
Report to the Commission

Regulation Crowdfunding



This is a report by the staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

June 18, 2019

Table of Contents

I.	Executive Summary	3
II.	Background.....	5
	A. Overview of Regulation Crowdfunding.....	6
	B. Overview of the Study and Report to the Commission	11
III.	Experience with Regulation Crowdfunding	13
	A. Regulation Crowdfunding Offerings Issuers, and Investors	14
	1. Capital formation in the crowdfunding market.....	14
	2. Characteristics of crowdfunding issuers and offerings	17
	3. Costs to issuers of undertaking a crowdfunding offering	23
	B. Regulation Crowdfunding Intermediaries	27
	C. Impact of Regulation Crowdfunding on Capital Formation and Investor Protection	27
	1. Issuer and intermediary compliance.....	27
	2. Issuer offering limits and investor investment limits	34
	3. Incidence of fraud, investor losses, and compliance with investor aggregates.....	42
	4. Intermediary fee and compensation structures.....	47
	5. Measures intermediaries have taken to reduce the risk of fraud, including reliance on issuer and investor representations	49
	6. The concept of a centralized database of investor contributions	51
	7. Intermediary policies and procedures	52
	8. Intermediary recordkeeping practices	52
	9. Secondary trading market practices	53
	10. Other aspects of the Regulation Crowdfunding experience	57

I. Executive Summary

The Jumpstart Our Business Startups Act (the “JOBS Act”),¹ enacted on April 5, 2012, established a regulatory structure for startups and small businesses to raise capital through securities offerings through crowdfunding.² On October 30, 2015, the Commission adopted the final rules for Regulation Crowdfunding to implement Title III of the JOBS Act (“Title III”).³ In the Adopting Release, the Commission stated that “staff will undertake to study and submit a report to the Commission no later than three years following the effective date of Regulation Crowdfunding on the impact of the regulation on capital formation and investor protection.”⁴

Consistent with the Adopting Release, staff has undertaken a study of the available information on the capital formation and investor protection impacts of Regulation Crowdfunding. This report has summarized quantitative information, where it was available to the staff, as well as qualitative observations of SEC staff and FINRA staff, and input from market participants regarding their experience with Regulation Crowdfunding. In some instances, the analysis was limited by a lack of data or confined to secondary sources. Further, due to the time frame of the study and market size to date, the analysis involved a relatively small number of issuers and a relatively short time period, which coincided with favorable economic conditions. Thus, the study’s findings may not be informative about future trends in the crowdfunding market.

¹ Pub. L. No. 112-106, 126 Stat. 306 (2012).

² In this report, the term “crowdfunding” is generally used to refer to securities-based crowdfunding under Regulation Crowdfunding and Section 4(A)(6) of the Securities Act, except where specified otherwise.

³ See *Crowdfunding*, Rel. No. 33-9974 (Oct. 30, 2015) [80 FR 71387 (Nov. 16, 2015)] (“Adopting Release”), at 71388.

⁴ Adopting Release, at 71390.

Certain information is summarized below, and our detailed analysis and findings are discussed more fully in the body of this report.

- The number of crowdfunding offerings as well as the total amount of funding during the considered period was relatively modest. Between May 16, 2016 and December 31, 2018, we estimate that there were 1,351 offerings, excluding withdrawn filings, seeking in the aggregate a target, or minimum, amount of \$94.3 million and a maximum amount of \$775.9 million.
- The market exhibited growth over time: 292 offerings initiated during the first year, 557 during the second year, and approximately 502 during the first part of the third year (from May 16, 2018 through December 31, 2018) since the rules went into effect. While most issuers undertook one offering during this period, some issuers (105) returned to the crowdfunding market for follow-on offerings.
- The typical offering was small and raised less than the 12-month offering limit. The median target amount sought was \$25,000 and the median maximum amount sought was \$500,000. We estimate that 539 offerings reported raising at least the minimum (target) amount. Of the offerings that were reported completed, the average offering sought a target amount of approximately \$52,428 and a maximum amount of approximately \$577,385 and raised approximately \$208,300 per offering and approximately \$107.9 million in the aggregate, which does not include investor commitments in ongoing offerings. The median amount reported raised was approximately \$107,367. We estimate that 29 offerings reported raising at least \$1.07 million from May 16, 2016 through December 31, 2018. In reviewing issuers conducting multiple offerings, we observed only three issuers that reported raising

more than \$1.07 million during the approximately 2.5 years since Regulation Crowdfunding went into effect.

- The majority of issuers that sought financing under Regulation Crowdfunding during the considered period were relatively small and early in their lifecycle. Based on information in offering statement filings, the median offering was by an issuer that was incorporated approximately two years prior to the offering and employed about three people. The median issuer had total assets of approximately \$30,000, cash holdings of approximately \$4,000, and no revenues (just over half of the offerings were by issuers with no revenues).
- During the considered period, there were relatively few enforcement actions taken against issuers and intermediaries in the crowdfunding market. However, this inference is inherently limited by the potential latency of misconduct as well as a relatively short period of observation.

II. Background

The JOBS Act crowdfunding provisions were intended to help startups and small businesses raise capital in a less costly manner by making relatively low dollar offerings of securities to a “crowd” of interested investors.⁵ On October 30, 2015, the Commission adopted the final rules for Regulation Crowdfunding, which went into effect on May 16, 2016, with the

⁵ See *Crowdfunding*, Rel. No. 33-9974 (Oct. 30, 2015) [80 FR 71387 (Nov. 16, 2015)] (“Adopting Release”), at 71388.

exception of the provisions governing funding portal registration, which became effective on January 29, 2016.⁶

A. Overview of Regulation Crowdfunding

Title III added new Section 4(a)(6) to the Securities Act of 1933,⁷ which provides an exemption from the registration requirements of Securities Act Section 5⁸ for certain crowdfunding transactions. Regulation Crowdfunding, which prescribes the rules governing the offer and sale of securities under Section 4(a)(6), permits an issuer to raise a maximum aggregate amount of \$1.07 million in a 12-month period,⁹ limits the amount individuals may invest in offerings under the exemption,¹⁰ requires issuers to disclose certain information about their business and the offering,¹¹ and creates a regulatory framework for the intermediaries that facilitate the crowdfunding transactions.¹²

Limits on how much each investor may invest over the course of a 12-month period in the aggregate across all crowdfunding offerings depend on the investor's annual income or net worth. If either the investor's annual income or net worth is less than \$107,000, the limit equals the greater of \$2,200 or five percent of the lesser of the annual income or net worth. If both the

⁶ FINRA also has adopted rules regarding funding portals. See <http://www.finra.org/industry/funding-portals>.

⁷ 15 U.S.C. 77d(a)(6).

⁸ 15 U.S.C. 77e.

⁹ 17 CFR 227.100(a)(1). When Regulation Crowdfunding was adopted, the maximum aggregate amount an issuer was permitted to raise in a 12-month period was \$1 million. On March 31, 2017, the Commission adjusted for inflation certain thresholds in Regulation Crowdfunding, as required by Title III of the JOBS Act, including the limit on capital raised. See *Inflation Adjustments and Other Technical Amendments under Titles I and III of the JOBS Act (Technical Amendments; Interpretation)*, Rel. No. 33-10332 (Mar. 31, 2017) [82 FR 17545 (Apr. 12, 2017)] ("2017 Amendments"). Inflation adjustment is required not less frequently than every five years.

¹⁰ 17 CFR 227.100(a)(2).

¹¹ 17 CFR 227.201-203.

¹² 17 CFR 227.100(a)(3), 227.300-305, 227.400-404.

investor's annual income and net worth are at least \$107,000, then the limit equals ten percent of the lesser of the annual income or net worth, up to a maximum of \$107,000.¹³

Certain categories of companies are ineligible to use the Regulation Crowdfunding exemption, including: (1) non-U.S. companies; (2) companies subject to the requirement to file reports under Section 13 or 15(d) of the Securities Exchange Act of 1934; (3) certain investment companies; (4) companies disqualified under the bad actor disqualification provisions of Regulation Crowdfunding;¹⁴ (5) companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement; and (6) companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.¹⁵

Securities purchased in a crowdfunding transaction generally cannot be resold for a period of one year, with certain exceptions.¹⁶ Holders of these securities do not count toward the record holder threshold that requires an issuer to register its securities with the Commission under Section 12(g) of the Exchange Act so long as the issuer is current in its annual reporting

¹³ 17 CFR 227.100(a). The investment limits prior to the 2017 inflation adjustments were the greater of \$2,000 or 5 percent of the lesser of the annual income or net worth, if either annual income or net worth was less than \$100,000 or 10 percent of the lesser of the annual income or net worth if both annual income and net worth were \$100,000 or more.

¹⁴ 17 CFR 227.503.

¹⁵ 17 CFR 227.100(b).

¹⁶ 17 CFR 227.501(a).

obligation, retains the services of a registered transfer agent, and has less than \$25 million in assets as of the end of its most recently completed fiscal year.¹⁷

Regulation Crowdfunding requires issuers to file certain information with the Commission on Form C and provide this information to investors and the relevant intermediary facilitating the crowdfunding offering. The information must be publicly available for at least 21 days before any securities may be sold, although the intermediary may accept investment commitments during that time.¹⁸

The issuer is required to disclose in its offering statement, among other things, information about its officers and directors as well as owners of 20% or more of the issuer; a description of the issuer's business and the use of proceeds from the offering; the price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount, and whether the issuer will accept investments in excess of the target offering amount; certain related-party transactions; a discussion of the issuer's financial condition; and financial statements.¹⁹

Requirements applicable to financial statements included in Form C depend on the amount offered and sold during a 12-month period:²⁰

- For issuers offering no more than \$107,000 in a 12-month period, the principal executive officer must certify that the financial statements are true and complete in all material

¹⁷ 17 CFR 240.12g-6. Section 12(g) provides that an issuer must register its securities once it has total assets exceeding \$10 million and a class of securities held of record by either 2,000 persons or 500 person that are not accredited investors.

¹⁸ See 17 CFR 227.303(a).

¹⁹ 17 CFR 227.201.

²⁰ 17 CFR 227.201(t).

respects and the disclosure must contain certain information from the issuer's federal income tax return. However, if financial statements are available that have been reviewed or audited by an independent accountant, those must be provided instead.

- Issuers offering more than \$107,000 but not more than \$535,000 in a 12-month period (or up to \$1,070,000 for the issuer's first crowdfunding offering) must have their financial statements reviewed by an independent accountant and file the accountant's review report with the Form C.
- Issuers offering more than \$535,000 in a 12-month period in a follow-on crowdfunding offering must have their financial statements audited by an independent accountant and file the accountant's audit report with the Form C.

Issuers are required to amend the offering document during the offering period to reflect material changes.²¹ In addition, issuers must provide updates on the issuer's progress toward reaching the target offering amount.²² Issuers that have sold securities in reliance on the Regulation Crowdfunding exemption also are required to file an annual report with the Commission on Form C-AR and provide it to investors.²³

Transactions must take place exclusively through a platform operated by a crowdfunding intermediary that is registered with the Commission (either a registered broker-dealer or a

²¹ 17 CFR 227.203(a)(2).

²² 17 CFR 227.203(a)(3). Issuers are not required to file interim progress updates if the crowdfunding intermediary makes publicly available on the intermediary's platform frequent updates regarding the progress of the issuer in meeting the target offering amount. In practice, consistent with this provision, we have observed that issuers generally rely on the intermediary to provide interim updates on its platform. However, issuers relying on this provision remain required to file a final offering update on Form C-U to disclose the total amount of securities sold in the offering no later than five business days after the offering deadline.

²³ 17 CFR 227.202; 227.203(b)(1). Financial statements enclosed in annual report must be accompanied by principal executive officer certification, unless reviewed or audited financial statements are otherwise available.

registered funding portal).²⁴ The rules require these intermediaries to provide investors with educational materials;²⁵ to take measures to reduce the risk of fraud;²⁶ to make available information about the issuer and the offering;²⁷ to provide communication channels to permit investors to communicate with each other and with representatives of the issuer about offerings on the platform;²⁸ and to satisfy other safeguards and requirements related to the offer and sale of crowdfunded securities, including having a reasonable basis for believing that the investor satisfies the investment limits.²⁹

Regulation Crowdfunding introduced a new category of registered intermediary, a funding portal, which may facilitate transactions under the exemption subject to certain restrictions.³⁰ The statute and the rules provide a safe harbor from broker-dealer registration under which funding portals can engage in certain activities conditioned on complying with the restrictions imposed by Regulation Crowdfunding.³¹ For example, a funding portal may not offer investment advice or make recommendations; solicit purchases, sales or offers to buy securities offered or displayed on its platform; compensate promoters and others for solicitations or based on the sale of securities; or hold, possess, or handle investor funds or securities.³²

²⁴ 17 CFR 227.100(a)(3).

²⁵ 17 CFR 227.302(b).

²⁶ 17 CFR 227.301.

²⁷ 17 CFR 227.303(a).

²⁸ 17 CFR 227.303(c).

²⁹ 17 CFR 227.303(b). *See generally* 17 CFR 227.300-305.

³⁰ 17 CFR 227.400-404.

³¹ 17 CFR 227.402.

³² 17 CFR 227.402(a).

B. Overview of the Study and Report to the Commission

In the Adopting Release, the Commission stated that the staff's report would include, but not be limited to, a review of: (1) issuer and intermediary compliance; (2) issuer offering limits and investor investment limits; (3) incidence of fraud, investor losses, and compliance with investor aggregates; (4) intermediary fee and compensation structures; (5) measures intermediaries have taken to reduce the risk of fraud, including reliance on issuer and investor representations; (6) the concept of a centralized database of investor contributions; (7) intermediary policies and procedures; (8) intermediary recordkeeping practices; and (9) secondary market trading practices.³³

We believe that the economic tradeoffs discussed in the Adopting Release generally continue to apply.³⁴ Below we discuss and analyze data on Regulation Crowdfunding that has become available since the rules went into effect in May 2016, focusing on the areas listed above. We present quantitative information where it is available. In certain cases, only qualitative information is available, or we lack sufficient data or information to perform an analysis from which to make reliable inferences. In some cases, our analysis is limited due to the nature of information required to be disclosed in Commission filings, made available by market participants, or otherwise available to Commission staff.

We summarize qualitative observations based on information available to the Commission staff, including: information from crowdfunding filings; data collected from crowdfunding intermediaries through the staff's look-back survey (described below); industry

³³ Adopting Release, at 71390.

³⁴ *See id.*, at 71482-71522 for a detailed discussion of the economic effects of Regulation Crowdfunding, <http://www.gpo.gov/fdsys/pkg/FR-2015-11-16/pdf/2015-28220.pdf>.

reports regarding the crowdfunding market; letters to the Commission and its staff about the crowdfunding market; transcripts from the Commission’s annual Government-Business Forum on Small Business Capital Formation (“Small Business Forum”);³⁵ enforcement actions; information provided by the North American Securities Administrators Association (“NASAA”); and discussions with FINRA staff that conduct examinations of crowdfunding intermediaries.

Where applicable, we discuss limitations that may significantly affect our analysis. For instance, the relatively short period of observation, which coincides with favorable economic conditions and other regulatory changes³⁶ affecting the exempt and public markets, may limit the ability to extrapolate our observations to future periods, and particularly, to periods of market downturns. While the number of crowdfunding offerings has continued to grow, the total number of crowdfunding offerings has remained relatively small when compared to the significantly larger number of other exempt offerings. This relatively small sample size further limits our ability to make inferences from the data. In addition, it is difficult to draw rigorous conclusions about the average magnitude of investor gains and losses or the risk of fraud in this market given the following factors that affect the Regulation Crowdfunding offering data: the

³⁵ The Small Business Investment Incentive Act of 1980 directed the Commission to conduct an annual government-business forum to undertake an ongoing review of the financing problems of small businesses. *See* 15 U.S.C. 80c-1. The Small Business Forum has met annually since 1982 to provide a platform to highlight perceived unnecessary impediments to small business capital formation and address whether they can be eliminated or reduced. Each forum seeks to develop recommendations for government and private action to improve the environment for small business capital formation, consistent with other public policy goals, including investor protection. Information about the Small Business Forum is available at <https://www.sec.gov/corpfin/infosmallbusbforum-2.shtml>.

³⁶ For example, in 2015, the Commission adopted amendments expanding Regulation A. *See Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A)*, Rel. No. 33-9741 (Mar. 25, 2015) [80 FR 21805 (Apr. 20, 2015)]. The Commission further amended Regulation A in 2018. *See Amendments to Regulation A*, Rel. No. 33-10591 (Dec. 19, 2018) [84 FR 520 (Jan. 31, 2019)]. In 2016, to facilitate intrastate and regional securities-based crowdfunding, the Commission adopted amendments to Rules 147 and Rule 504 and adopted new Rule 147A. *See Exemptions to Facilitate Intrastate and Regional Securities Offerings*, Rel. No. 33-10238 (Oct. 26, 2016) [81 FR 83494 (Nov. 21, 2016)].

relatively short period of time since the first crowdfunding offering for the typical issuer in the sample, the long period of time typically required for a startup issuer to experience a liquidity event or close its business, the absence of initial public offerings (“IPOs”) or exchange listings by crowdfunding issuers during the considered period, the lack of a secondary trading market in crowdfunding securities, the lack of data on the rate of repayment for debt securities issued in crowdfunding offerings, and the often considerable latency of fraud schemes. Data obtained under the existing Regulation Crowdfunding regime may not predict the evolution of the market if the regulatory regime is modified because such changes may affect the types of issuers, investors, and intermediaries drawn to this market. Relatedly, our analysis does not capture companies that do not pursue crowdfunding offerings today because of particular features of the existing regulatory regime.

As part of this report, the staff engaged in outreach to market participants, including intermediaries, for information on the impact of Regulation Crowdfunding on capital formation and investor protection. In furtherance of this goal and to facilitate its study, the staff formulated a questionnaire (the “look-back survey”) and requested data and other information to inform the staff’s study, including data covering periods since the date of effectiveness of Regulation Crowdfunding, from a small number of crowdfunding intermediaries. Participation in the look-back survey was voluntary.

III. Experience with Regulation Crowdfunding

We have examined available data and other information on the experience of issuers, intermediaries, investors, and Commission staff with Regulation Crowdfunding during the period

from May 16, 2016 (the effective date) through December 31, 2018 (the “considered period”), unless otherwise specified.³⁷

A. Regulation Crowdfunding Offerings, Issuers, and Investors

1. Capital formation in the crowdfunding market

Based on the analysis of information in Form C filings, the considered period was characterized by interest in Regulation Crowdfunding from a diverse range of early-stage issuers. We estimate that there were 1,351 offerings,³⁸ excluding withdrawn filings, seeking in the aggregate a target, or minimum, amount of \$94.3 million and a maximum amount of \$775.9 million. While most issuers undertook one offering during this period, some issuers (105) returned to the crowdfunding market for follow-on offerings.

During this period, there appeared to be growing interest in the use of the Regulation Crowdfunding exemption. We estimate that there were 292 offerings initiated (excluding withdrawn offerings) during the first year of Regulation Crowdfunding, 557 during the second year, and approximately 502 during the first part of the third year (May 16, 2018 – December 31, 2018).

³⁷ For early experience with Regulation Crowdfunding offerings during May 2016-December 2016, see U.S. Securities-based Crowdfunding under Title III of the JOBS Act, DERA White Paper, https://www.sec.gov/dera/staff-papers/white-papers/28feb17_ivanov-knyazeva_crowdfunding-under-titleiii-jobs-act.html (“2017 White Paper”).

³⁸ This information is based on data as reported by filers in filings on the Commission’s Electronic Data Gathering, Analysis and Retrieval (“EDGAR”) system. For offerings that have been amended, the statistics use the latest amendment as of the end of the considered period. The offering statistics exclude 107 withdrawn offerings (involving a Form C-W filing or an intermediary that has withdrawn its registration as of the report date). Form C-W does not contain information on the reason for the withdrawal. Some withdrawn offerings may be failed offerings. Several offerings were classified withdrawn due to the withdrawal of registration of the funding portal. Amounts raised may be lower than the target or maximum amounts sought.

The majority of issuers raised significantly less than the existing offering limit or the maximum amount specified in their offering statements. Between May 2016 and December 31, 2018, we estimate that 29 offerings reported raising at least \$1.07 million. Only three issuers have reported raising more than \$1.07 million, but in two or more offerings during the approximately 2.5 years since Regulation Crowdfunding went into effect (aggregating multiple offerings for issuers that conducted more than one offering). Because Regulation Crowdfunding requires that an issuer obtain commitments totaling at least the target amount in order to sell securities in a crowdfunding offering,³⁹ almost all offerings elected to accept oversubscriptions, adopting a minimum-maximum structure. We summarize statistics of the offer amounts and reported proceeds in the table below.⁴⁰

Table 1. Offering amounts and reported proceeds during May 16, 2016 - December 31, 2018

	Number	Average	Median	Aggregate (in millions)
Target amount sought in initiated offerings	1,351	\$69,800	\$25,000	\$94.3
Maximum amount sought in initiated offerings ⁴¹	1,351	\$602,200	\$500,000	\$775.9
Amounts reported as raised in completed offerings	519	\$208,400	\$107,367	\$108.2

³⁹ See 17 CFR 227.201(g); 17 CFR 227.304.

⁴⁰ The aggregate amounts of reported proceeds in the table are a lower bound on the aggregate amounts raised. Industry statistics report significantly higher aggregate amounts of investor commitments during this time period. For instance, one industry source reports approximately \$194 million raised in total as of the end of 2018, including \$109.3 million raised during 2018. See <https://www.crowdfundinsider.com/2019/02/144537-there-are-47-finra-regulated-reg-cf-portals-in-2018-109-3-million-was-raised-using-this-security-exemption/> (citing a report by Crowdfund Capital Advisors (“CCA”)). The cited estimates may exceed filings-based estimates for several reasons. Almost all issuers rely on the intermediary to fulfill the requirement of providing interim progress updates and only file a final progress update. Thus, filings-based estimates have a lag, proportionate to the pipeline of ongoing offerings. Some issuers in offerings reported to have met the target amount based on industry data either did not file or did not timely file a final progress update on Form C-U.

⁴¹ It is capped at the offering limit for issuers undertaking multiple offerings in a 12-month period.

To put the magnitude of the capital raising in the U.S. crowdfunding market, and the potential for future growth, in context, we compare it to amounts raised in crowdfunding markets in several other countries, reflected in the following table.

Table 2. Amounts Raised in non-U.S. Crowdfunding Markets in 2016

Country	Exemption Adopted	Amount Raised in 2016
United Kingdom	2011	\$335 million (£272 million) ⁴²
Germany	2011	\$49 million (€47 million) ⁴³
Sweden	2011	\$48 million (€46 million) ⁴⁴
France	2014	\$45 million (€43 million) ⁴⁵
China	2014	\$460 million ⁴⁶

In the U.K., the largest European crowdfunding market, which started in 2011, crowdfunding issuers raised approximately £333 million (\$450 million) in 2017, significantly larger than the reported amounts raised by U.S. crowdfunding issuers over the period May 16, 2016 – December 31, 2018. The amount of capital raised through equity-only crowdfunding in China in 2017 was approximately \$225 million. Caution is due when interpreting the differences in amounts raised between the U.S. and other countries because of differences in regulatory

⁴² See The 3rd European Alternative Finance Industry Report (2017), Cambridge Center for Alternative Finance, University of Cambridge, available at: https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/expanding-horizons/#.XKcZSK_4fcs. To convert Euros to USD, we used the exchange rate as of the end of each calendar year.

⁴³ See *id.*

⁴⁴ See *id.*

⁴⁵ See *id.*

⁴⁶ See The 3rd Asia Pacific Region Alternative Finance Industry Report (2018), Cambridge Center for Alternative Finance, University of Cambridge, available at: https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/3rd-asia-pacific-region-alternative-finance-industry-report/#.XKdyaa_4fcs.

regimes and tax treatments of crowdfunding securities investments. For example, crowdfunding investors in the U.K. are subject to more favorable tax treatment compared to their U.S. peers.⁴⁷ In addition, as noted, the U.K. crowdfunding market is older and more developed than the U.S. crowdfunding market. U.K. regulations also generally permit issuers to raise larger amounts of capital through crowdfunding offerings compared to the offering thresholds in Regulation Crowdfunding.⁴⁸

2. Characteristics of crowdfunding issuers and offerings⁴⁹

a. Crowdfunding issuers

While there was variation among issuers undertaking Regulation Crowdfunding offerings during the considered period, the typical issuer was small and at an early stage of its lifecycle.⁵⁰ Statistics of issuer characteristics are presented in Table 3. Approximately 64% of issuers were organized as corporations; most of the remaining ones were organized as LLCs. The median offering was by an issuer that was incorporated approximately two years prior to the offering and employed about three people.⁵¹ The median issuer had total assets of approximately \$30,000, cash holdings of approximately \$4,000, and no revenues (just over half of the offerings were by issuers with no revenues). Approximately 59% of issuers had some debt prior to the offering

⁴⁷ For example, the Enterprise Investment Scheme (EIS) offers income tax relief of 30 percent on investments of up to £1 million in a given tax year. Shares are free from capital gains tax if they are held for at least three years and income tax relief was claimed on them.

⁴⁸ See The Financial Services and Markets Act 2000 (Prospectus and Markets in Financial Instruments) Regulations 2018 No. 786.

⁴⁹ Unless specified otherwise, information was based on the XML portion of Form C and was not checked against information in the offering circular exhibits or on campaign websites.

⁵⁰ A small number of issuers are older or larger, resulting in a right tail or right-skewed distribution with means that tend to be higher than medians.

⁵¹ If a filing has been amended, we use the financial statements and issuer information provided in the most recent Form C/A associated with the offering.

(approximately 51% had some short-term debt and approximately 36% had some long-term debt). Approximately 10% of offerings were by issuers that had attained profitability in the most recent fiscal year prior to the offering. Due to the young age of the issuers, approximately half of the crowdfunding issuers disclosed a prior year of financial statements. The typical rate of asset and revenue growth experienced in the fiscal year leading up to the crowdfunding offering by an issuer providing this information was substantial, perhaps in part because these issuers are very small and start from very small asset and revenue values.

Table 3. Issuer characteristics⁵²

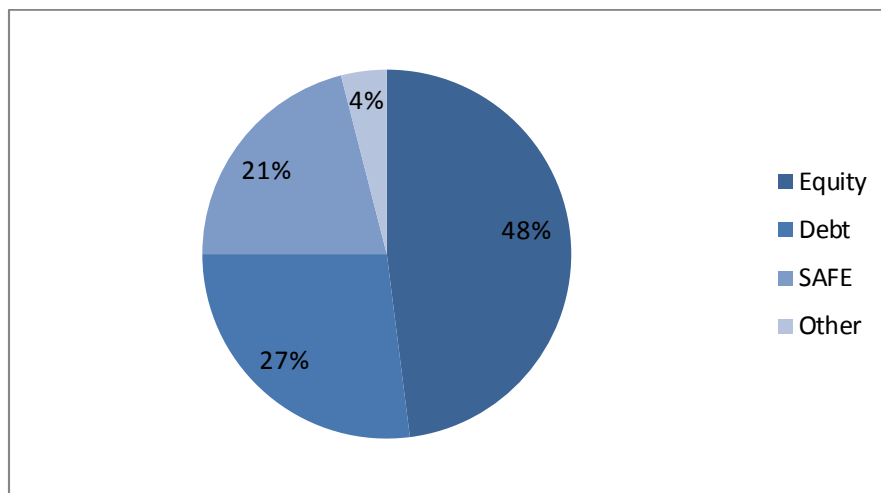
	Mean	Median
%: Legal status is "corporation"	63.9%	
Issuer age (months since incorporation)	35.4	21.1
%: Issuer age is ≤ 3 months	9.3%	
Employees	5.2	3.0
Assets (\$000s)	324.2	29.1
%: Issuer has no assets	24.3%	
Revenue (\$000s)	301.1	0.0
%: Issuer is pre-revenue	52.7%	
Net income or loss (\$000s)	-182.5	-11.2
%: Issuer has a positive net income	9.6%	
Cash (\$000s)	78.5	4.4
Debt (\$000s)	338.4	12.1
Long-term debt (\$000s)	198.1	0.0
Debt/assets	55.4	0.86
%: Issuer has debt	59.0%	
Asset growth	2,953.2%	20.7%
Sales growth	857.4%	40.6%

⁵² This issuer data is computed on the basis of 1,246 issuers, except for asset growth, which is computed on the basis of 575 issuers and sales growth, which is computed on the basis of 358 issuers. For newly formed issuers, asset and sales growth rates are not available. Averages of growth rates reported in the table are affected by extreme values to the extent that the previous period's assets or sales were close to zero, in which case medians of growth rates may be more informative.

b. Crowdfunding offerings

The average offering lasted approximately four months; the median offering duration was three months. The distribution of security types in crowdfunding offerings, based on number of offerings (Figure 1a) and based on target amount sought (Figure 1b), is summarized in the figures below.⁵³

Figure 1a. Security types in Regulation Crowdfunding offerings (number of offerings)



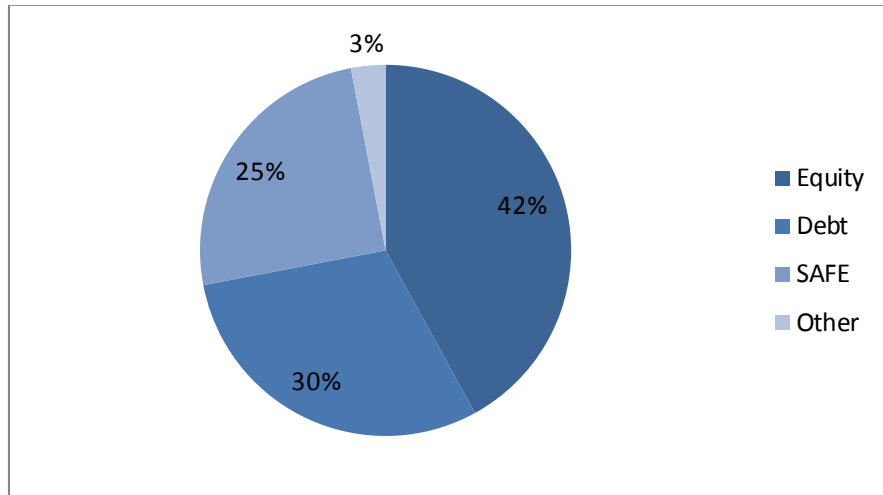
⁵³ Equity is comprised of common and preferred equity (including partnership/membership units and interests). Approximately a third of offerings were by issuers organized as limited liability companies or as partnerships.

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. In addition, some of the revenue share agreements remaining in the “other security type” category may have quasi-debt features.

Simple agreements for future equity (“SAFEs”) are identified by keyword from “other security type description”. *See infra* note 59 for a discussion of SAFEs.

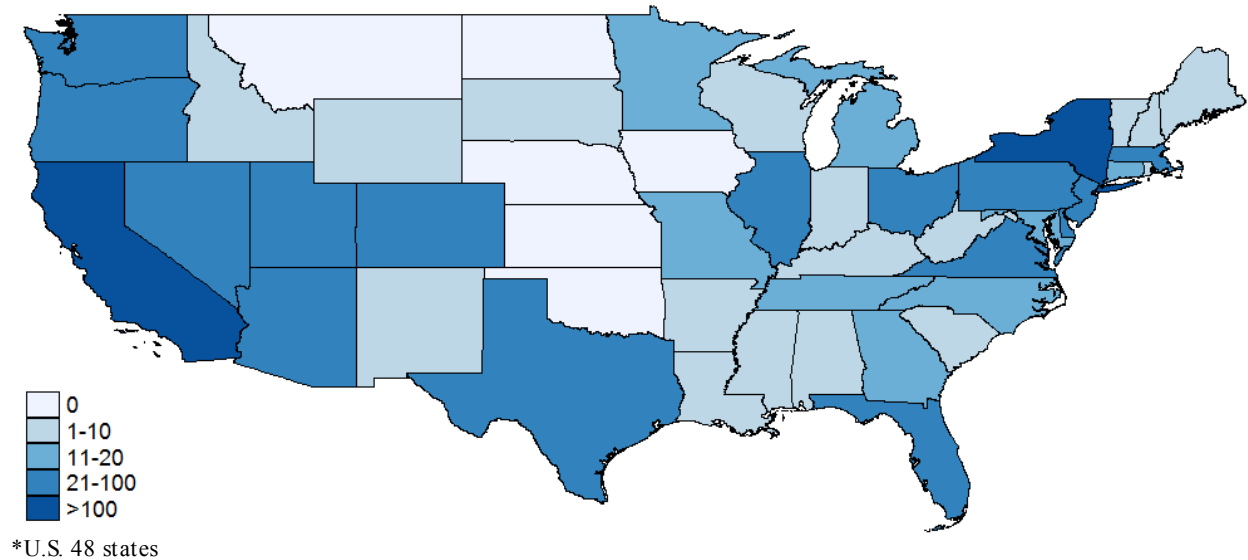
Anecdotal review suggests that some equity and debt offerings were denoted as “other” in the form. Where detected, such instances were re-classified manually based on the “other security type description” field. Examples of “other” are, for instance, tokens, simple agreement for future tokens (“SAFTs”), and revenue participation agreements.

Figure 1b. Security types in Regulation Crowdfunding offerings (target amount sought)



Offerings were geographically concentrated, with just under a third of the offerings made by issuers located in California (approximately 32%), followed by New York (approximately 11%) and Texas (approximately 7%). Figure 2 reflects the geographic concentration of offerings based on the number of offering statement filings by issuer location.

Figure 2. Number of Offerings by Issuer Location



c. Crowdfunding investors and potential investor risks

According to one industry report, the total number of investors in successful offerings increased from 77,558 in 2017 to 147,448 in 2018.⁵⁴ Information on average amounts invested or the number of investors per offering is not available for the full sample of Regulation Crowdfunding offerings, and it is not required to be reported in progress updates. For completed offerings on three large funding portals during the period December 2017 – December 2018, we estimate the average number of investors per offering to be 113. Information on crowdfunding investors and per-investor investment amounts, where available from other sources, is summarized in Section III.C.2.b below.

Regulation Crowdfunding offerings exhibited similar characteristics commonly identified in the context of other unregistered offerings, but we lack data to assess how these characteristics may relate to investor risks and losses in the Regulation Crowdfunding market.⁵⁵ Similar to securities issued in unregistered offerings by other startups, crowdfunding securities were characterized by minimal liquidity.⁵⁶ Further, the separation between ownership and control was likely more pronounced for investors in crowdfunding issuers than for other private investors in traditional angel- or venture-backed startups due to the highly dispersed nature of crowdfunding holdings relative to the concentrated holdings held by founders, other officers, and large private investors, as well as the frequently more limited nature of voting rights of crowdfunding securities (due to use of debt and SAFE securities that generally do not have

⁵⁴ See <https://cdn.crowdfundinsider.com/wp-content/uploads/2019/02/CCA-2018-State-of-Regulation-Crowdfunding-Summary-FINAL.pdf>.

⁵⁵ See *supra* Section III.A.2.a and *infra* note 74.

⁵⁶ During the considered period, a secondary trading market for crowdfunding securities was generally non-existent. See *infra* Section III.C.9.

voting rights, as well as classes of equity securities that lack voting rights).⁵⁷ Further, small and less well-known issuers with a limited track record, which crowdfunding issuers often are, generally tend to be associated with greater information asymmetries (instances where investors have less information about the issuer's prospects than the issuer or the issuer's executives), particularly when reporting is scaled and there is a lack of independent research coverage.⁵⁸

Certain payoff structures and contractual terms common in securities issued in crowdfunding offerings may be more difficult for retail investors to evaluate, particularly those facing high information asymmetries about issuers and their future prospects. In particular, some concern has been expressed about the risks to retail investors of SAFEs in crowdfunding offerings.⁵⁹ We recognize that some of these contractual features may be associated with higher

⁵⁷ Equity and equity-linked crowdfunding securities tended to have limited or no voting rights, resulting in separation of cash flow and control rights. *See, e.g.*, What's Market: Federal Crowdfunding Offerings, by Practical Law Corporate & Securities, <https://content.next.westlaw.com/w-002-5319>. *See also* https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes; <http://www.finra.org/investors/highlights/5-things-you-need-know-about-safe-securities-and-crowdfunding>. In their responses to the look-back survey some market participants report that crowdfunding issuers are hesitant to offer voting rights to crowdfunding investors because the logistical challenges of seeking any required shareholder vote pose too high a risk to later financing and governance of the issuer. *See infra* Section III.C.10.

⁵⁸ *See supra* Section III.A.2.a. *See also, e.g.*, Healy, Paul M. and Krishna G. Palepu, 2001, Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature, *Journal of Accounting and Economics* 31(1–3), 405–440; Welker, Michael, 1995, Disclosure policy, information asymmetry, and liquidity in equity markets, *Contemporary Accounting Research* 11(2), 801–827; Frankel, Richard and Xu Li, 2004, Characteristics of a firm's information environment and the information asymmetry between insiders and outsiders, *Journal of Accounting and Economics* 37(2), 229–259; Sufi, Amir, 2007, Information asymmetry and financing arrangements: Evidence from syndicated loans, *Journal of Finance* 62(2), 629–668; Fu, Renhui, Arthur Kraft, and Huai Zhang, 2012, Financial reporting frequency, information asymmetry, and the cost of equity, *Journal of Accounting and Economics* 54(2–3), 132–149; Brüggemann, Ulf, Aditya Kaul, Christian Leuz, and Ingrid M. Werner, 2018, The Twilight Zone: OTC regulatory regimes and market quality, *Review of Financial Studies* 31(3), 898–942.

⁵⁹ *See* Office of the Investor Advocate, Report on Activities for Fiscal Year 2016, <https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-on-activities-2016.pdf>; <https://www.crowdcheck.com/blog/buyer-beware-securities-are-not-always-what-they-seem>; Green, Joseph, and John Coyle, 2016, Crowdfunding and the not-so-safe SAFE, 102 *Virginia Law Review* 168. *But see* Wroldsen, Jack, 2017, Crowdfunding investment contracts, 11 *Virginia Law & Business Review*. *See also* 2017 White Paper; https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

investment returns, but we are unable to perform an analysis of risk-adjusted returns to such investments due to a lack of subsequent liquidity events by issuers and the lack of a secondary trading market for crowdfunding securities during the considered period.

3. Costs to issuers of undertaking a crowdfunding offering

An important factor in a small issuer's decision to undertake a crowdfunding offering is the cost of the offering. There are several types of costs associated with a crowdfunding campaign: platform fees, legal, accounting, marketing expenses, etc. We discuss platform fees in Section III.C.3 below.

We have limited information on costs incurred by issuers in the process of conducting an offering because issuers are not required to disclose costs related to their offerings in Commission filings. We have estimated the type and magnitude of the offering costs based on information contained in a survey by a consulting company⁶⁰ and information provided by market participants to the staff.

According to the survey, the average issuer employed three people who collectively spent 241 hours to launch a crowdfunding campaign. Based on the survey estimates, the total cost of creating a campaign page, issuer disclosures, film, and video, and hiring a marketing firm, a lawyer, and an accountant amounts to approximately 5.3% of the amount raised.

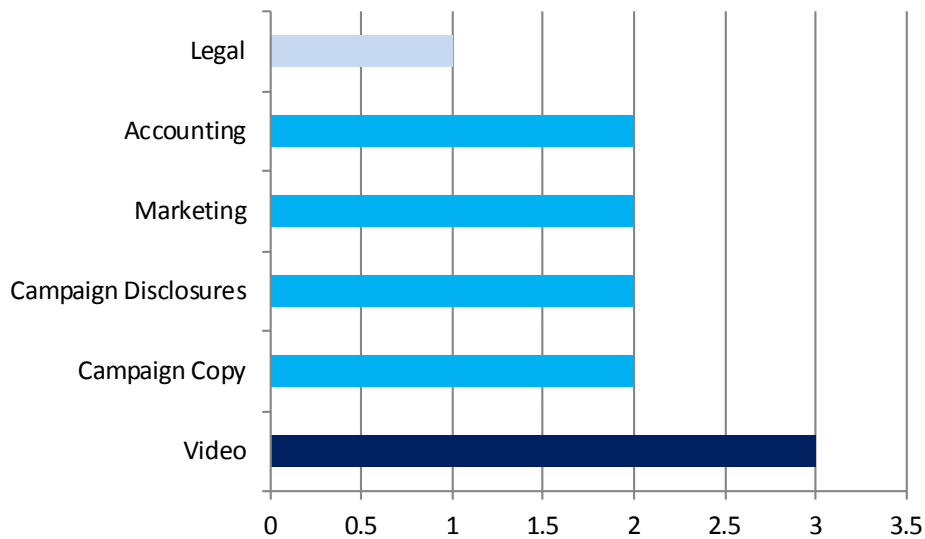
In terms of human capital, as Figure 1 suggests, the largest average use of resources is for the creation of the campaign video (3 persons on average), and the lowest is for legal services (1

See also <https://www.crowdcheck.com/blog/compliance-reg-cf-when-failure-becomes-fraud> and <http://www.finra.org/investors/highlights/5-things-you-need-know-about-safe-securities-and-crowdfunding>.

⁶⁰ *See* How Much Does a Regulation Crowdfunding Campaign Actually Cost?, August 2018, available at: <http://crowdfundcapitaladvisors.com/how-much-does-a-regulation-crowdfunding-campaign-actually-cost> (“CCA survey”). The survey targeted 485 crowdfunding issuers and obtained a 16.7% response rate. Definitions of cost categories may differ across various sources.

person). On the other hand, disclosure preparation requires the largest number of hours, on average 86 hours (Figure 2), while legal and accounting services require 15 and 17 hours, respectively. Disclosure preparation is also most expensive in dollar terms, averaging \$6,218 per campaign, followed by marketing expenses and legal expenses (Figure 3).

Figure 3a. Average resources (individuals) required per activity⁶¹



⁶¹ *Id.* The figure was created using data from the CCA survey.

Figure 3b. Average time (hours) allocated per activity⁶²

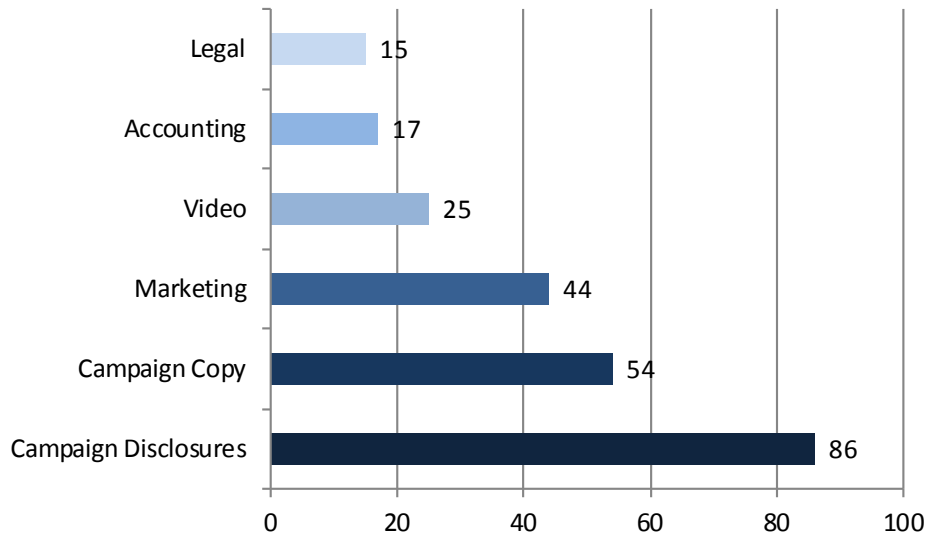
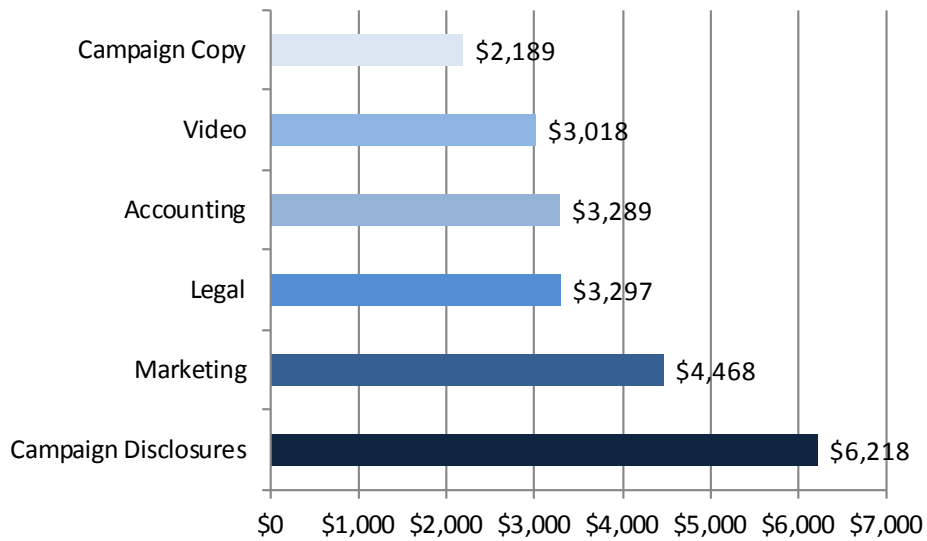


Figure 3c. Average breakdown of costs (in dollars) per activity⁶³



⁶² *Id.* The figure was created using data from the CCA survey.

⁶³ *Id.* The figure was created using data from the CCA survey.

In comparison, one market participant estimated costs as follows:⁶⁴

Type of cost	Magnitude (in dollars)
Accounting costs	\$2,000-\$10,000
Legal costs	\$3,000-\$10,000
Bank/transaction fees (escrow/payments/transfer agent fees))	\$3,000-\$5,000

According to this market participant, marketing costs tend to vary by issuer, totaling up to 20% of the target offering amount. For example, a high-quality videographer usually costs about \$2,000-\$5,000 dollars. This is not surprising, given that another industry study has documented the importance of having a high-quality video for the success of a crowdfunding campaign.⁶⁵ Also according to this market participant, bank and transaction fees also may vary depending on the type of back-end infrastructure developed by the intermediary and the type of securities offered (e.g., equity vs. debt). Some fees, such as transfer agent fees, could be on an annual basis, while others could be on a per-investor basis.

One intermediary responding to the look-back survey also estimated that issuers spent approximately three to four weeks to prepare their Form C. Additionally, this intermediary stated that most issuers use cash accounting and spent thousands of dollars both to prepare financial statements that instead comply with U.S. generally accepted accounting principles (“U.S. GAAP”) and then to have those financial statements reviewed or audited by an independent auditor.

⁶⁴ Definitions of cost categories may differ across various sources.

⁶⁵ See <http://crowdfundcapitaladvisors.com/crowdfunding-video-hurting-campaign/>. The study further indicates that “a professionally executed video can be done for as little as \$5,000.”

B. Regulation Crowdfunding Intermediaries

As of the end of the considered period, there were 45 funding portals registered with FINRA, most of which had facilitated at least one offering.⁶⁶ In addition, nine registered broker-dealers participated in at least one crowdfunding offering (other than withdrawn offerings). Most offerings (just under 90%) were conducted through funding portals, suggesting specialization in the market. There also was a considerable amount of concentration. The majority of initiated and completed offerings were conducted through the three largest funding portals. The three platforms with the greatest number of initiated offerings accounted for approximately two-thirds of all initiated offerings and proceeds raised reported on Form C-U. It is possible that smaller intermediaries may exit the crowdfunding market if they fail to attract sufficient deal flow to sustain their business model.⁶⁷

C. Impact of Regulation Crowdfunding on Capital Formation and Investor Protection

In addition to the general data provided above about the experiences of issuers, investors, and intermediaries with Regulation Crowdfunding, this section separately addresses each of the items that the Commission identified in the Adopting Release for inclusion in the staff report.

1. Issuer and intermediary compliance

Below we summarize observations regarding compliance by issuers and intermediaries.

⁶⁶ See <http://www.finra.org/about/funding-portals-we-regulate>.

⁶⁷ As of February 15, 2019, seven funding portals have withdrawn their registrations. See <https://www.finra.org/about/funding-portals-we-regulate/former-funding-portal-members>. See also *infra* note 106.

a. Issuer compliance

Offering statements filed on Form C are not subject to staff review before the issuer may sell securities. Staff's experience with and analysis of filings has revealed differences among issuers' compliance,⁶⁸ primarily in the following areas: (1) financial statement requirements; (2) the requirement to file an annual report on Form C-AR (for issuers that have sold securities under the exemption and have not terminated their reporting obligations);⁶⁹ and (3) the requirement to file a final progress update on Form C-U.⁷⁰

Observations regarding compliance with disclosure requirements may be attributable in part to the fact that the majority of issuers have had no, or very limited, prior experience with securities offerings and Commission filings.⁷¹ These observations also are consistent with the likely more limited involvement of specialized outside counsel and independent auditors in the preparation of issuer filings as compared to larger offerings under other exemptions, and the

⁶⁸ Staff 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. *See also, e.g.*, <https://www.crowdcheck.com/blog/compliance-reg-cf-financial-statements-under-rule-201>; <https://www.crowdcheck.com/blog/regulation-cf-annual-filing-season-starts-battling-200>; <https://www.crowdcheck.com/blog/investor-alert-2-has-your-company-provided-you-updates>.

⁶⁹ From May 16, 2016 through December 31, 2018, among issuers that reported completed offerings (see Table 1), we estimate that 252 issuers filed annual reports and 20 terminated reporting. Issuers that have sold securities in reliance on the Regulation Crowdfunding exemption are required to file an annual report on Form C-AR no later than 120 days after the end of the fiscal year covered by the report. *See* 17 CFR 227.203(b)(1). Because almost all issuers during the considered period had a calendar fiscal year, annual reports are required to be filed in April for the majority of issuers.

⁷⁰ One industry observer also pointed to possible failures to update Form C with changes in material information and to possible inconsistencies in complying with the terms of SAFEs issued under the exemption, such as in instances of changes in control. *See* <https://www.crowdcheck.com/blog/compliance-reg-cf-when-failure-becomes-fraud>.

⁷¹ The majority of new Form C filers (approximately 85%) had not made prior filings with the Commission. Among issuers that had made prior filings with the Commission, many had only filed a notice on Form D, which requires very limited information about a Regulation D offering.

potentially limited experience of outside counsel and other professional service providers with Regulation Crowdfunding, given the newness of the exemption.

A typical issuer using Regulation Crowdfunding has going concern risks, so it is possible that issuers that fail to file annual reports on Form C-AR have ceased operations because of business failures or because the capital that they raised was not sufficient to fund operations and remain as a going concern. Thus, to some extent, the failure to file periodic reports may reflect business failures rather than noncompliance.⁷²

A potential check on issuer noncompliance is the intermediary through which the crowdfunding offering is conducted. In addition to reputational concerns, intermediaries have an incentive to ensure that issuers and their disclosures are compliant because intermediaries are required under Regulation Crowdfunding to have a reasonable basis for believing that an issuer complies with the requirements of Section 4A(b).⁷³ In their responses to the look-back survey, intermediaries stated that they play a gatekeeper role with respect to issuer compliance and reported rejecting some offerings, for instance, by ineligible categories of issuers or issuers that the intermediaries believed were not compliant with Regulation Crowdfunding requirements.

⁷² An issuer that liquidates or otherwise becomes eligible to terminate reporting (17 CFR 227.202(b)), must file a notice of termination of reporting on Form C-TR (17 CFR 203(b)(3)). Some issuers that fail to file annual reports might be eligible to terminate reporting but might have failed to file a Form C-TR. We cannot ascertain the prevalence of such cases due to data constraints. No crowdfunding issuers have become Exchange Act reporting companies during the considered period. We lack data on issuers that liquidated or issuers that repurchased all of the crowdfunding securities they issued. While we can observe asset size at the issuer level, we lack issuer-level information on the number of shareholders of record because it is not required to be reported on Form C-U and the availability of such information from other sources is limited. An issuer seeking to terminate reporting because it has fewer than 300 shareholders of record must still file at least one annual report on Form C-AR, and an issuer seeking to terminate reporting because its assets do not exceed \$10 million must file at least three annual reports, before terminating reporting. *See* 17 CFR 227.202(b).

⁷³ *See also* Adopting Release at 71477 (regarding potential “issuer” liability for material misstatements or omissions in a crowdfunding offering).

We recognize that potential failures to comply with disclosure requirements could pose risks to investors. We cannot assess the general magnitude of such risks in this market due to the limited data available to us at this time.⁷⁴

Some studies and market participants have expressed concern about the cost and complexity of relying on Regulation Crowdfunding.⁷⁵ Market participants have stated that many issuers face significant challenges due to the time and cost required to comply with the regulations, including complying with U.S. GAAP financial statement requirements, obtaining a review report, and preparing a Form C, and that many new companies are not able to bear those costs given the uncertainty regarding whether they would raise capital successfully.⁷⁶

⁷⁴ Secondary trading for crowdfunding securities was virtually non-existent during the considered period, and market price information was therefore not available, thus we cannot evaluate returns of primary market investors through this approach. We lack information on issuer repayments, liquidations, or acquisitions and whether investors obtained any recovery in those instances. None of the issuers proceeded to a follow-on registered offering, and while some proceeded to a follow-on Regulation Crowdfunding or Regulation A offering, valuations may be difficult to compare to those in the initial offering due to differences in security design and terms. Further, it is similarly difficult to determine whether valuations in follow-on Regulation Crowdfunding offerings are based on an informed analysis of fundamental value. Some crowdfunding issuers proceeded to an offering under Regulation D, but similar points apply, compounded by the lack of information about valuations in offerings under Regulation D.

⁷⁵ See, e.g., A Financial System That Creates Economic Opportunities Capital Markets, U.S. Department of Treasury (2017), <https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf> (“Treasury Report”), at 40 (stating that “market participants have expressed concerns about the cost and complexity of using crowdfunding compared to private placement offerings”); Report of the 2018 SEC Government-Business Forum on Small Business Capital Formation, <https://www.sec.gov/files/gbfor37.pdf> (“2018 Small Business Forum Report”); Statement of the U.S. Chamber of Commerce to HFSC, March 22, 2017, <https://docs.house.gov/meetings/BA/BA16/20170322/105717/HHRG-115-BA16-Wstate-OuaadmanT-20170322.pdf>, at 12-13; Lindsay M. Abate (2016) One Year of Equity Crowdfunding: Initial Market Developments and Trends, U.S. Small Business Administration Office of Advocacy Economic Research Series, https://www.sba.gov/sites/default/files/advocacy/Crowdfunding_Issue_Brief_2018.pdf (“SBA Study”), at 12 (suggesting that “exempting businesses seeking very small amounts of capital from certain requirements may make crowdfunding a more attractive and worthwhile option for small and young firms that are otherwise a good fit for this capital raising method”).

⁷⁶ See, e.g., Report of the 2017 SEC Government-Business Forum on Small Business Capital Formation, available at: <https://www.sec.gov/files/gbfor36.pdf> (“2017 Small Business Forum Report”).

To help reduce issuer cost and regulatory complexity, market participants have recommended several revisions to the rules. For example, the 2015 Small Business Forum recommended permitting crowdfunding issuers to provide reviewed rather than audited financial statements in subsequent offerings unless audited financial statements of the issuer that have been audited by an independent auditor are available.⁷⁷ In addition, the 2017 Small Business Forum recommended that the Commission allow crowdfunding issuers to test-the-waters prior to filing their Form C,⁷⁸ allowing issuers to determine the potential market interest in their securities prior to expending the time and cost required to comply with the regulations. Most recently, the 2018 Small Business Forum recommended loosening the advertising restrictions to allow issuers to market their projects more effectively, suggesting that the rules are difficult for issuers to understand and “run counter to the intent of the law: to promote the democratization of investing”.⁷⁹ In the look-back survey, several intermediaries recommended that the Commission consider one or more of the above Small Business Forum recommendations. Market participants also have raised concerns about the requirements for issuers seeking to raise smaller amounts in compliance with Regulation Crowdfunding. For example, the 2017 and 2018 Small Business Forums recommended easing the requirements for smaller and debt-only crowdfunding offerings under \$250,000, including limiting the ongoing reporting obligations to actual noteholders (not to the general public); and scaling regulation to reduce relatively inelastic accounting, legal and

⁷⁷ See Report of the 2015 SEC Government-Business Forum on Small Business Capital Formation, available at: <https://www.sec.gov/info/smallbus/gbfor34.pdf> (“2015 Small Business Forum Report”).

⁷⁸ See 2017 Small Business Forum Report, at 18.

⁷⁹ See 2018 Small Business Forum Report.

other costs.⁸⁰ In addition, one intermediary stated concerns about what it viewed as the high cost of annual reports, as well as the risk of disclosure of proprietary information, because of the requirement to file annual reports publicly on EDGAR. Another intermediary stated that smaller issuers that do not have reviewed or audited financial statements may find it difficult to prepare a statement of changes of equity, because the typical accounting software does not print it automatically. This respondent stated that these issuers also often have trouble accurately preparing a cash flow statement or accounting for stock issuances or issuances of stock options and warrants. Another intermediary similarly stated that many issuers are unfamiliar with the statement of stockholders' equity. Yet another intermediary stated that the issuer requirements of Regulation Crowdfunding are more appropriate for larger equity offerings and recommended scaling them for smaller (sub-\$107,000) offerings, particularly, for small debt offerings, to avoid what it described as unnecessary complexity. Market participants have also expressed concerns about the burden for issuers of complying with the requirement that 21 days elapse before a security can be sold, particularly for issuers that need funds quickly.

b. Intermediary compliance

Staff's analysis of intermediary compliance practices is based largely on information obtained through the look-back survey and through discussions with FINRA staff that conduct examinations of funding portals. Regulation Crowdfunding requirements, including measures to reduce the risk of fraud (see also Section III.C.5 below), appropriate policies and procedures (see also Section III.C.7), and recordkeeping practices (see also Section III.C.8), constitute important investor protections by providing a required framework to prevent intermediary misconduct.

⁸⁰ See, e.g., 2017 Small Business Forum Report, at 18; 2018 Small Business Forum Report.

FINRA staff, in conversations with the Commission staff, has stated that they believe that funding portals are generally aware of their compliance and recordkeeping obligations, but cautions that this is a novel area of the securities laws and therefore many of the participants are new to regulation and oversight. FINRA staff stated that in some instances, examinations revealed that funding portals were attempting to comply with Regulation Crowdfunding requirements, but FINRA staff believed the funding portals were only in partial compliance. In various instances, FINRA staff issued comments regarding revisions to advertising communications to help ensure compliance with FINRA rules or Regulation Crowdfunding.

SEC staff is aware of four FINRA actions involving funding portals' alleged noncompliance with the intermediary requirements of Regulation Crowdfunding or FINRA rules.⁸¹ Aside from these three actions, FINRA staff stated that they generally have found that funding portal founders and officers are aware of their regulatory obligations and are attempting to comply with them.

The 2017 and 2018 Small Business Forums recommended that the Commission lead a joint effort with FINRA to provide guidance to participants in crowdfunding offerings.⁸² Some intermediary respondents to the look-back survey stated that they generally have not experienced significant challenges complying with Regulation Crowdfunding requirements. However, some intermediary respondents indicated that compliance with current rules can be costly, including complying with FINRA requirements and examinations. One of those respondents stated that “the most expensive requirement is keeping up with the [significant][...] volume of FINRA

⁸¹ See *infra* note 106.

⁸² See 2017 Small Business Forum Report; 2018 Small Business Forum Report.

communications, which requires a full-time employee to communicate with them, and a dedicated engineering resource,” which are costs passed on to issuers in the form of higher fees. A different intermediary stated that the prohibition against funding portals handling investor funds significantly increased costs for funding portals, as well as for issuers and investors, while reducing the quality and timeliness of the investment and fund transfer process, with what it viewed as only limited investor protection benefits.

That same intermediary respondent to the look-back survey stated that all offerings are reviewed by its Chief Compliance Officer (“CCO”) and are monitored throughout the offering process. In addition, the intermediary explained that the CCO instructs each employee that specific events must be reported, including but not limited to: material discrepancies in information; altered documents or signatures; contradictions in information; inability or unwillingness to provide information; business model based on unrealistic assumptions; and any indication that the issuer has been rejected by another intermediary without reasonable explanation.

2. Issuer offering limits and investor investment limits

a. Issuer offering limits

From the inception of Regulation Crowdfunding in May 2016 through December 31, 2018, for the majority of issuers, cumulative amounts reported raised did not reach the existing Regulation Crowdfunding 12-month offering limits.⁸³ This is consistent with the small size and early-stage nature of the issuers and information asymmetries about issuer prospects in relation to offered valuations. We estimate that 29 offerings reported raising at least \$1.07 million from

⁸³ See Section III.A.1.

May 2016 through December 31, 2018. Only three issuers have reported raising more than \$1.07 million, but in two or more offerings during the approximately 2.5 years since Regulation Crowdfunding went into effect (aggregating across multiple offerings for issuers that conducted more than one offering).

We may draw some inference about potential capital formation effects of a higher limit based on the experience of Regulation Crowdfunding issuers with other offering methods that either do not have an offering limit or have a higher offering limit. Crowdfunding issuers may rely on Regulation D for various reasons, such as to ensure that the Regulation Crowdfunding offering remains within the required limit,⁸⁴ to draw a different investor pool (such as accredited investors), or to avoid investment limits. Issuers may opt to initially rely on Regulation D rather than Regulation Crowdfunding, to postpone having to provide the disclosures required by Form C. We summarize the reported Regulation D offerings by Regulation Crowdfunding issuers in the table below.

⁸⁴ Pursuant to the concurrent offering guidance provided in the Adopting Release, some crowdfunding issuers conduct side-by-side offerings under Regulation Crowdfunding and Rule 506(c) to allow accredited investors to invest in a Rule 506 offering, rather than the concurrent Regulation Crowdfunding offering, in order to ensure that the Regulation Crowdfunding offering remains within the conditions of the exemption. *See* Adopting Release, at 71392.

Table 4. Regulation D offerings during the period January 1, 2009 through December 31, 2018 by Regulation Crowdfunding Issuers

Timing of filing of Form D	Number of Issuers ⁸⁵	Amount raised per offering		Regulation D exemption used		
		Average	Median	Rule 506(b)	Rule 506(c)	Rule 504
Prior to Issuer's First Regulation Crowdfunding offering	188	\$851,877	\$195,500	73%	19%	7%
Subsequent to Issuer's First Regulation Crowdfunding offering	85	\$1,589,137	\$199,860	50%	47%	3%
Prior or subsequent to Issuer's First Regulation Crowdfunding offering ⁸⁶	244	\$908,780	\$200,000	68%	25%	7%

Comparisons to other types of offering that either do not have an offering limit or have a higher offering limit, such as traditional registered offerings or Regulation A offerings,⁸⁷ may be of limited use because of the differences in the structure of the market for those offerings and the types of issuers that are likely to rely on those offering methods. For instance, during the considered period, very few Regulation Crowdfunding issuers subsequently had a Regulation A offering statement qualified,⁸⁸ and none has subsequently offered securities in a registered

⁸⁵ This number reflects the number of issuers that filed at least one Form D during the period indicated.

⁸⁶ Some of the issuers filed Form D both prior to, and subsequent to, the first Regulation Crowdfunding offering. Therefore, the number of issuers in the third row does not equal the sum of the numbers in the first two rows (adding up the numbers in the first two rows would lead to double counting of some crowdfunding issuers that filed Form D).

⁸⁷ As of December 31, 2018, 91% of qualified Regulation A offerings sought to raise up to \$1 million and 73% qualified offerings sought to raise up to \$5 million.

⁸⁸ Approximately ten Form C filers have also had a Regulation A offering statement qualified, either before, or in most of those cases, following their Regulation Crowdfunding offering. Because most such Regulation A

offering or filed an Exchange Act registration statement to become a reporting company.⁸⁹ This is consistent with crowdfunding issuers typically being in the early stage of their lifecycle (often at the idea or seed stage, and in some cases, having been organized a number of years earlier but not having begun substantial operations) and lacking a sufficient track record of product market and financial performance, or sufficient scale or potential to scale up their business, that would make an IPO, or an offering under Regulation A, a viable path to accessing the public markets.

We have received feedback from several market participants on the statutorily based issuer offering limits. The 2017 Small Business Forum, the Treasury Report, and several respondents to the look-back survey have stated that the offering limit should be higher, recommending limits from \$5 million to \$20 million.⁹⁰ On the other hand, one intermediary stated that the current \$1.07 million offering limit is appropriate, noting that most offerings are well below that level. A different intermediary stated that very few potential issuers expressed interest in raising over \$107,000. Some of the intermediaries that recommended an increased offering limit stated their view that while few offerings reach the current limit, many issuers choose not to rely on the crowdfunding exemption because the limit is too low. According to some of these intermediaries, some issuers choose to raise funds needed in excess of the offering

offerings remain ongoing, we lack data to evaluate the amounts of financing raised. Approximately 15 Form C filers had filed a Regulation A offering statement, before or after their Regulation Crowdfunding offering, but those offering statements either had not been qualified or had been withdrawn as of the end of the considered period.

⁸⁹ Two issuers that had filed a registration statement several years prior to conducting a Regulation Crowdfunding offering had either withdrawn it or had not had that registration statement declared effective during the considered period. Several of the issuers had filed Exchange Act reports in prior years but have since ceased Exchange Act reporting.

⁹⁰ *See, e.g.*, Treasury Report, at 41 (recommending “increasing the limit on how much can be raised over a 12-month period from \$1 million to \$5 million, as it will potentially allow companies to lower the offering costs per dollar raised”) and 2017 Small Business Forum Report, at 18 (recommending a \$5 million limit).

limit through a separate offering, which they consider to be a less optimal experience for investors and a more costly and potentially riskier approach for issuers. Another market participant stated that many early-stage issuers require more than \$1.07 million and that, but for the offering limit, Regulation Crowdfunding would provide a better solution than other available exemptions. Some of these market participants stated that the existing offering limit may deter some high-quality, high-growth issuers with substantial financing needs from relying on Regulation Crowdfunding, thereby lowering the average quality of issuers in the Regulation Crowdfunding market. One intermediary respondent stated that raising the offering limit could attract more issuers and expand opportunities for non-accredited investors. A different intermediary stated that the few issuers that had raised the maximum offering amount through its platform would have sought to raise additional capital had they been permitted to do so, and that high-quality issuers may have significant upfront capital needs that exceed the existing limit.

b. Investor investment limits

Information on amounts invested by an average investor or the number of investors per offering is not available for the full sample of Regulation Crowdfunding offerings.⁹¹ Information on offerings from one intermediary from May 2016 through September 2018 provides some insight into the typical investment size, investor composition, and number of investors in crowdfunding offerings.⁹² All issuers in funded offerings, had at least one

⁹¹ This information is not required to be reported in progress updates.

⁹² There were approximately 31,500 unique crowdfunding investors in this sample utilizing the platform during this period.

accredited investor in their crowdfunding offering.⁹³ Accredited investors comprised approximately 9% of investors in this sample but accounted for approximately 40% of amounts invested in funded offerings due to investing higher amounts on average. The table below provides statistics on total amounts of commitments per investor in offerings funded through that platform during the entire May 2016-September 2018 period, by accredited investor status.⁹⁴

Table 5. Total commitments in offerings funded on the platform during the considered period⁹⁵

<i>Total per investor, per issuer</i>	Median	Average	
All investors	\$260	\$830	
Non-accredited investors	\$250	\$600	
Accredited investors	\$840	\$2,030	
<i>Total per investor, across issuers</i>	Median	Average	
All investors	\$490	\$1,340	
Non-accredited investors	\$300	\$890	
Accredited investors	\$2,200	\$5,750	
<i>Total per investor, across issuers as % of 12-month limit⁹⁶</i>	Median	Average	% investors ≥100%
All investors	17%	34%	6%
Non-accredited investors	18%	33%	6%
Accredited investors	13%	35%	7%
<i>Number of investors per issuer</i>	Median	Average	
All investors	258	416	
Non-accredited investors	214	349	
Accredited investors	41	67	

⁹³ We exclude investments redirected to a Rule 506(c) offering; offerings that were not funded (i.e., were either canceled or ongoing) or had missing data; observations where an investor made but subsequently withdrew the commitments, yielding a cumulative investment of zero; and investor observations with missing accredited investor status.

⁹⁴ *Id.* Dollar amounts rounded to ten-dollar increments.

⁹⁵ The sample included 111 issuers in funded offerings.

⁹⁶ Totals include commitments during the entire considered 2.5-year period and thus over the entire 2.5-year period a fraction of investors exceeded the amounts provided in the 12-month investment limit.

For most investors with available data on annual income and net worth (approximately 30% of investors in offerings funded on the platform), cumulative amounts invested during the entire considered period (almost 2.5 years) through this intermediary's platform did not reach the investment limit, with fewer than 10% of investors on the platform investing amounts exceeding their 12-month investment limit over the entire 2.5-year period.

According to information provided by another intermediary respondent to the look-back survey, the median (average) crowdfunding investment through its platform was \$1,335 (\$500), with investors making an average of 2.7 investments and approximately 40% of investors making two or more investments. According to information provided by a different intermediary respondent, the average investment was approximately \$992, and investors made an average of 1.5 investments. Based on available data, we are unable to determine whether these investors also invested in crowdfunding offerings through other crowdfunding platforms; thus, these estimates are likely to represent a lower bound on average investment amounts.

A number of market participants have expressed concerns about the statutorily-based investment limits.⁹⁷ The 2018 Small Business Forum recommended increasing the investor limits for all investors, suggesting that doing so would help the market grow and allow more individual investments into the marketplace.⁹⁸ The 2017 Small Business Forum and some intermediary respondents to the look-back survey recommended that the investor limits should apply on a per-investment basis rather than across all crowdfunding offerings.⁹⁹ Several market

⁹⁷ See, e.g., Treasury Report, 2018 Small Business Forum Report.

⁹⁸ See 2018 Small Business Forum Report,

⁹⁹ See 2017 Small Business Forum Report, at 17 (also recommending the investment limit be rationalized by entity type rather than income).

participants and the 2015 Small Business Forum recommended basing the 5% or 10% limit on the greater of the investor's net worth or income rather than the lesser of those two amounts.¹⁰⁰ Some stated that allowing investors to invest the higher 10% amount only if both their net worth and income exceed the \$107,000 threshold is inconsistent with the accredited investor definition where the investor is required only to meet either the net worth or the income standard. One market participant stated that requiring both net worth and income to meet the \$107,000 threshold could result in an accredited investor being subject to the lower 5% investment limit.

Several market participants and the 2017 and 2018 Small Business Forums recommended that the investment limits not apply to accredited investors, who face no such limits under other exemptions.¹⁰¹ The 2018 Small Business Forum stated that removing the individual accredited investor limits would make crowdfunding offerings more attractive to accredited investors and make it easier for offerings to reach their maximum offering goals.¹⁰² In conjunction with removing the investment limits for individual accredited investors, the 2018 Small Business Forum recommended verification of accredited investor status.¹⁰³ Similarly, some intermediaries recommended that intermediaries be required to verify accredited investor status, income, or net worth for certain larger investments, such as those over \$25,000 in a 12-month period.¹⁰⁴ Additionally, some intermediaries stated that conducting a separate Regulation D offering to

¹⁰⁰ See Treasury Report, at 41; 2015 Small Business Forum.

¹⁰¹ See, e.g., Treasury Report, at 41; 2018 Small Business Forum Report; 2017 Small Business Forum Report, at 17. See also 2015 Small Business Forum Report (recommending increasing the investment limit for accredited investors).

¹⁰² See 2018 Small Business Forum Report.

¹⁰³ See 2018 Small Business Forum Report.

¹⁰⁴ See 2018 Small Business Forum Report.

allow accredited investors to invest greater amounts was unnecessarily confusing to investors and more costly to issuers.

3. Incidence of fraud, investor losses, and compliance with investor aggregates

a. Incidence of fraud

During the considered period, there were few instances of legal proceedings (involving FINRA or the Commission) referencing Regulation Crowdfunding, so we cannot infer a systematic relation between any particular characteristics of the offerings and the incidence of such legal actions. In particular, a search of publicly available information in the Commission's litigation releases has not identified civil complaints or administrative proceedings filed against Regulation Crowdfunding issuers or intermediaries.¹⁰⁵ We have, however, identified four actions initiated by FINRA against a funding portal member that involved alleged violations of Regulation Crowdfunding or FINRA rules.¹⁰⁶

In addition, NASAA provided some information from a small number of state regulators on those states' experience with Regulation Crowdfunding in their jurisdictions. One state reported two instances where the state regulator alerted an issuer about potentially misleading statements or content in their offering materials, one of which was in response to a complaint submitted to the regulator. The state noted that one of those issuers ultimately raised no funds,

¹⁰⁵ We excluded results where the term "crowdfunding" was determined to have been used more generally and a violation related to Regulation Crowdfunding or a violation of another Securities Act or Exchange Act provision related to a Regulation Crowdfunding offering was not alleged.

¹⁰⁶ See http://www.finra.org/sites/default/files/fda_documents/2016051563901_FDA_JG411996.pdf and http://www.finra.org/sites/default/files/fda_documents/2017053428201%20DreamFunded%20Marketplace%20CRD%20283594%20and%20Manuel%20Fernandez%20CRD%206639970%20Extended%20Hearing%20Panel%20Decision%20va.pdf. See also https://www.finra.org/sites/default/files/publication_file/Disciplinary_Actions_April_2019.pdf and https://www.finra.org/sites/default/files/publication_file/Disciplinary_Actions_May_2019.pdf.

and the other promptly removed the content in question. The information provided by NASAA revealed no enforcement actions against Crowdfunding issuers or intermediaries taken by the small number of state regulators that provided information.

We also received anecdotal information about potential fraud or misconduct through the look-back survey. One intermediary respondent stated that it had received “few investor complaints of a serious nature regarding potential fraud, lack of disclosures, or loss of an investment.” Another intermediary respondent stated that it was not aware of any investor complaints related to inadequate disclosure, loss of investment, or fraud. It further stated that it was not aware of any instances of fraud or other concerns about investor protection in the crowdfunding industry other than one funding portal whose registration as a funding portal was terminated.¹⁰⁷ A different intermediary similarly stated that it had not rejected any offerings due to a belief that the issuer or offering presented the potential for fraud or investor protection concerns and that it has not received any related investor complaints. As discussed in Section III.C.1 above, we also have received feedback from other market participants outside of the look-back survey expressing concerns about potentially insufficient information in offering statements and other potential instances of non-compliance.

We reiterate that such observations do not account for instances of potential misconduct that were not detected or not subject to an enforcement action. While factors such as the public nature of crowdfunding campaigns, the requirement to use an intermediary, and various other requirements of Regulation Crowdfunding offerings may have served as deterrents to potential misconduct, we cannot distinguish the low incidence of observed potential misconduct from the

¹⁰⁷ See http://www.finra.org/sites/default/files/fda_documents/2016051563901_FDA_JG411996.pdf.

possibility of high latency of potential misconduct among crowdfunding issuers and intermediaries. Commission enforcement staff continues to monitor the securities-based crowdfunding market for investor protection risks and instances of potential misconduct.

b. Investor losses

As discussed above in Section III.C.1, we are not aware of any information on losses incurred by investors in crowdfunding offerings. Even if such information were available, because of the high level of ordinary business risk and failure for small and startup issuers, in the absence of documented instances of misconduct, it may be difficult to attribute a cause to the losses.

A few intermediaries stated that they lacked data on crowdfunding investor losses and returns at this time. While one intermediary referenced the current status of the crowdfunding issuers that have listed on its platform, the status of many of these investments is listed as “alive” with no additional information available. This status is broadly consistent with the illiquidity associated with the securities of startup issuers that this exemption was intended to benefit. Intermediaries that historically have only listed debt securities under the exemption reported that investors have received a positive rate of return for securities that had begun repayments.¹⁰⁸

We can draw some inference about the issuer survival rate based on whether an issuer returned to the crowdfunding market for a follow-on offering, filed an annual report on Form C-AR, or made another filing with the Commission, after the initial offering. Approximately two-thirds of issuers that reported completing a crowdfunding offering in 2016-2017 made at least

¹⁰⁸ In addition, one intermediary expressed the view that there is a difference in expectations and risk tolerance between debt and equity investors, with debt investors reacting more strongly, as opposed to equity investors, after an issuer declared bankruptcy or was consistently late with payments.

one filing on EDGAR in 2018 (typically, an annual report or a filing in connection with a follow-on offering).¹⁰⁹ Among issuers with no EDGAR filing activity in 2018, however, we cannot distinguish between issuers that ceased operations and issuers that remained in business but failed to file periodic reports. For example, among issuers that reported completed crowdfunding offerings in 2016-2017 with no subsequent filing activity in 2018, approximately four-fifths of the websites listed in their prior Form C filing remained available. In addition, most of the issuers with websites that remained accessible appeared to be offering products or services, although we cannot determine if those issuers were generating substantial business. Further, 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 2018.¹¹⁰ Conversely, crowdfunding issuers with EDGAR filing activity in 2018 may fail in subsequent years. The limited period of observation and the concentration of crowdfunding offerings in the second half of the considered period preclude a systematic medium- to long-term analysis of issuer outcomes. Further, any inference related to this market should be considered in the context of the survival rate of startup businesses generally. For example, based on Bureau of Labor Statistics (BLS) data on establishment survival rates, one-, three-, and five-year survival

¹⁰⁹ We exclude filings of Form C-TR to terminate reporting and filings withdrawing offering filings.

¹¹⁰ Name-based searches of information in S&P Capital IQ for issuers that reported completing crowdfunding offerings in 2016-2017 with no subsequent filing activity in 2018 yielded profile information for over ninety percent of issuers. None of those profiles contained mentions of bankruptcy filings. We repeated the name-based search in Lexis Advance for issuers that reported completing crowdfunding offerings in 2016-2017 with no subsequent filing activity in 2018 and similarly did not identify any bankruptcy filings. Name-based searches, however, may not yield comprehensive results. In addition, small startup issuers that fail may not need to file for bankruptcy protection. For instance, such an issuer might elect not to file for bankruptcy protection if it does not have outstanding debt and conducted a non-debt offering; has outstanding debt, but has minimal assets; or lacks funds for attorney and filing fees.

rates for private sector establishments formed in March 2013 were approximately 80%, 61%, and 51%, respectively.¹¹¹

c. Compliance with investor aggregates

As discussed in Section III.C.2.b above, based on limited information about investment amounts available from a few intermediaries, average amounts invested on a given platform were substantially below the existing investment limits. Because we do not have information on whether investors invested through multiple crowdfunding platforms, we cannot evaluate the extent of compliance with the investment limits.

In response to the look-back survey, crowdfunding intermediaries stated that they generally rely on information provided by the individual investors to assess compliance with investor aggregates. Several intermediaries stated that their software requires investors to disclose their net worth and income and then calculates the investment limit for each investor. The software takes into account any other investments on that platform and allows an investor to enter any other investments made under Regulation Crowdfunding on other platforms. The software does not allow an investment to proceed if the amount an investor seeks to invest is greater than the individual's investment limit. If the individual's investments are higher than \$25,000, one intermediary takes steps to verify, similar to Rule 506(c), the individual's net worth and income. Another intermediary stated that its compliance personnel spot-checks representations at random and also spot-checks any representation that provides for an investment limit over \$10,000.

¹¹¹ See BLS Business Employment Dynamics Establishment Age and Survival Data, available at <https://www.bls.gov/bdm/bdmage.htm> and https://www.bls.gov/bdm/us_age_naics_00_table7.txt.

FINRA staff stated that funding portals generally rely solely on investor representations regarding annual income and net worth. Some funding portals maintain their own databases comprised of information submitted by investors prior to each investment about their income and net worth as well as investor recertification prior to a follow-on investment. Based on discussions with FINRA staff, we understand that funding portals generally do not rely on third-party providers for verification of annual income and net worth.

4. Intermediary fee and compensation structures

Based on the analysis of Form C filings during the considered period, most intermediaries received a percentage fee paid in cash and/or securities contingent on the completion of the offering.¹¹² The average (median) cash compensation in these crowdfunding offerings was 5.7% (6%) of the offering proceeds. Intermediary cash compensation reported in Form C filings ranged from 0.1% to 10% of the offering proceeds. Approximately 37% of offerings reported an intermediary receiving securities of the issuer as part of intermediary compensation. When an intermediary received securities as part of its compensation in a crowdfunding offering, the average (median) amount was 2.9% (2%) of the offering proceeds. In addition to the compensation in the form of cash and securities, sometimes intermediaries required that issuers reimburse them for out-of-pocket third-party expenses incurred on behalf of the issuer in connection with the offering. Such reimbursements occurred in about 23% of the crowdfunding offerings.

¹¹² There is some variation in how issuers present information on intermediary compensation in Form C filings. We have made adjustments to improve consistency of the estimate but noise may remain.

Based on staff analysis of Form C data, compensation generally differed between intermediaries that were funding portals and intermediaries that were broker-dealers. The average (median) fee that broker-dealer-affiliated intermediaries charged was 7.1% (7.5%), higher than the fee that funding portals charged, which was 5.5% (6%). The difference could be explained by several potential factors, including differences in pricing practices or reputation, the greater range of services that may be offered by registered broker-dealers, or economies of scale (because most of the crowdfunding deal flow during the considered period happened through funding portals and has been concentrated in a small number of those funding portals). Broker-dealer-affiliated platforms also more frequently take securities as part of their compensation (in 88% of crowdfunding campaigns) compared to the 29% for funding portals. When they take securities, broker-dealer-affiliated platforms take on average 4.4%, more than double that of funding portals (2%). The median securities interest for broker-dealer-affiliated platforms is also more than double that taken by funding portals – 5% versus 2%.

Some intermediary respondents to the look-back survey reported charging only a cash fee. Some intermediary respondents reported assessing fees for additional services rendered to issuers, such as assisting the issuer with the preparation of offering materials and crowdfunding filings with the Commission, or in the event the issuer withdraws its offering. Some intermediary respondents reported assessing additional per-investor fees as a percentage of the amount invested, with some of those intermediaries applying minimum and/or maximum levels of fees per investor.

Market participants have provided some feedback on the restrictions on intermediary compensation under Regulation Crowdfunding. The 2017 and 2018 Small Business Forums recommended that the Commission allow portals to receive compensation on different terms than

the investor (e.g., warrants to purchase on the same terms as the investors) as well as to co-invest in offerings they facilitate.¹¹³

5. Measures intermediaries have taken to reduce the risk of fraud, including reliance on issuer and investor representations

Staff's analysis of intermediary measures to reduce the risk of fraud, including reliance on issuer and investor representations, is based on responses to the look-back survey and discussions with FINRA staff.

In response to the look-back survey, one intermediary stated that it has often decided not to list prospective offerings due to the potential for fraud or investor protection concerns but that such issuers are usually identified before an issuer launches on its platform. In the few instances where such issuers are not identified until after they launch, the intermediary cancels the offering and returns funds to investors. This intermediary described its current process to address the risk of fraud related to offerings as having two team members interview the founder of an issuer at different times, looking for depth of understanding in the market and challenges they are facing. In addition to background checks, as required by the rules, this intermediary looks for other red flags, shutting down offerings as necessary.

Another intermediary stated that its application requires a certification that there have been no instances of fraud by the issuer or its predecessors, officers, directors, promoters, or greater than 20% owners and that the intermediary performs due diligence by reviewing relevant financial information and operating agreements to ensure consistency. This intermediary also stated that it hired a third party to perform background checks and that it did not have any

¹¹³ See 2017 Small Business Forum Report; 2018 Small Business Forum Report.

instances where an issuer was prevented from selling securities due to a disqualification event. The intermediary stated that it had prevented a small number of prospective issuers that it believed were not complying with Regulation Crowdfunding disclosure requirements or that were ineligible under Regulation Crowdfunding from listing on its platform. This intermediary stated that it did not have to cancel or delist any offerings due to fraud, investor losses, or compliance with investor aggregates.

A different intermediary stated that in addition to its due diligence and initial screening process, which includes background checks, it conducts spot checks for every issuer and, if a fact or figure cannot be verified, it must be removed or corrected. Another intermediary stated that its screening process included bad actor checks and a number of issuer documents and checks to screen out other ineligible issuers. This intermediary also performed due diligence prior to disbursing funds to address investor protection concerns.

Commission staff discussions with FINRA staff suggest that, to verify issuer representations in Form C disclosures, most funding portals have an onboarding process for prospective issuers whereby the funding portal may request information about the issuer's business plan, corporate formation documentation, and other materials. Funding portals also complete checklists and undertake discussions with prospective issuers. Funding portals reject some prospective issuers as part of their measures to reduce the risk of fraud.

Some intermediaries provide education and guidance to issuers regarding their obligations under Regulation Crowdfunding, including disclosure obligations and ongoing reporting. However, staff is unaware of steps taken by any intermediary to ensure that issuers verify the independence of an accountant, verify compliance with advertising restrictions, or remain compliant with ongoing reporting obligations after an offering has concluded. Some

intermediaries stated that it is difficult to ensure compliance once an offering is over. One intermediary suggested that a database viewable only by intermediaries to share information on possibly fraudulent issuers could be of great benefit.

6. The concept of a centralized database of investor contributions

To our knowledge, a centralized database of investor information has not been created for Regulation Crowdfunding. Staff received input regarding the concept of a centralized database of investor contributions in our discussions with crowdfunding intermediaries and in response to the look-back survey. Of the intermediaries surveyed, none identified any benefits from such a database, but all cited potential drawbacks or described why there was no need for the database. Several intermediaries stated that such a database would be difficult to implement, could increase compliance costs due to the need to verify information and to secure investor data, and could add friction to what they described as an already costly process and diminish the appeal of crowdfunding.

One intermediary stated that a centralized database was neither necessary nor practical given the small portion of investors they estimated were reaching their investment limits. In addition, this intermediary stated that given the amount of data that would be shared, resolving discrepancies in the data would be unduly burdensome. Several intermediaries expressed privacy and security concerns with sharing personally identifiable information. These factors may also impose costs on investors. Several intermediaries cautioned that investors would likely be wary of having their information shared and that those concerns might dissuade them from investing.

In addition, because information about an investor's historical contributions through a crowdfunding intermediary's platform may have proprietary value, any requirement to share

information about investor commitments by submitting it to a centralized database may have competitive effects on intermediaries. For example, at least one intermediary cited the risk that intermediaries already compete for issuers and that a centralized database would increase the potential for “poaching” investors.

7. Intermediary policies and procedures

Staff’s analysis of intermediary policies and procedures is based on intermediary responses to the look-back survey as well as discussions with FINRA staff. Intermediary respondents to the look-back survey generally did not report problems with the development and implementation of policies and procedures to ensure compliance with federal securities laws, Regulation Crowdfunding, and FINRA funding portal rules. One intermediary respondent stated that the original implementation of the policies and procedures was time-consuming but not technically difficult and stated that FINRA staff provided helpful additional guidance. This intermediary stated that it performed an internal audit every quarter in conjunction with its written supervisory procedures as well as maintained several checklists that it used before launching an issuer.

Staff’s discussions with FINRA staff indicate that as part of the new member application process, FINRA staff reviews an entity’s policies and procedures. In some instances, more robust or specific procedures are suggested. A registrant’s policies and procedures are also within the scope of FINRA examinations.

8. Intermediary recordkeeping practices

Staff’s analysis of intermediary recordkeeping practices is based on intermediary responses to the look-back survey as well as staff discussions with FINRA staff. One intermediary respondent to the look-back survey stated that it had not experienced issues with

meeting recordkeeping requirements, which it handled using its software rather than a third party. Another intermediary respondent similarly stated that it had not experienced issues with record retention or considered it necessary to retain a third party to assist with recordkeeping, given current volumes and technology employed. This intermediary stated that creating and retaining records had not been burdensome. A different intermediary respondent stated that the recordkeeping requirements were adequate and that it has not encountered issues related to record retention. Another intermediary cited software licensing costs incurred as part of the burden of meeting the recordkeeping requirements. Several other intermediaries referenced retaining a third party as part of their recordkeeping compliance.

FINRA staff stated that, in their view, funding portals are generally aware of their recordkeeping obligations, but given that this is a new requirement for a new type of entity – funding portals – and that many of the participants are new to regulation and oversight, there may be a need for further education as to what constitutes a record (in particular, social media posts). In some instances funding portals were unable to produce certain records during an exam, but FINRA staff expressed the belief that most examined portals were complying with recordkeeping requirements.

9. Secondary trading market practices

During the considered period, a secondary trading market for crowdfunding securities was generally non-existent. Securities Act Section 4(a)(6) and Regulation Crowdfunding restrict transferability of securities sold under the exemption for one year after issuance, with a few

exceptions.¹¹⁴ A secondary trading market has not emerged for securities of most issuers in crowdfunding offerings that occurred during the considered period, including for securities of issuers for which the one-year transferability restriction has expired.¹¹⁵ While a lack of secondary market liquidity for the typical crowdfunding startup may make it more difficult for issuers to attract sufficient investor interest in primary offerings,¹¹⁶ it is broadly consistent with the illiquidity of other startup securities.

Staff observations are consistent with look-back survey responses. One intermediary respondent to the look-back survey stated that it is not aware of any investor in offerings through its platform that has resold its stake in a crowdfunding issuer. Another intermediary respondent to the look-back survey similarly stated that it was not aware of any secondary market that has developed in the industry but stated that users occasionally transfer their shares from one owner to another, a practice for which it has recently enabled a feature on its platforms.

¹¹⁴ Secondary offers and sales of crowdfunding securities must be registered with the Commission or eligible for an exemption. In addition, crowdfunding securities cannot be resold for a period of one year, except to the issuer, an accredited investor, in a registered offering, or to certain family members or trusts or in connection with the death or divorce of the purchaser or other similar circumstance. *See* 17 CFR 227.501(a).

¹¹⁵ We have identified very few instances of crowdfunding issuers that also had a class of shares quoted on the OTC market but we could not confirm whether the class of shares is the same as the class issued in the crowdfunding offering. We are not aware of crowdfunding intermediaries that conducted secondary trading of crowdfunding securities during the considered period. One intermediary's website provides information resources to aid buyers and sellers interested in secondary trading of a few of the past issuers that conducted a crowdfunding offering through its platform. All resales are conducted through a registered broker-dealer. *See* <https://www.startengine.com/secondary>; Vallabh Rao, "StartEngine is democratising startup investment in the US through OPOs and ICOs, Your Story" (27 February 2018) (mentioning StartEngine's secondary crowdfunding market). The intermediary notes on its website that the website serves only "as a communication tool and information resource for buyers and sellers of securities originally purchased through securities crowdfunding" and that no transactions are conducted through it. Rather, resale transactions must be conducted through a registered broker-dealer. Due to data constraints, we are unable to estimate deal volume associated with such resales.

¹¹⁶ Joan MacLeod Hemingway (2017) Selling Crowdfunded Equity: A New Frontier. *Oklahoma Law Review* 70(1); Austin, J., 2018. How Do I Sell My Crowdfunded Shares? Developing Exchanges and Markets to Trade Securities Issued by Start-ups and Small Companies. *Harvard Business Law Review* Vol. 8 (2017-2018).

We lack sufficient information to attribute the lack of secondary trading in crowdfunding securities to a specific cause. It may be due to a combination of factors related to a lack of interest in secondary trading of crowdfunding securities from registered broker-dealers, issuers, and prospective secondary market investors. Broker-dealers may be unwilling to quote crowdfunding securities because of low potential transaction fees per quoted issuer as a result of likely low trading volume in such securities, as compared to high fixed costs of due diligence and compliance with Rule 15c2-11.¹¹⁷ A funding portal could not facilitate a secondary market in crowdfunding securities because by definition, a funding portal can act as an intermediary only in connection with a transaction involving the offer or sale of securities for the account of others “solely” pursuant to the crowdfunding exemption for primary offerings under Section 4(6) of the Securities Act.¹¹⁸ There may not be enough investor interest in buying the securities of issuers that participate in crowdfunding today at prevailing valuations (*e.g.*, the average primary market offering has not reached the maximum offered), and investors interested in crowdfunding securities may prefer the primary market (where they may be able to collect nonfinancial awards). Information asymmetries between new and existing investors about the valuation of crowdfunding securities can also limit secondary market trading. Crowdfunding issuers may not want to solicit a broker-dealer to quote their securities on the OTC market. Some issuers or their founders may prefer a longer-term investor base or may seek to avoid the downside valuation risk of securities trading lower on the OTC market. Other issuers might plan to terminate reporting and not make periodic information available. Some issuers may be ineligible for the

¹¹⁷ See generally https://www.finra.org/sites/default/files/notice_comment_file_ref/17-14_OTCmarkets_comment.pdf.

¹¹⁸ See Section 3(a)(80) of the Exchange Act (definition of “funding portal”).

upper tiers of the OTC market but unwilling to have their securities quoted on the lower tier of the OTC market.

One intermediary respondent to the look-back survey observed that the difficulty in attracting “high-quality” issuers to the primary crowdfunding market and the “low adoption of investors” make it premature to expect a secondary market. This intermediary, which recommended certain changes to Regulation Crowdfunding that it believes would draw “higher quality” issuers, stated that, with such changes, it could take at least five years for a critical mass of investors to have enough liquidity for a secondary market to begin to function, and that such a secondary market would first begin with the most valuable, high-growth issuers. Another intermediary respondent to the look-back survey stated that challenges in supporting a secondary market for Regulation Crowdfunding securities would be similar to those faced by current public markets, and that in order for any such secondary market to thrive, it would require sufficient trading volume (ideally supported by market makers), quality third-party research, analysis, and content, and continued access to current information about issuers in the market. A different intermediary similarly cited the limited scale of the present crowdfunding market as a barrier to the development of a secondary trading market. Another intermediary stated that state blue sky restrictions on secondary trading likely deter the development of a secondary market in crowdfunding securities.¹¹⁹

¹¹⁹ Section 18 of Securities Act preempts state registration and qualification requirements for the offers and sales of securities under Section 4(a)(6). *See* 15 U.S.C. 77r(b)(4)(C). However, Section 18 does not preempt state registration and qualification for resales of those securities.

10. Other aspects of the Regulation Crowdfunding experience

We also received feedback and suggestions from market participants regarding, or are otherwise aware of reports and studies that have addressed, various aspects of Regulation Crowdfunding and how it may be improved. We summarize these observations below.

Some intermediaries that responded to the look-back survey commented that certain issuer requirements may be preventing issuers from raising capital through Regulation Crowdfunding. These intermediaries recommended allowing non-US issuers and Exchange Act reporting issuers¹²⁰ to engage in crowdfunding; and allowing intermediaries to file Form C-U on behalf of the issuer after funds are released from escrow.

Several intermediaries informed the staff that issuers also were concerned that a large number of shareholders would result in the issuer becoming required to register its securities under Section 12(g) of the Exchange Act once it failed to meet the conditional exemption under Regulation Crowdfunding.¹²¹ Several of these reported that, because of the risk of mandatory registration under Section 12(g) issuers are often reluctant to accept more than 500 investors in a crowdfunding offering or they retain repurchase rights to the securities offered. A number of market participants recommended expanding Regulation Crowdfunding's exemption from Section 12(g).

Another issue frequently raised by market participants is the prohibition against conducting a crowdfunding offering through a special purpose vehicle or fund organized to invest in, or lend money to, a single company (an "SPV"). Section 4A(f) of the Securities Act

¹²⁰ See also <https://www.sec.gov/rules/petitions/2016/petn4-699.pdf>, at note 6.

¹²¹ See also Treasury Report, at 41 (recommending "that the conditional exemption from Section 12(g) be modified by raising the maximum revenue requirement from \$25 million to \$100 million").

and Regulation Crowdfunding exclude certain types of issuers from relying on the crowdfunding exemption, including certain investment companies. As a result of the investment company exclusion, SPVs are not eligible to raise funds under Regulation Crowdfunding.¹²² Some intermediaries have told the staff that many issuers have elected not to pursue an offering under Regulation Crowdfunding because, without an SPV, a large number of investors on an issuer’s capitalization table can be unwieldy and potentially impede future financing.¹²³ Similarly, some intermediaries report that crowdfunding issuers are hesitant to offer voting rights to crowdfunding investors because the logistical challenges of seeking any required shareholder vote are too high a risk in the event of later financing and governance of the issuer.¹²⁴ The Treasury Report and the 2016 and 2017 Small Business Forums recommended allowing the use of SPVs to promote simplification of the capitalization table by aggregating investors with appropriate conditions.¹²⁵ Market participants cited other potential investor protections an SPV structure could provide, such as allowing small investors to invest alongside a sophisticated lead investor who may negotiate better terms, protect against dilution by negotiating during subsequent financings, mentor the company, and represent smaller investors on the board. The Treasury Report recommended allowing the use of SPVs advised by a registered investment

¹²² See Section 4A(f), 17 CFR 227.100(b), and Adopting Release, at 71397.

¹²³ See also Nicholas Tommarello, *Until Congress Acts, Don’t Invest in Startups to Make Money* (July 22, 2016), *Fortune*; Letter from Wefunder dated June 8, 2016; Letter from Wefunder dated May 16, 2017.

¹²⁴ See *id.*

¹²⁵ See Treasury Report, at 41 (recommending “allowing single-purpose crowdfunding vehicles advised by a registered investment adviser”); 2015 Small Business Forum Report (recommending that the Commission permit investments by SPVs, including those that share an adviser or sub-adviser, and determine that such SPVs are not investment companies for purposes of the Investment Company Act); 2016 SEC Government-Business Forum on Small Business Capital Formation, <https://www.sec.gov/files/gbfor35.pdf>; 2017 Small Business Forum Report, at 18.

adviser, which may mitigate issuers' concerns about vehicles having an unwieldy number of shareholders and tripping the registration thresholds of Section 12(g).¹²⁶ However, in light of what it cited as potential conflicts of interest between the issuer, lead investors, and other investors, including non-accredited investors, the Treasury Report recommended that any rulemaking in this area prioritize: (1) alignment of interests between the lead investor and the other investors participating in the vehicle; (2) regular dissemination of information from the issuer; and (3) minority voting protections with respect to significant corporate actions.¹²⁷

One study also expressed concern about low participation in crowdfunding among issuers that are currently underrepresented (*e.g.*, rural businesses and businesses in other areas not already considered technology and finance hubs, as well as female entrepreneurs).¹²⁸

¹²⁶ *See* Treasury Report.

¹²⁷ *See id.*

¹²⁸ *See* SBA Study, at 13. The study, based on the first year of Regulation Crowdfunding, observed low crowdfunding participation among firms that are currently underrepresented: For example, it found that there was less crowdfunding activity among businesses located in states and metropolitan areas that are not already considered technology and finance hubs. The study also found that women were underrepresented among equity crowdfunding issuers in its analysis.