbo until 2014).

12. See discussion *infra* Parts II.C, IV.

13. See Wilson & Trenholm, *supra* note 6; Schapiro, *supra* note 5.

their precious financial resources.<sup>14</sup> Such risk, coupled with the ever-increasing number of companies that use the term “crowdfund” in their online domain names, validates the SEC’s concerns in regards to protecting this new type of investor.<sup>15</sup>

Unfortunately, fraud is nothing new to the American people.<sup>16</sup> Despite the SEC’s incessant efforts to regulate the securities industry through investor protections, there will always be individuals working to circumvent the SEC’s regulations in an attempt to harm American investors.<sup>17</sup> When investors fall victim to fraudulent crowdfunding schemes, as did John Smith, they will likely seek an attorney’s advice. Thus, practitioners need to be cognizant of the fact that currently, both Texas and federal law provide remedies to redress financial loss.<sup>18</sup> The issue is not whether there will be fraudulent crowdfunding schemes, but rather, how many?

This Comment explores investor protection under Title III of the JOBS Act and provides practitioners with remedies available under Texas and federal law to redress financial harm to their clients. Part II provides an overview of crowdfunding, along with perspectives from those who will be utilizing the crowdfunding exemption.<sup>19</sup> Part III then discusses the requirements currently in place under Title III of the JOBS Act.<sup>20</sup> Next, Part IV provides proposals to the SEC to facilitate investor protection, which include the establishment of a central database to monitor statutory caps for individual investments, as well as a uniform system of education for all intermediaries.<sup>21</sup> Finally, Part V offers various remedies for clients who have fallen victim to securities fraud.<sup>22</sup>

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14. See Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy> (describing the types of investors likely to utilize crowdfunding and noting that crowdfunding is not limited to “accredited” or “sophisticated” investors); see also C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 104–13 (2012) (discussing studies that illustrate the general public’s lack of financial knowledge and the risks associated with investing in startup companies).

15. See Bradford, *supra* note 14, at 104–13; see also Eric Markowitz, *Crowdfunding Start-ups Wait in Wings as SEC Stalls*, INC.COM, <http://www.inc.com/eric-markowitz/crowdfunding-start-ups-wait-for-sec.html> (last updated Jan. 8, 2013).

16. See *infra* Part II.C.

17. See *infra* Part II.C.

18. See *infra* Part V.

19. See *infra* Part II.

20. See *infra* Part III.

21. See *infra* Part IV.

22. See *infra* Part V.

## II. CROWDFUNDING IN GENERAL

### A. A Proven Model

On a crowdfunding website, an individual or a company will post a request for funding, which details the proposed product and business plan.<sup>23</sup> The request will inform website browsers what they will receive if they choose to invest in the product or business, and if a person chooses to invest—anything from a few dollars to the total amount requested by the entrepreneur—the website then facilitates the exchange of funds.<sup>24</sup> The crowdfunding model, which relies on the solicitation of donors online, has proven successful in raising money.<sup>25</sup> According to the Crowdfunding Industry Report, conducted in 2012 by the research firm Massolution, crowdfunding platforms raised almost \$2.7 billion worldwide, with North America representing \$1.6 billion of that total.<sup>26</sup> Websites such as Kickstarter and Kiva are two such platforms that have flourished by tapping into the “crowd” for fundraising efforts online; however, each falls into different crowdfunding categories.<sup>27</sup>

### B. Categories of Crowdfunding

Currently, crowdfunding platforms fall into different categories based on what investors receive in return for their contribution or donation.<sup>28</sup> The different categories of crowdfunding include (1) lending-based, (2) reward-based, (3) donation-based, and (4) equity-based.<sup>29</sup>

Under lending-based crowdfunding, a person provides a loan to a third party through a website such as Kiva, which is headquartered in San Francisco, California.<sup>30</sup> In 2005, Kiva became the first website to offer individuals the

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23. See Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1736–37 (2012) (explaining how crowdfunding works); Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) (suggesting that crowdfunding finds its roots in crowdsourcing); Karina Sigar, Comment, *Fret No More: Inapplicability of Crowdfunding Concerns in the Internet Age and the JOBS Act’s Safeguards*, 64 ADMIN. L. REV. 473, 478–80 (2012) (explaining the crowdfunding mechanism).

24. See, e.g., Sigar, *supra* note 23, at 478–80.

25. See *3013CF-The Crowdfunding Industry Report*, CROWDSOURCING (Apr. 11, 2013), <http://www.crowdsourcing.org/editorial/2013cf-the-crowdfunding-industry-report/25107> [hereinafter *Crowdfunding Industry Report*]; see also *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER (May 18, 2012), <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/posts/230097> (demonstrating the power of crowdfunding by the success of the Pebble Watch fundraiser that generated over \$10 million in contributions from 68,929 individuals).

26. *Crowdfunding Industry Report*, *supra* note 25.

27. See *infra* Part II.B.

28. See *Crowdfunding Industry Report*, *supra* note 25.

29. *Id.*

30. See *About Us*, KIVA, <http://www.kiva.org/about> (last visited Sept. 8, 2013) (providing information about Kiva); see also Bradford, *supra* note 14, at 20–21 (discussing the Kiva model).

ability to provide a loan to entrepreneurs who did not have access to traditional banking systems.<sup>31</sup> Although most traditional loans have interest rates and origination fees that enable lenders to make a profit, the loans provided through Kiva only offer repayment of the amount loaned.<sup>32</sup> Since its inception, Kiva has been able to provide \$469,811,625 in loans to individuals in seventy-two different countries.<sup>33</sup>

The next category, reward-based crowdfunding, is conducted through websites such as Indiegogo and Kickstarter, and utilizes the internet as a crowdfunding platform for creative projects.<sup>34</sup> These websites allow an individual to post an idea for a project online and ask other Internet users for financial support.<sup>35</sup> Most of the projects displayed on these different websites relate to creative industries, and although these websites solicit financial support from investors for projects, the investors do not receive an equity interest in the corresponding project.<sup>36</sup> In place of an equitable interest, these websites typically offer material rewards—a copy of the album, a phone call from the author, or a “thank you” in the credits.<sup>37</sup>

The third category, donation-based, includes websites such as Razoo.<sup>38</sup> On Razoo, individuals can browse different fundraisers and nonprofit organizations listed on the website and make online donations.<sup>39</sup> An individual who contributes through a donation-based website receives no reward or repayment for his investment, but can write-off his investment as a charitable contribution.<sup>40</sup> In addition to nonprofit organizations, donation-based crowdfunding is currently being utilized in the political arena.<sup>41</sup>

The final category, equity-based crowdfunding, allows an investor to receive an ownership or equitable interest in a company or project in which he

31. See Bill Clark, *The History & Evolution of Crowdfunding*, MASHABLE.COM (Sept. 15, 2011), <http://mashable.com/2011/09/15/crowdfunding-history>; see also *About Us*, KIVA, *supra* note 30.

32. See *About Us*, KIVA, *supra* note 30 (explaining how Kiva works).

33. *Id.* (providing statistics on Kiva’s loan distributions).

34. See INDIEGOGO, <http://www.indiegogo.com> (last visited Sept. 23, 2012); KICKSTARTER, <http://www.kickstarter.com> (last visited Sept. 23, 2012); see also Bradford, *supra* note 14, at 16–20 (providing a detailed description of reward-based crowdfunding sites).

35. See sources cited *supra* note 34.

36. See INDIEGOGO, *supra* note 34; KICKSTARTER, *supra* note 34 (indicating that the projects currently supported are primarily creative); see also Bradford, *supra* note 14, at 16 (explaining that investors sometimes do not receive an equity interest or earnings).

37. See, e.g., KICKSTARTER, *supra* note 34 (describing rewards that vary from copies of the actual item to creative collaborations, experiences, and mementos).

38. See *What Is Razoo?*, RAZOO, <http://www.razoo.com/p/overview> (last visited Oct. 28, 2012); see also Bradford, *supra* note 14, at 15–17 (providing an overview of donation sites).

39. See *What Is Razoo?*, RAZOO, *supra* note 38.

40. See Bradford, *supra* note 14, at 15 (noting that no rewards are offered on donation-based sites and that “only 22% of all crowdfunding initiatives were requests for donations”); see also 26 U.S.C. § 170 (2012) (allowing deductions for some charitable contributions).

41. See Jose Antonio Vargas, *Obama Raised Half a Billion Online*, WASH. POST (Nov. 20, 2008), <http://voices.washingtonpost.com/44/2008/11/obama-raised-half-a-billion-on.html> (noting that, in 2008, the Obama campaign raised over \$500 million through 6.5 million online donations).

invests.<sup>42</sup> The problem with websites offering equity interests in return for an investment, however, is that they are subject to the securities laws of the United States.<sup>43</sup> Until Title III of the JOBS Act is implemented, an individual or company may not offer an equity interest in return for an investor's contribution.<sup>44</sup>

### C. Perspectives on Joining the Crowd

Overall, the crowdfunding model has proven successful in various categories, and below is a discussion of equity-based crowdfunding's relative viability through the eyes of those who will be utilizing the exemption under Title III of the JOBS Act once the SEC implements the final rules.<sup>45</sup>

#### 1. Startup Company Looking for Capital

Entrepreneurs in need of a cash infusion for their small business or startup company typically resort to bank loans, friends and family, or venture capitalists and angel investors.<sup>46</sup> With the recession, however, these traditional sources of funding no longer suffice as realistic options for entrepreneurs looking to develop and expand their businesses, and in turn, entrepreneurs look at equity-based crowdfunding as a possible source of capital.<sup>47</sup> From an entrepreneur or startup company's perspective, the crowdfunding exemption could bridge the financial gap by granting access to capital needed for development and expansion.<sup>48</sup>

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42. See Bradford, *supra* note 14, at 24–27 (discussing the equity-based crowdfunding model).

43. See *id.* (discussing *profunder.com*, an equity-based website that was shut down by the California Department of Corporations for selling unregistered securities); see also Sigar, *supra* note 23, at 478–80 (explaining that equity interests offered online would be classified as investment contracts under the securities laws).

44. See Bradford, *supra* note 14, at 24–27; see also Sigar, *supra* note 23, at 478–80.

45. See *About Us*, KIVA, *supra* note 30 (noting that \$469,811,625 in loans have been generated through its website); KICKSTARTER, *supra* note 34.

46. See Bradford, *supra* note 14, at 100–04 (discussing the funding gap facing small businesses); Sigar, *supra* note 23, at 480–81 (discussing the current financial situation facing entrepreneurs and startup companies); see also *About Us*, STARTUP EXEMPTION, <http://www.startupexemption.com/about-us#axzz2goqM9rAl> (last visited Oct. 21, 2012) (discussing the current financial crisis and how startup companies and small businesses need a new way to acquire capital).

47. See *Petition: Long*, STARTUP EXEMPTION, <http://www.startupexemption.com/petition#axzz2goqM9rAl> (last visited Oct. 21, 2012) (“Since the financial meltdown traditional financing has virtually disappeared. Banks are holding on to their cash, credit card companies are charging exorbitant interest rates and according to the private financing group Angelsoft, only 2.3% of startups receive private (VC, PE or Angel) financing.”); see also Bradford, *supra* note 14, at 100–04; Sigar, *supra* note 23, at 480–81.

48. See sources cited *supra* note 46.

## 2. *The Online Investor*

For individual investors, crowdfunding provides an opportunity to invest in the “next big thing” and not only receive a free T-shirt, but also receive an equity interest in that company.<sup>49</sup> Because the crowdfunding model relies on the general public for contributions, the biggest concern is protection of those who lack financial literacy from fraudulent conspiracies.<sup>50</sup> With the rise in Ponzi schemes and stories about individuals losing their life savings, using a website as an investment vehicle garners legitimate concerns.<sup>51</sup> Currently, Title III of the JOBS Act places statutory caps on individual investments to limit the amount an individual could lose on a crowdfunding platform;<sup>52</sup> however, just because a limit is placed on what investors can lose does not mean that they will be adequately protected from those who seek to use the crowdfunding portals as a medium for fraud.<sup>53</sup> Investors need confidence that they will be protected from bad actors and will be provided with remedies to recover any money lost due to fraudulent activities.<sup>54</sup>

## 3. *Funding Portal*

The North American Securities Administrators Association (NASAA) recently conducted a search and found there were 8,800 websites that contained the name “crowdfund.”<sup>55</sup> According to NASAA, this number is almost ten times more than what it was in 2011.<sup>56</sup> This dramatic increase in the number of websites containing the word “crowdfund” illustrates that people are

49. See Bradford, *supra* note 14, at 116 (“Securities crowdfunding increases the potential gains to these investors. Instead of making a donation or settling for some reward, investors in crowdfunded securities can receive [an] interest or a share of the entrepreneur’s profits.”).

50. See, e.g., *id.* at 109 (noting that there “would be a less significant concern if crowdfunding investors were sophisticated enough to protect themselves”); Hazen, *supra* note 23, at 1765–66 (discussing investor protection under the crowdfunding exemption); see also Alan R. Palmiter, *Pricing Disclosure: Crowdfunding’s Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 399–401 (2012) (discussing the investor education requirement of the JOBS Act).

51. See, e.g., Hazen, *supra* note 23, at 1767–68 (discussing Ponzi schemes and boiler room tactics); see also Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Across Borders*, N.Y. TIMES (Dec. 19, 2008), <http://www.nytimes.com/2008/12/20/business/20madoff.html?pagewanted=all&r=0> (discussing the Madoff Ponzi scheme); Nathan Vardi, *Allen Stanford Convicted in \$7 Billion Ponzi Scheme*, FORBES (Mar. 6, 2012), <http://www.forbes.com/sites/nathanvardi/2012/03/06/allen-stanford-convicted-in-7-billion-ponzi-scheme> (discussing Allen Stanford’s twenty-year Ponzi scheme).

52. See Jumpstart Our Business Startups Act (JOBS Act), H.R. 3606, 112th Cong. (2d Sess. 2012) (enacted at JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315 (2012)) (to be codified in scattered sections of Title 15 of the United States Code).

53. See Bradford, *supra* note 14, at 115–16 (stating that any kind of securities offering will lead to an increase in fraud and investor losses).

54. See sources cited *supra* note 46.

55. NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet, NASAA (Dec. 5, 2012), <http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet> [hereinafter *Sharp Spike in Crowdfunding Presence*].

56. *Id.*



anticipating the success of crowdfunding.<sup>57</sup> Although these domain names have been registered, it does not necessarily mean that they will operate as funding portals because the intermediary requirements currently in place under Title III could outweigh the benefits for an intermediary that would like to offer securities through its website.<sup>58</sup>

The two primary requirements placed on intermediaries relate to investor education and statutory caps for individual investments.<sup>59</sup> Websites such as Kickstarter and Kiva have been successful in the crowdfunding industry, but they are not required to comply with such stringent requirements.<sup>60</sup> As proposed in Part IV, if intermediaries are provided with specific tools to assist in ensuring that investors are protected, then crowdfunding intermediaries will not be at such a heightened risk of being sued if an investor loses money.<sup>61</sup>

### III. JOBS ACT: AN IN-DEPTH LOOK AT CROWDFUNDING UNDER TITLE III

Before the JOBS Act was signed into law in April 2012, there were numerous proposals directed at exempting equity-based crowdfunding.<sup>62</sup> Following these proposals, on January 31, 2012, President Obama sent the Startup America Legislative Agenda to Congress.<sup>63</sup> Outlined in this agenda were four proposals that would assist startups and small businesses in getting capital to grow their businesses, which ultimately would create jobs.<sup>64</sup> After various bills were introduced in the House and Senate, the JOBS Act took its final form and passed with a strong bipartisan vote.<sup>65</sup> Congress gave the SEC the task of implementing the JOBS Act, and provided below is an overview of the rules currently in place under Title III of the Act.<sup>66</sup>

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57. *Id.*

58. *See, e.g.*, JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315–23 (2012) (to be codified in scattered sections of Title 17 of the United States Code).

59. *See id.*

60. *See* discussion *supra* Part II.A–B (noting that the websites Kickstarter and Kiva do not currently offer equity interests; therefore, they are not subject to the rules and regulations of the SEC).

61. *See* discussion *infra* Part IV.

62. *See* Bradford, *supra* note 14, at 81–84 (discussing the various proposals for a crowdfunding exemption).

63. *See, e.g.*, Press Release, The White House Office of the Press Sec’y, On One-Year Anniversary of Startup Am. Initiative President Obama Sends Startup Am. Legislative Agenda to Cong. (Jan. 31, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/01/31/one-year-anniversary-startup-america-initiative-president-obama-sends-st>.

64. *See id.* The four proposals were to (1) raise the limit for mini-offerings; (2) allow startups to raise capital through crowdfunding; (3) create an IPO on-ramp; and (4) expand the small business investment company. *Id.*

65. *See* Hazen, *supra* note 23, at 1750–54 (providing a discussion of the various bills that were introduced in the House and Senate).

66. *See* Schapiro, *supra* note 5.

### A. *Limitations on Amounts Raised & Individual Investments*

Specifically, Title III of the JOBS Act amends § 4 of the 1933 Act and places certain requirements on companies, intermediaries, and investors that utilize the exemption.<sup>67</sup> Under § 4(6) of the 1933 Act, the maximum amount a company can raise under the crowdfunding exemption is \$1 million during a twelve-month period.<sup>68</sup> Additionally, limitations exist for the amount of money a single investor can invest during a twelve-month period.<sup>69</sup> With respect to investors having a net worth less than \$100,000, the maximum amount is the greater of \$2,000 or 5% of their annual income or net worth.<sup>70</sup> For investors who have a net worth or annual income over \$100,000, the maximum amount they can invest is limited to 10% of their annual income or net worth, not to exceed an aggregate amount of \$100,000.<sup>71</sup>

The statutory cap on individuals' investments is an attempt to mitigate the losses that can be sustained without "breaking the bank."<sup>72</sup> Unlike unregulated crowdfunded offerings, in which no limitations exist on the amount an investor can contribute, the statutory caps protect investors from losing all of their money on risky business ventures.<sup>73</sup>

### B. *Broker & Funding Portal Requirements*

Startup companies that issue securities in accordance with Title III must use either a broker or a funding portal registered with the SEC.<sup>74</sup> Section 3(h), added to the 1934 Act, "requires the SEC to exempt, conditionally or unconditionally, an intermediary operating a funding portal from the requirement to register with the SEC as a broker."<sup>75</sup> But the mere registration of an intermediary, without more, does not provide adequate protection for

67. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315 (2012) (to be codified in various sections of Title 17 of the United States Code).

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *See id.*

73. *See, e.g.,* Sigar, *supra* note 23, at 494–96 (noting that the statutory caps act as a safeguard for investor protection).

74. JOBS Act, 126 Stat. at 316–17.

75. *Jumpstart Our Business Startups Act: Frequently Asked Questions About Crowdfunding Intermediaries*, SEC. & EXCHANGE COMMISSION (May 7, 2012), <http://www.sec.gov/divisions/marketreg/tmjbsact-crowdfundingintermediariesfaq.htm> [hereinafter *Crowdfunding Intermediaries*]. A funding portal is defined as a crowdfunding intermediary that does not:

- (A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the [SEC], by rule, determines appropriate.

JOBS Act, 126 Stat. at 322.

investors in the digital age.<sup>76</sup> Considering the history of fraudulent acts by those registered with the SEC, investors cannot rely on a false sense of security that a broker or funding portal is operating in accordance with SEC rules.<sup>77</sup>

### 1. Self-Regulatory Organization

The first requirement under Title III obligates intermediaries to register with a Self-Regulatory Organization (SRO).<sup>78</sup> The SRO must be registered under § 15A of the 1934 Act, and currently, the Financial Industry Regulatory Authority (FINRA) is the only registered SRO.<sup>79</sup> The crowdfunding industry is currently working to create an SRO because Congress did not specify whether the intermediaries must register with FINRA or if they can register with another SRO.<sup>80</sup> The crowdfunding SRO would provide the same services as FINRA, but would focus specifically on regulation of the crowdfunding industry.<sup>81</sup> Requiring an intermediary to register with an SRO is important because it adds another layer of protection to ensure investors that they are being protected from fraudulent practices.<sup>82</sup> Additionally, if the crowdfunding industry is successful in creating a separate SRO, this separate SRO will assist in promoting investor confidence because it will be comprised of members who have a financial stake in the success of crowdfunding.<sup>83</sup> Thus, they would be diligent in their efforts to oversee that those utilizing the crowdfunding exemption are following the rules put in place.<sup>84</sup>

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76. See Hazen, *supra* note 23, at 1736–37. “The SEC’s resources are limited, and the Commission cannot be expected to be effective in the crowdfunding arena—especially considering widely reported enforcement failures involving much larger economic stakes.” *Id.* at 1757.

77. See *id.* at 1767–68; see also Henriques, *supra* note 51; Vardi, *supra* note 51; *supra* text accompanying note 51.

78. See JOBS Act, 126 Stat. at 316.

79. *Crowdfunding Intermediaries*, *supra* note 75. “FINRA’s mission is to protect America’s investors by making sure the securities industry operates fairly and honestly.” *Fixed Income Capital Markets*, CITY SEC. CORP., [www.citysecurities.com/what-we-do/fixed-income-capital-markets/resources/](http://www.citysecurities.com/what-we-do/fixed-income-capital-markets/resources/) (last visited Sept. 8, 2013).

80. See JOBS Act, 126 Stat. at 316 (requiring that intermediaries register with an SRO, but not expressly stating that it has to be FINRA). “SROs can effectively complement the SEC in regulating the market . . . due to the flexibility of SROs compared to government agencies, the expertise of SRO members, and the inherent incentives of SROs.” Sigar, *supra* note 23, at 500. “Bad actors undermine the industry, which causes potential investors to lose confidence in the market and could destroy the market entirely.” *Id.*

81. See *Crowdfunding Industry to Unite Behind Regulatory Organization to Protect Investors*, GATE TECHNOLOGIES (Mar. 23, 2012), [www.gatetechnologies.com/?q=content/crowdfunding-industry-unite-behind-regulatory-organization-protect](http://www.gatetechnologies.com/?q=content/crowdfunding-industry-unite-behind-regulatory-organization-protect) (noting that the Crowdfunding Intermediary Regulatory Association (CFIRA) “will commit to providing investor protection and market integrity through effective and efficient regulation of those within the crowdfunding industry”). Founding partners of CFIRA are Startup Exemption, The SoHo Loft Capital Creation (TSLCC) Events, and Gate Technologies & GATE Impact. *Id.*

82. See, e.g., Sigar, *supra* note 23, at 499–503 (analyzing the importance of an SRO tailored specifically for the crowdfunding industry).

83. See *id.*

84. See *id.*

## 2. Investor Education

Next, intermediaries are tasked with educating investors about the risks associated with making an investment in a startup company.<sup>85</sup> The general public's lack of knowledge, however, presents a problem.<sup>86</sup> A recent SEC study found "four key content areas to promote financial literacy: (1) different types of risk; (2) the fees and costs associated with investing; (3) proactive steps for avoiding fraud; and (4) general investment knowledge, including topics such as compound interest."<sup>87</sup> But Title III does not expressly state what questions intermediaries need to ask investors, or how to ask them.<sup>88</sup> Proposed in Part IV of this Comment is a uniform system of investor education to certify that individuals who choose to purchase a crowdfunded security online understand the risks associated with the offering.<sup>89</sup>

## 3. Monitoring Individual Caps

The last major requirement under Title III obligates intermediaries to protect investors from exceeding their individual investment limits.<sup>90</sup> Title III, however, does not provide intermediaries with a method to monitor the limitations placed on investors.<sup>91</sup> The lack of guidance in this particular area raises concerns over investor protection because investors could easily exceed the statutory caps designed to protect them from significant monetary losses.<sup>92</sup> To exacerbate the problem this poses to investor protection, many different funding portals will be offering interests from different companies; thus, investors are likely to contribute amounts through many different websites.<sup>93</sup> Without a way to monitor individual investment activity, the statutory caps placed on investors will not provide a meaningful safeguard.<sup>94</sup>

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85. See JOBS Act, 126 Stat. at 316.

86. See Bradford, *supra* note 14, at 104–13 (discussing studies that illustrate the lack of financial knowledge by the general public, along with the risks associated with investing in startup companies).

87. Palmiter, *supra* note 50, at 400.

88. See JOBS Act, 126 Stat. at 316.

89. See discussion *infra* Part IV.B.

90. See JOBS Act, 126 Stat. at 316.

91. See discussion *infra* Part IV.A.

92. See JOBS Act, 126 Stat. at 316 (requiring intermediaries to ensure that investors do not exceed the express statutory caps; however, there is no guidance given to intermediaries as to how to comply with this requirement).

93. See *Crowdfunding Industry Report*, *supra* note 23, at 2 (noting that as of the date of the survey, which was completed in the first quarter of 2012, the Directory of Crowdfunding Sites contained 452 active crowdfunding platforms); *Sharp Spike in Crowdfunding Presence*, *supra* note 55.

94. See, e.g., Sigar, *supra* note 23, at 494–96 (considering the statutory caps on individual investments a safeguard to protect investors from losing money). Intermediaries need guidance to comply with this requirement, and Part IV of this Comment explains how a centralized database that monitors statutory caps will assist intermediaries in complying with this requirement. See discussion *infra* Part IV.A.

*C. Disclosure Requirements for Issuers*

A company that issues securities under the crowdfunding exemption must file certain disclosures with the SEC and must provide these disclosures to the intermediary and investors.<sup>95</sup> The required disclosures include information on the officers, directors, and major shareholders of the issuers, along with a description of the company's business and anticipated business plan.<sup>96</sup> The issuer must also disclose a target offering amount, the deadline to reach the stated amount, and updates on the progress of the issuer in reaching that amount.<sup>97</sup>

Title III also imposes various requirements on issuers, depending on the target offering amount of the issuer.<sup>98</sup> The target amounts are separated into three categories: \$100,000 or less; more than \$100,000, but less than or equal to \$500,000; and more than \$500,000.<sup>99</sup> For target amounts of \$100,000 or less, Title III requires that the issuer provide income tax returns for the most recent completed year, along with financial statements that are certified by the principal executive officer.<sup>100</sup> The next category, which applies to amounts over \$100,000 but less than \$500,000, requires the issuer to provide financial statements reviewed by an independent public accountant.<sup>101</sup> For amounts over \$500,000, the issuer must provide audited financial statements.<sup>102</sup>

The express disclosure requirements seem to strike a balance between being too permissive and too burdensome.<sup>103</sup> If the disclosure requirements are overly permissive, the doors are opened to increased fraudulent acts that take advantage of the unsophistication of the crowd.<sup>104</sup> To the contrary, if they are too burdensome, the exemption will not be utilized to its maximum potential because the costs of compliance will outweigh the benefits of offering securities to the general public.<sup>105</sup>

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95. JOBS Act, 126 Stat. at 317.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *See id.* at 317–18; *see also* Hazen, *supra* note 23, at 1765–68 (discussing the disclosure requirements currently in place under the JOBS Act).

104. *See* Hazen, *supra* note 23, at 1765–68.

105. *See generally* Sigar, *supra* note 23, at 482–84 (discussing the administrative and accounting challenges).

## IV. FACILITATING INVESTOR PROTECTION: PROPOSALS TO THE SEC

The SEC is currently in the process of finalizing the rules for Title III of the JOBS Act, and summarized below are two proposals to the SEC that address issues that could arise under the current scheme.<sup>106</sup>

A. *Central Database to Monitor Individual Caps*

For investors, the statutory cap on individual contributions provides a safeguard to protect them from losing their entire savings.<sup>107</sup> The JOBS Act places the requirement on intermediaries to ensure that these investors do not exceed the aggregate limit allowed, but as noted in Part III, this will be a problem because investors will likely utilize more than one broker or funding portal.<sup>108</sup>

In order to streamline the process and make the JOBS Act more attractive to intermediaries, an independent third party should maintain a separate database that contains all of the information on investors relating to the maximum amount they can invest.<sup>109</sup> Once investors provide information to an intermediary, this information would be immediately transmitted to the third-party database to determine the maximum contribution for that investor.<sup>110</sup> Software could be developed to communicate between intermediaries and third parties that would electronically transmit information after an investor completes a transaction.<sup>111</sup> This software could then limit investors who attempt to exceed their maximum amount.<sup>112</sup>

Before the target amount is acquired for a company, intermediaries are required to allow investors to cancel their investments.<sup>113</sup> If an investor does cancel his or her investment, the software could recognize this transaction and adjust the investor's statutory cap accordingly.<sup>114</sup> Also, if a company does not succeed in reaching its target amount, investors receive their money back; therefore, the software could recognize this event and credit the investors' accounts.<sup>115</sup> Essentially, this database would benefit intermediaries who

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106. See Markowitz, *supra* note 15 (explaining that the SEC still has to work out the details for the JOBS Act and that there is really no deadline for implementation).

107. See JOBS Act, 126 Stat. at 315; discussion *supra* Part III.A.

108. See discussion *supra* Part III.B.3.

109. See, e.g., John Gladstone Mills III, *Entertainment on the Internet: First Amendment and Copyright Issues*, 79 J. PAT. & TRADEMARK OFF. SOC'Y 461, 467 (1997) (describing a Software Membership Organization (SMO) that "would statistically monitor selected transmissions from each Internet provider").

110. See, e.g., Thomas M. Pitegoff, *Open Source, Open World: New Possibilities for Computer Software in Business*, 11 BUS. L. TODAY 52, 52 (2001) (explaining how proprietary software can be developed).

111. See *id.*

112. See *id.*

113. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 316 (2012) (to be codified in various sections of Title 17 of the United States Code).

114. See *id.*

115. See, e.g., Pitegoff, *supra* note 110, at 52.

participate in crowdfunding, as well as maintain the level of protection the statutory caps are intended to afford.<sup>116</sup>

### B. Uniform System for Investor Education

Another area of concern regarding investor protection pertains to the ability of the general public to invest in inherently risky startup companies.<sup>117</sup> To assist with this troublesome component of crowdfunding, the JOBS Act requires intermediaries to ensure investors are educated; however, it does not provide any guidance on how to accomplish this task.<sup>118</sup> The majority of crowdfunding will likely occur through online funding portals, with each portal having a large number of individual investors.<sup>119</sup> To assist in the education of investors, the SEC should implement rules that require each funding portal to ask investors the same questions to test their financial knowledge, as well as adopt a uniform system to ensure that investors spend the appropriate time educating themselves on startup businesses.<sup>120</sup>

Under this proposal for a uniform system, an investor could be linked to a third-party website and directed to take an online course featuring “text passages, streaming videos, flash animations and interactive quizzes designed to make . . . [the learning] experience engaging and enjoyable.”<sup>121</sup> The SEC and the crowdfunding industry could work together to develop the appropriate questions to ensure unsophisticated investors become educated to the point that they understand the risks associated with investing their money in a startup company.<sup>122</sup> Each question would be timed to safeguard against investors just guessing their way through the quiz to finish quickly, and after each answer is submitted, the investor would be provided with an explanation on each of the choices and why the one he chose was correct or incorrect.<sup>123</sup> Some of the

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116. See discussion *supra* Part III.B.3.

117. See, e.g., Bradford, *supra* note 14, at 104–13.

118. See *id.*

119. See Palmiter, *supra* note 50, at 400; discussion *supra* Part II.C.3.

120. See Bradford, *supra* note 14, at 138–39 (proposing a similar system for investor education); Heminway & Hoffman, *supra* note 23, at 957–59 (discussing investor education).

121. *How it Works*, TEX. ONLINE ADULT DRIVER’S EDUC., <http://adultdriversed.getdefensive.com/how-it-works-adult-drivers-ed.aspx> (last visited Sept. 10, 2013) [hereinafter TEX. ONLINE ADULT DRIVER’S EDUC.]. An SEC study found that having investor education centralized will ensure uniformity. See Palmiter, *supra* note 50, at 400. Because all individuals learn differently, it is important to incorporate a system conducive to various learning styles. See generally Aida M. Alaka, *Learning Styles: What Difference Do the Differences Make?*, 5 CHARLESTON L. REV. 133, 142 (2011) (discussing the different learning styles and explaining that “[m]atching or mismatching students’ learning styles with instructional techniques affects learning significantly”).

122. See Bradford, *supra* note 14, at 138–39.

123. See TEX. ONLINE ADULT DRIVER’S EDUC., *supra* note 121. Online driving courses are timed to ensure that course participants spend the appropriate amount of time on each subject. See *id.*; see also Bradford, *supra* note 14, at 109 (noting that there “would be a less significant concern if crowdfunding investors were sophisticated enough to protect themselves”).

basic questions and answers that could be incorporated into this uniform system are stated on the SEC's website:

- Is this investment product registered with the SEC and my state securities agency?
- Does this investment match my investment goals? Why is this investment suitable for me?
- How will this investment make money? (Dividends? Interest? Capital gains?) Specifically, what must happen for this investment to increase in value? (For example, increase in interest rates, real estate values, or market share?)
- What are the total fees to purchase, maintain, and sell this investment? Are there ways that I can reduce or avoid some of the fees that I'll pay, such as purchasing the investment directly? After all the fees are paid, how much does this investment have to increase in value before I break even?
- How liquid is this investment? How easy would it be to sell if I needed my money right away?
- What are the specific risks associated with this investment? What is the maximum I could lose? (For example, what will be the effect of changing interest rates, economic recession, high competition, or stock market ups and downs?)
- How long has the company been in business? Is its management experienced? Has management been successful in the past? Have they ever made money for investors before?
- Is the company making money? How are they doing compared to their competitors?<sup>124</sup>

In addition to providing the investor education quiz, the third-party site could maintain a database of all of the investors who took the quiz so that investors do not have to take the quiz each time they decide to make an investment through a funding portal. This uniform system would ensure that all of the investors who are investing through a crowdfunding platform receive the same minimum level of education as each other, as well as assist intermediaries in complying with the requirements of the JOBS Act.<sup>125</sup>

The word is out about crowdfunding, and the doors have been opened for a surge of people to lose their money because they believe they can now

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124. See *Ask Questions: Questions You Should Ask About Your Investments . . . and What to Do if You Run Into Problems*, SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/investor/pubs/askquestions.htm> (last modified Aug. 1, 2007).

125. See discussion *supra* Part III.B.



purchase an equity interest in a company through a website.<sup>126</sup> Thus, practitioners should be aware of the remedies currently available to their clients if they purchase an unregistered security, as well as remedies available for fraudulent acts by companies or funding portals after Title III becomes effective.<sup>127</sup>

## V. WHAT CAN I DO TO GET MY MONEY BACK?: STATE AND FEDERAL REMEDIES

As illustrated in the John Smith hypothetical introduced in Part I of this Comment, an investor could lose money by purchasing an unregistered security through an online funding portal.<sup>128</sup> Given this risk, there are remedies currently available to investors under state and federal law.<sup>129</sup> Conversely, after Title III becomes effective, securities offered through websites such as GetRichCrowdfunding will be exempt from registration.<sup>130</sup> But if a company or funding portal makes a misrepresentation or omits a material fact that induces an investor, such as John Smith, to purchase a security, remedies exist to redress the financial loss.<sup>131</sup>

### A. Purchasing Unregistered Securities

#### 1. State Remedy: Texas Securities Act

In Texas, the remedy for purchasing an unregistered security falls under § 33A(1) of the Texas Securities Act (TSA) and provides investors with the option to sue for rescission of a transaction.<sup>132</sup> For an investor to bring a claim under § 33A(1) he must (1) be the person who purchased the security, and (2) bring the claim for the violation within three years from the date he purchased the security.<sup>133</sup> John Smith would clearly satisfy these two requirements, provided he does not delay bringing the claim against Friendsbook.<sup>134</sup> An advantage to suing for rescission is that Friendsbook has no statutory defenses under § 33A(1) because, “in essence, [it is] a strict liability statute.”<sup>135</sup>

If successful under § 33A(1), John would be able to recoup the amount he paid for the security, minus any income that he might have received as a result

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126. See *Sharp Spike in Crowdfunding Presence*, *supra* note 55 (noting the spike in the number of domain names that contain the word “crowdfund”).

127. See discussion *infra* Part V.

128. See discussion *supra* Part I.

129. See discussion *infra* Parts V.A–B.

130. See discussion *supra* Part III.

131. See discussion *infra* Parts V.A–B.

132. TEX. REV. CIV. STAT. ANN. art. 581, § 33A(1) (West 2010).

133. See *id.*; Keith A. Rowley, *The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99, 115 (1998).

134. See discussion *supra* Part I.

135. Rowley, *supra* note 133, at 114.

of owning the security.<sup>136</sup> In addition, John would be able to recover any prejudgment interest on the amount he paid for the security.<sup>137</sup> Any court costs and attorney fees would also be recoverable to the extent that the attorney fees are reasonable under the circumstances.<sup>138</sup>

## 2. Federal Remedy: Securities Act of 1933

Although the TSA provides one remedy for investors such as John Smith, the 1933 Act provides a similar remedy that would allow him to rescind the transaction.<sup>139</sup> John could bring a claim under § 12(1) of the 1933 Act for rescission of the transaction with Friendsbook.<sup>140</sup>

To plead a cause of action under Section 12(1), a plaintiff must allege that: 1) The defendant offered or sold a security; 2) The mails or some means of communication interstate commerce were utilized in connection with the offer or sale; 3) Section 5 applied to the transaction and was violated; 4) The requirements of Section 13, the statute of limitations provision, were met; and 5) If rescission is the requested relief, that the plaintiff has tendered the security.<sup>141</sup>

Similar to the TSA, John could recover the consideration paid for the security minus any income received as a result of owning the security.<sup>142</sup> Friendsbook would have no statutory defenses under § 12(1), but the problem that John could face relates to the statute of limitations provision in § 13.<sup>143</sup> Unlike § 33A(1) of the TSA, which allows John to bring a claim within three years from the date he purchased the security, § 13 of the 1933 Act only provides a one-year window for § 12(1) claims.<sup>144</sup> The 1933 Act, however, does provide John a three-year window from the date the securities were first offered to the public, but this could be a problem because Friendsbook may have been offering unregistered securities for longer than three years.<sup>145</sup> Essentially, both windows could close on John before he realizes he purchased an unregistered security.<sup>146</sup>

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136. TEX. REV. CIV. STAT. ANN. art. 581, § 33D(1) (West Supp. 2001).

137. *Id.* § 33D(2).

138. *Id.* § 33D(7).

139. See 15 U.S.C. § 771(1) (2012); see also 2 RONALD E. MALLIN ET AL., LEGAL MALPRACTICE § 13, at 8 (2013 ed.) (explaining § 12(1) of the Securities Act of 1933).

140. 15 U.S.C. § 771(1).

141. MALLIN ET AL., *supra* note 139, at 8.

142. See, e.g., Richard M. Weinroth, *Overview of Civil and Criminal Liability of Clients and Attorneys for Federal and Arizona Securities Violations*, 26 ARIZ. ST. L.J. 1, 8 (1994).

143. MALLIN ET AL., *supra* note 139, at 8.

144. See *id.*

145. See *id.*

146. See *id.*

The two remedies available to John Smith, § 33A(1) of the TSA and § 12(1) of the 1933 Act, provide him with the opportunity to recover any financial loss suffered by purchasing an unregistered security online.<sup>147</sup> Suppose that Title III of the JOBS Act is implemented and Friendsbook qualifies under the crowdfunding exemption and does not have to register its securities.<sup>148</sup> Suppose further that Friendsbook made a misrepresentation or omission of material fact that induced John Smith to purchase a security: what remedies would be available?<sup>149</sup>

### B. Victim of Fraud

After Title III becomes effective, various remedies exist under state and federal law to address fraudulent acts by a funding portal or company offering crowdfunded securities.<sup>150</sup> Essentially, a plaintiff is not limited to selecting one remedy over another and has the option of stating a cause of action under all of the state and federal remedies discussed below.<sup>151</sup>

#### 1. Options in Texas

For victims of fraud, Title III has “no impact or limitation on . . . State authority to take enforcement action with regard to an issuer, funding portal, or any other person or entity using the [crowdfunding] exemption . . . .”<sup>152</sup> By not limiting a State’s authority to take action with respect to fraudulent acts, investors and practitioners have more options when bringing a claim against an individual or company that has defrauded them.<sup>153</sup> In Texas, investors such as John Smith could recover their financial losses by “su[ing] for rescission due to or damages arising from a misrepresentation or omission of material fact pursuant to (1) common law; (2) the Texas Securities Act; [or] (3) section 27.01 of the Texas Business and Commerce Code.”<sup>154</sup>

The statutes of limitations for the remedies available in Texas are four years for common law fraud, three years for the TSA, and four years for the

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147. See *supra* text accompanying notes 141–146.

148. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 322 (2012) (to be codified in various sections of Title 17 of the United States Code).

149. See discussion *infra* Part V.B.1–2.

150. See discussion *infra* Part V.B.1–2.

151. Rowley, *supra* note 133, at 203; see *Dorsey v. Portfolio Equities, Inc.*, 540 F.3d 333, 341–44 (5th Cir. 2008) (discussing the different remedies for securities fraud in Texas).

152. JOBS Act, 126 Stat. at 322 (footnotes omitted).

153. See discussion *infra* Part V.B.1–2.

154. Rowley, *supra* note 133, at 122. Common law fraud in Texas requires “a material misrepresentation, which was false, and which was either known to be false when made or was asserted without knowledge of the truth, which was intended to be acted upon, which was relied upon, and which caused injury.” *Dorsey*, 540 F.3d at 341 (quoting *Johnson & Johnson Med., Inc. v. Sanchez*, 924 S.W.2d 925, 929–30 (Tex. 1996)) (internal quotation marks omitted); see TEX. REV. CIV. STAT. ANN. art. 581, § 33 (West 2010); TEX. BUS. & COMM. CODE ANN. § 27.01 (West 2009).

Texas Business and Commerce Code.<sup>155</sup> Two important aspects of these remedies are (1) the reliance of the investor on the misrepresentation or omission of material fact by the defendant, and (2) the defendant's state of mind when making the misrepresentation or omission.<sup>156</sup> For claims under the TSA, reliance is not a factor; however, under common law fraud and § 27.01 of the Texas Business and Commerce Code, the investor must prove that he or she relied on the misrepresentation or omission of material fact when purchasing the security.<sup>157</sup> The second aspect, the defendant's state of mind, is taken into consideration under common law fraud, but not the TSA or § 27.01 of the Texas Business and Commerce Code.<sup>158</sup> In considering the defendant's state of mind, the plaintiff must prove that the defendant acted with scienter—the “intent to deceive or act[ing] with a highly reckless disregard for the truth.”<sup>159</sup>

Considering the express disclosure requirements under Title III of the JOBS Act, an investor would likely be successful under any of the three remedies in Texas.<sup>160</sup> The advantage for investors who purchase crowdfunded securities and sue under § 27.01 of the Texas Business and Commerce Code is that they are statutorily entitled to recover court costs and attorney's fees.<sup>161</sup> A claim under TSA allows court costs to be recovered, but the attorney's fees are left to the court's discretion.<sup>162</sup> To the contrary, a successful claim alleging common law fraud does not entitle the plaintiff to be awarded court costs or attorney's fees.<sup>163</sup> Accordingly, this makes § 27.01 of the Texas and Business Commerce Code the best option for an investor who is defrauded by a company.<sup>164</sup> In addition to the remedies available in Texas, investors also have options available to them to recover financial losses under the 1933 Act and the 1934 Act.<sup>165</sup>

## 2. Title III of the JOBS Act and Rule 10b-5

Title III amends the 1933 Act to allow an investor to bring a private action against an issuer of securities, as well as a funding portal, for misrepresentations and omissions made in connection with a crowdfunded offering.<sup>166</sup> Section 12(2) does not require that the plaintiff rely on the

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155. See Rowley, *supra* note 133, at 201–02.

156. *Id.*

157. *Id.* at 122.

158. *Id.*

159. Hazen, *supra* note 23, at 1757–58.

160. See discussion *supra* Part III.C.

161. See, e.g., Rowley, *supra* note 133, at 202.

162. See *id.*

163. See *id.*

164. See *id.* at 202–03.

165. See discussion *infra* Part V.B.2.

166. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 319 (2012) (to be codified in scattered sections of Title 17 of the United States Code); see also Palmiter, *supra* note 50, at 403–08 (providing an in-depth discussion of the private remedy available under § 12 of the JOBS Act).

misrepresentations or omissions and provides the same remedies available under § 12(1) of the Act.<sup>167</sup> Defendants do have one defense under § 12(2), and it requires them to show that they “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission made to the person purchasing the security.”<sup>168</sup>

In addition to § 12(2), investors have another remedy under the federal securities laws, Rule 10b-5, which derives from the 1934 Act.<sup>169</sup> “In order to state a cause of action under Rule 10b-5 as it relates to material omissions and misstatements, a private plaintiff must allege a material misstatement or omission in connection with the purchase or sale of a security, made with scienter by the defendant, and justifiably relied upon by the plaintiff.”<sup>170</sup> If successful under Rule 10b-5, a plaintiff can rescind the transaction or recover damages.<sup>171</sup>

Providing adequate remedies for investors is crucial to the success of crowdfunding because it is inevitable that there will be fraudulent schemes that arise, and if investors lose substantial amounts of money with no recovery option, crowdfunding will not become a viable tool for raising capital.<sup>172</sup>

## VI. CONCLUSION

The JOBS Act is intended not only to assist entrepreneurs and startups in acquiring capital, but also to assist in creating what the acronym spells out—“jobs.”<sup>173</sup> Some sources say that this has been the worst recession since the Great Depression, with the unemployment rate averaging around 9.3% from 2009–2011.<sup>174</sup> Studies show that entrepreneurs create jobs by starting new businesses; thus, it is important to provide resources such as the JOBS Act that enable businesses to develop and expand, which in turn creates new jobs.<sup>175</sup>

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167. See Weinroth, *supra* note 142, at 22.

168. *Id.* at 23; see also Hazen, *supra* note 23, at 1757–58 (discussing the requirements of Rule 10b-5).

169. 17 C.F.R. § 240.10b-5 (2013); see Hazen, *supra* note 23, at 1765–66. Crowdfunding will “likely . . . attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.” Hazen, *supra* note 23, at 1765–66.

170. Weinroth, *supra* note 142, at 24 (footnotes omitted).

171. *Id.*

172. See Bradford, *supra* note 14, at 115–16.

173. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of Title 17 of the United States Code).

174. See Michael B. Sauter et al., *The 13 Worst Recessions, Depressions, and Panics in American History*, 24/7 WALL ST. (Sept. 9, 2012, 6:14 PM), <http://247wallst.com/2010/09/09/the-13-worst-recessions-depressions-and-panics-in-american-history/3> (noting that the crisis began in March 2008, when investment bank Bear Stearns was “the first of dozens of major American institutions to fail or be bailed out by the Fed”); see also *Household Data Annual Averages*, U.S. DEP’T OF LABOR: BUREAU OF LABOR STAT. 2 (2012), <http://www.bls.gov/cps/cpsaat01.pdf> (noting that the unemployment rate of the civilian non-institutional population increased from 5.8% in 2008 to 9.3% in 2009, 9.6% in 2010, and 8.9% in 2011).

175. See Brian Tracy, *The Role of the Entrepreneur*, ENTREPRENEUR (June 19, 2005), <http://www.entrepreneur.com/article/78478> (describing entrepreneurs as being a “national treasure” and “the most important people in a market economy”); see also Michael Brenner, *Technology and The Power of Small Business To Drive Innovation and Jobs*, FORBES (Apr. 10, 2012, 11:56 AM), <http://www.forbes.com>.

But before the JOBS Act can have any impact on creating new jobs, the SEC must implement the final rules that allow equity-based crowdfunding to become a reality.<sup>176</sup> As discussed, different layers of protection exist under the JOBS Act to protect investors, but as proposed in this Comment, one area that needs to be amended relates to intermediaries and investor education.<sup>177</sup> The JOBS Act places the burden on intermediaries to educate a new type of investor; however, there is no uniform system to confirm that all of the intermediaries are taking the appropriate steps to ensure investors are receiving adequate education before investing.<sup>178</sup> The proposals relieve some of the burden on intermediaries and ensure that the safeguards under the JOBS Act protect investors.<sup>179</sup>

The “crowdfunded security” may not be a familiar term to many people, but “securities fraud” is, and it can arrive in small or large packages.<sup>180</sup> Whether investors lose \$250 or \$2,500, remedies exist under state and federal law to redress harm caused to them by a fraudulent act.<sup>181</sup> It is crucial for practitioners to understand the different remedies available to clients who become victims of crowdfunding, because an investor who lacks financial literacy is just “one click away” from having to sell the farm.<sup>182</sup>

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com/sites/sap/2012/04/10/technology-and-the-power-of-small-business-to-drive-innovation-and-jobs (noting that over the past seventeen years, small businesses have accounted for 65% of new jobs); Dane Stangler & Robert E. Litan, *Kauffman Foundation Research Series: Firm Formation and Economic Growth—Where Will the Jobs Come From?*, EWING MARION KAUFFMAN FOUND. (Nov. 2009), [http://www.kauffman.org/uploaded/Files/where\\_will\\_the\\_jobs\\_come\\_from.pdf](http://www.kauffman.org/uploaded/Files/where_will_the_jobs_come_from.pdf) (discussing 2007 Census data that illustrates the impact of startups).

176. See Markowitz, *supra* note 15.

177. See discussion *supra* Part V.

178. See discussion *supra* Parts III.B.2, IV.B.

179. See discussion *supra* Part IV.

180. See discussion *supra* Part I.

181. See discussion *supra* Part V.

182. See discussion *supra* Part II.A–B.