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The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting

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THE RISK OF MONEY LAUNDERING THROUGH CROWDFUNDING: A FUNDING PORTAL'S GUIDE TO COMPLIANCE AND CRIME FIGHTING

*Zachary Robock**

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With the recent passage of the Jumpstart Our Business Startups Act (“JOBS Act”) and proposed regulations, equity crowdfunding is poised to play an important role in fundraising for many types of emerging growth companies. A fundamental purpose of crowdfunding is to reduce economic barriers to capital markets for emerging growth companies, in part by relaxing rigorous information disclosure requirements currently mandated by the Securities and Exchange Commission (“SEC”).¹ Relaxed regulation should help reduce the cost of fundraising, but it will also present certain risks. Investor fraud is a common concern, which is addressed at length in the JOBS Act and related regulation.² Perhaps less obvious, but nonetheless present, is the risk of money laundering, which is the subject of this Note.

Money laundering in crowdfunding may manifest in several ways. For example, an issuer may collude with investors to exchange money for securities in a nefarious enterprise under the façade of a business transaction. More specifically, a fake investor seeking to purchase bulk narcotics (or other contraband) could crowdfund a sham company owned by a narcotics distributor. The investor/buyer would receive narcotics plus

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1. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) [hereinafter “JOBS Act”] (providing that the Act is intended “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”).

2. See, e.g., JOBS Act § 301 (“This title may be cited as the ‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012’ or the ‘CROWDFUND Act.’”) (emphasis added); Crowdfunding, 78 Fed. Reg. 66428, 66461–65 (proposed Nov. 5, 2013) [hereinafter “Regulation Crowdfunding”] (providing a section entitled “Measures to Reduce Risk of Fraud”).

(worthless) equity. The issuer/narcotics distributor would receive funds electronically under the guise of a legitimate crowdfunding offering, which would be easier to integrate into the financial system than if the transaction were conducted in cash.

A similar process could be used to funnel money out of the country to fund terrorism. If fifty fake investors crowdfund a sham company that purports to do charitable work abroad, the investors could transfer funds to the company by purchasing (worthless) equity, and the company could transfer the money abroad under the guise of its business. The existence of a public crowdfunding solicitation would actually bolster the apparent legitimacy of the international funds transfer. Of course, these risks apply to any securities offering, which is precisely why the SEC's proposed regulations require crowdfunding portals to comply with anti-money laundering regulations analogous to a traditional broker-dealer.³

This Note explores money laundering risks presented by equity crowdfunding and recommends an approach for funding portals to manage these risks. Part I discusses the topic of crowdfunding, focusing primarily on proposed regulations for crowdfunding portals, issuers, and investors. Part II provides an overview of the significant role that financial institutions in the United States play in the monitoring, reporting, and prevention of money laundering and terrorist financing. Part III recommends implementing a risk-based approach to combat money laundering, which should enable funding portals to fulfill regulatory obligations while containing costs.

PART I: OVERVIEW OF JOBS ACT

The JOBS Act was passed on April 5, 2012 with a stated goal of “improving access to the public capital markets for emerging growth companies.”⁴ Toward this goal, Title I of the JOBS Act relaxes the regulatory disclosure requirements for emerging growth companies, thereby reducing significant legal and accounting costs.⁵ Title II lifts the historic ban on public solicitation, reducing the costs associated with private placement and increasing the potential pool of investors.⁶ Title III provides a new exemption to the Securities Act of 1933⁷ for equity crowdfunding, which is a process for emerging growth companies to raise relatively small amounts of money from a large crowd of investors—both accredited and unac-

3. Regulation Crowdfunding, *supra* note 2, at 66491 (“[A] funding portal would be required to comply with all of the provisions in the [Bank Secrecy Act] and its implementing regulations that are applicable to broker-dealers.”).

4. JOBS Act pmb. (discussing purpose of JOBS Act).

5. *Id.* §§ 101–108.

6. *Id.* § 201 (codified at 15 U.S.C. § 77d(a)(1)).

7. *Id.* § 302 (codified at 15 U.S.C. § 77d).

credited.⁸ Crowdfunding offerings are limited to a maximum of \$1,000,000 per issuer, per twelve-month period.⁹

There are three main participants in a crowdfunding transaction, each of which has reduced obligations as compared to a traditional securities offering. The first major participant is the emerging growth company seeking to raise funds, referred to as the issuer.¹⁰ The second major participant is the investor, who contributes capital to the emerging growth company in exchange for an equity stake.¹¹ The third major participant is an intermediary¹²—either a funding portal¹³ or a traditional broker-dealer¹⁴—that facilitates the connection between issuers and investors.

A. Requirements for Investors

Investors in a crowdfunding transaction may be accredited¹⁵ or unaccredited.¹⁶ Regardless of accreditation status, there are statutory limits on the amount of money that an investor may invest through crowdfunding during a twelve-month period.¹⁷ If an investor has an annual income or net worth less than \$100,000, then during a twelve-month period, the investor may only purchase securities worth up to \$2,000 or 5% of the investor's annual income or net worth, whichever is greater.¹⁸ If an investor has an annual income or net worth of \$100,000 or more, then during a twelve-month period, the investor may only purchase securities worth 10% of the investor's annual income or net worth, up to a maximum in-

8. Regulation Crowdfunding, *supra* note 2, at 66429 n.12; Heather L. Traeger, Theodore W. Kassinger & Zachary D. Kaufman, *Democratizing Entrepreneurship: An Overview of the Past, Present, and Future of Crowdfunding*, 45 Bloomberg BNA Sec. Regulation & Law Report 208, 208–17 (2013).

9. JOBS Act § 302 (codified at 15 U.S.C. § 77d(a)(6)(A)).

10. *Id.* (codified at 15 U.S.C.A § 77d-1(b)).

11. Traeger et al., *supra* note 8, at 45.

12. JOBS Act § 302 (codified at 15 U.S.C.A § 77d-1(a)).

13. *Id.* § 304 (codified at 15 U.S.C. § 78c(a)(80)) (defining “funding portal”).

14. 15 U.S.C. § 78c(a)(4) (defining “broker”); 15 U.S.C. § 78c(a)(5) (defining “dealer”); JOBS Act § 304 (codified at 15 U.S.C. § 78c(h)(1)); *see also* 31 C.F.R. § 1023.320(a)(1) (2013) (introducing the term “broker-dealer”).

15. 17 C.F.R. § 230.501(a) (2013) (defining “accredited”).

16. Regulation Crowdfunding, *supra* note 2, at 66429 n.12 (“[C]rowdfunding is premised on permitting sales of securities to any interested person, not just to investors who meet specific qualifications, such as accredited investors.”).

17. *Id.* at 66434 (declining to provide different investment limits for accredited and unaccredited investors).

18. JOBS Act § 302 (codified at 15 U.S.C. § 77d(a)(6)(B)(i)) (providing that the threshold is “the greater of \$2,000 or 5 percent”); *see also* Regulation Crowdfunding, *supra* note 2, at 66433 (clarifying that the threshold is based on the greater of net worth or annual income).

vestment of \$100,000.¹⁹ This limit is cumulative across all crowdfunding investments made by the investor.²⁰

Interestingly, the burden of ensuring that aggregate investment limits are not violated falls primarily on the intermediary, rather than the investor or the issuer.²¹ However, this should not be overly burdensome. Under the proposed regulations, an intermediary may rely on an investor's representations about other crowdfunding investments to enforce the aggregate twelve-month cap, unless the intermediary has reason to question the reliability of the representations.²²

B. Requirements for Issuers

An issuer must disclose basic material information on the company, including: its location, ownership, and capital structure; the identities of its officers, directors, and 20% or more shareholders;²³ and information regarding the business experience of directors and officers of the issuer for the preceding three years.²⁴ The issuer must also provide a target offering amount, a description of its business plan, and an explanation of the intended use of the funds raised.²⁵ Importantly, the issuer must disclose varying degrees of financial information depending on its target offering amount. If the target offering is over \$500,000, then the issuer must disclose audited financials.²⁶ If the target offering is \$500,000 or less, but over \$100,000, then the issuer must disclose financial statements reviewed by an independent accountant (but not necessarily formally audited).²⁷ If the target offering is \$100,000 or less, then the issuer need only provide financial statements certified to be true and complete by the issuer's prin-

19. JOBS Act § 302 (codified at 15 U.S.C. § 77d(a)(6)(B)(ii)); *see also* Regulation Crowdfunding, *supra* note 2, at 66433 (clarifying that the threshold is based on the greater of net worth or annual income).

20. Regulation Crowdfunding, *supra* note 2, at 66469 (providing that “[s]ection 4(a)(6)(B) imposes certain limitations on the aggregate amount of securities that can be sold to an investor *in reliance on Section 4(a)(6)* during a 12-month period.”) (emphasis added); 158 CONG. REC. S5476 (daily ed. July 26, 2012) (statement of Sen. Merkley) (explaining that aggregate investor caps are intended to apply cumulatively across all crowdfunding investments because the inherent riskiness of funding emerging growth companies is “not amenable to ordinary means of mitigation through diversification”); *see* JOBS Act § 302 (codified at 15 U.S.C. § 77d-1(a)(8)) (clarifying that investor limits apply “in the aggregate, from all issuers,” and providing that this responsibility only pertains to securities offered pursuant to Section 4(a)(6), which is the section on Crowdfunding); *see also id.* (codified at 15 U.S.C. § 77d(a)(6)(B)(i)–(ii) (outlining the investment limits)).

21. *See* JOBS Act § 302 (codified at 15 U.S.C. § 77d-1(a)(8)).

22. Regulation Crowdfunding, *supra* note 2, at 66470 (providing that “an intermediary may rely on an investor’s representations concerning compliance with investment limitation requirements.”).

23. *See* JOBS Act § 302 (codified at 15 U.S.C. §§ 77d-1(b)(1)(A), (B), (H)).

24. Regulation Crowdfunding, *supra* note 2, at 66439.

25. JOBS Act § 302 (codified at 15 U.S.C. §§ 77d-1(b)(1)(C), (E), (F)).

26. *Id.* (codified at 15 U.S.C. §§ 77d-1(b)(1)(D)(iii)).

27. *See id.* (codified at 15 U.S.C. §§ 77d-1(b)(1)(D)(ii)).

cial executive officer, plus income tax returns for the prior year (if any).²⁸ Despite these relaxed disclosure requirements, issuers remain liable for any material misrepresentations or omissions.²⁹

One final consideration is that the issuer must be a domestic company.³⁰ However, this should not prevent an issuer from organizing a domestic holding company to issue securities and receive funds and then immediately forwarding those funds to an international affiliate.³¹ This will be the likely structure adopted by legitimate international emerging growth companies, especially those seeking to raise money in the United States to carry out double bottom-line missions abroad.³² At first glance, this requirement may seem an unnecessary formality if the funds will be immediately sent on to an international affiliate. However, it does serve some anti-money laundering and anti-fraud purposes by requiring *someone* in the United States to be the registered agent of the company and establishing jurisdiction for a lawsuit. It may also ensure that the funds received as a result of the crowdfunding offering are initially deposited into a domestic bank account subject to domestic regulatory requirements, which would help create a more accessible paper trail for United States law enforcement.³³

C. Requirements for Intermediaries

All crowdfunding transactions must be conducted through a registered intermediary—either a funding portal or a broker-dealer.³⁴ Collectively, these intermediaries will serve as an online marketplace for issuers to publicize crowdfunding offerings and for investors to conveniently browse investment opportunities.³⁵ The SEC estimates that in a mature crowdfunding market, there will be approximately 50 funding portals and

28. *Id.* (codified at 15 U.S.C. §§ 77d-1(b)(1)(D)(i)).

29. *Id.* (codified at 15 U.S.C. § 77d-1(c)).

30. *Id.* (codified at 15 U.S.C. § 77d-1(f)(1)).

31. See Regulation Crowdfunding, *supra* note 2, at 66436–37 (providing criteria for issuers that would not qualify for the crowdfunding exemption; none of the exclusionary criteria appear to disqualify a domestic holding company established for the purpose of transferring funds to a specified affiliate abroad).

32. Chance Barnett, *Will Crowdfunding Ignite Investing For Profits and Purpose?*, FORBES (August 9, 2012, 11:10 AM), <http://www.forbes.com/sites/chancebarnett/2012/08/09/will-crowdfunding-ignite-investing-for-profits-purpose>. See Lori Kozlowski, *Impact Investing: The Power of Two Bottom Lines*, FORBES (Oct. 2, 2012, 2:08 PM), <http://www.forbes.com/sites/lorikozlowski/2012/10/02/impact-investing-the-power-of-two-bottom-lines>, for a discussion of double bottom line companies seeking to achieve both financial returns and social returns.

33. The JOBS Act and proposed regulations are silent as to whether funds must be deposited into a domestic bank account. For both money laundering and fraud concerns, this should be required and should be clarified in the SEC's final rules on crowdfunding.

34. JOBS Act § 302 (codified at 15 U.S.C. § 77d(a)(6)(C)).

35. Regulation Crowdfunding, *supra* note 2, at 66529 (“The proposed rules would also require that an intermediary execute transactions exclusively through its online platform.”).

approximately 60 broker-dealers.³⁶ The two entity types will engage in similar activity in terms of serving as a marketplace for crowdfunding offerings; however, broker-dealers will be permitted to continue to engage in broader securities activities, while funding portals' activities will be limited to the crowdfunding realm.³⁷ Consistent with the difference in permitted activities, funding portals will be exempt from traditional broker-dealer registration and will instead be subject to more narrowly tailored registration and regulation requirements.³⁸ Such narrow tailoring should enable funding portals to facilitate crowdfunding transactions without imposing an undue burden given the funding portals' limited activities.³⁹

Specifically, funding portals may not "offer investment advice or recommendations,"⁴⁰ nor may funding portals "hold, manage, possess, or otherwise handle investor funds or securities."⁴¹ Because of this latter prohibition, a funding portal must partner with a bank or other qualified third party in order to effectuate the actual exchange of funds for securities.⁴² Figure 1, below, illustrates the general structure of a crowdfunding transaction. Primary contact between the issuer and investors is facilitated by the funding portal; however, the back-office exchange of funds for stock must be conducted by a bank or other qualified third party.⁴³

36. *See id.* at 66527.

37. *See id.* at 66528, 66533, 66429 ("A person that operates [a funding portal] for the purchase of securities of startups and small businesses . . . may find it impractical in view of the limited nature of that person's activities and business to register as a broker-dealer and operate under the full set of regulatory obligations that apply to broker-dealers.").

38. JOBS Act § 304 (codified at 15 U.S.C. § 78c(h)); *see also* Regulation Crowdfunding, *supra* note 2, at 66555–56 (requiring a funding portal to be a member of a national securities association registered with the SEC); *id.* at 66459 (providing that the Financial Industry Regulatory Authority (FINRA) is the only national securities association that currently meets the aforementioned requirement).

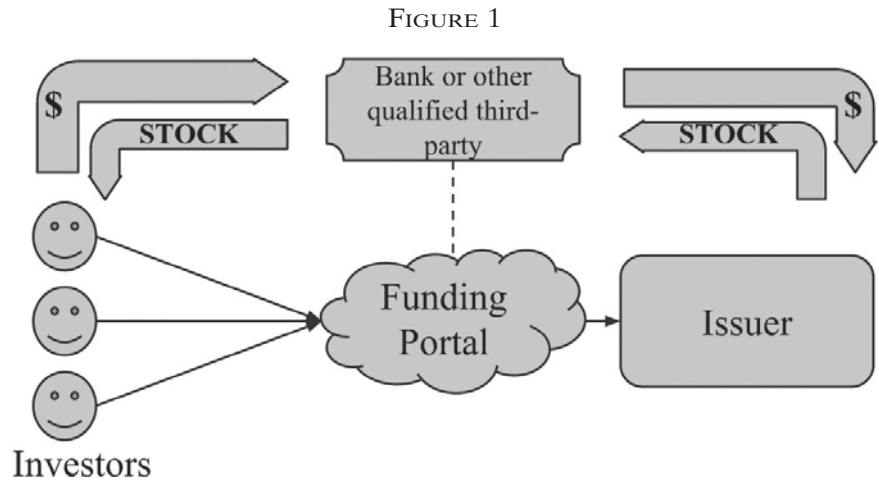
39. Regulation Crowdfunding, *supra* note 2, at 66528, 66533, 66429; 158 Cong. Rec. S5476 (daily ed. July 26, 2012) (statement of Sen. Merkley) ("The CROWDFUND Act is designed so that funding portals will be subject to fewer regulatory requirements than broker-dealers because they will do fewer things than broker-dealers.").

40. JOBS Act § 304 (codified at 15 U.S.C. § 77c(80)(A)). *But see* Regulation Crowdfunding, *supra* note 2, at 66463–64 (discussing Proposed Regulation § 227.301(c), which requires an intermediary to deny access to issuers if fraud or other investor protection concerns are presented; this requirement arguably constitutes investment advice as an implicit recommendation that issuers listed on the funding portal present an acceptable level of fraud risk).

41. JOBS Act § 304 (codified at 15 U.S.C. § 77c(80)(D)).

42. 15 U.S.C. § 78c(a)(6) (defining "bank"); Regulation Crowdfunding, *supra* note 2, at 66557–58 (discussing Proposed Regulation § 227.303(e)(2)); *see also id.* at 66532 ("Intermediaries registered as funding portals would be required to direct investors to transmit the funds or other consideration directly to a qualified third party.").

43. Regulation Crowdfunding, *supra* note 2, at 66557–58 (discussing Proposed Regulation § 227.303(e)); *see also id.* at 66532.



Funding portals also have affirmative duties to educate and protect investors by ensuring that each investor reads and understands the risks associated with equity investing in emerging growth companies.⁴⁴ The JOBS Act requires that funding portals take measures to reduce the risk of fraud, including obtaining a “background and securities enforcement regulatory history check” on the issuer, its directors, officers, and 20% or more shareholders, as well as any other measures a funding portal deems appropriate.⁴⁵ Finally, the SEC’s proposed regulations provide that funding portals must comply with Bank Secrecy Act anti-money laundering requirements analogous to a broker-dealer—namely, the regulations promulgated under 15 C.F.R. Chapter X, Part 1023.⁴⁶ Parts II and III explore these obligations in greater detail.

PART II: ROLE OF FINANCIAL INSTITUTIONS IN COMBATING MONEY LAUNDERING IN THE UNITED STATES

Financial institutions⁴⁷ in the United States play an important role in combating money laundering,⁴⁸ terrorist financing, and other crimes associated with illicit wealth generation and transmission, a compliance process known as Anti-Money Laundering (“AML”).⁴⁹ Under the Bank

44. JOBS Act § 302 (codified at 15 U.S.C. § 77d-1(a)(4)).

45. *Id.* (codified at 15 U.S.C. § 77d-1(a)(5)); Regulation Crowdfunding, *supra* note 2, at 66463–64.

46. Regulation Crowdfunding, *supra* note 2, at 66490–95 (discussing, in part, Proposed Regulation § 227.403(b)).

47. See 31 U.S.C. § 5312(a)(2) (2012) (defining “financial institution”).

48. BLACK’S LAW DICTIONARY 1159 (10th ed. 2009) (defining money laundering as “[t]he act of transferring illegally obtained money through legitimate people or accounts so that its original source cannot be traced.”).

49. See generally *Bank Secrecy Act Anti-Money Laundering Examination Manual: Suspicious Activity Reporting*, FED. FIN. INSTS. EXAMINATION COUNCIL, <https://www.ffc.gov/>

Secrecy Act,⁵⁰ every financial institution is required to implement an AML program to monitor, investigate, and report “suspicious activity”⁵¹ to the Treasury Department—specifically, the Financial Crimes Enforcement Network (“FinCEN”).⁵² FinCEN maintains a database of every Suspicious Activity Report (“SAR”) filed by financial institutions, which can be accessed by certain law enforcement agencies to aid in investigations.⁵³

For example, if the Federal Bureau of Investigation (“FBI”) is investigating John Smith for suspected human trafficking, an FBI agent can request a FinCEN SAR database search for “John Smith,” or for John Smith’s known addresses, telephone numbers, Social Security numbers, and other information.⁵⁴ If John Smith has been frequently depositing \$9,999 in cash into a single bank account in an apparent attempt to avoid the \$10,000 currency transaction reporting threshold,⁵⁵ that bank would probably have filed a SAR, which would contain John Smith’s name, demographic information, and a description of John’s Smith suspicious activity. The agent could then request additional information from the financial institution that may be helpful in her investigation, including: other sources of funds to John Smith’s account; the destination of any large payments out of the account; and other accounts maintained by John Smith.⁵⁶ The SAR process enables the agent to leverage the financial institution’s expertise in identifying suspicious activity and navigating its own internal systems, and to quickly focus her investigation on known suspicious activity.⁵⁷

bsa_aml_infobase/pages_manual/OLM_015.htm (last visited Sept. 25, 2014) (discussing the important role of financial institutions in AML).

50. The term “Bank Secrecy Act” refers to a legislative framework that requires United States financial institutions to assist law enforcement agencies in the detection and prevention of money laundering. It encompasses *inter alia* the Currency and Foreign Transactions Reporting Act of 1970, the PATRIOT Act, and regulations promulgated under 31 C.F.R. Chapter X. See *FinCEN’s Mandate from Congress*, FIN. CRIMES ENFORCEMENT NETWORK, http://www.fincen.gov/statutes_regs/bsa/ (last visited Nov. 30, 2014) (“The Currency and Foreign Transactions Reporting Act of 1970 (which legislative framework is commonly referred to as the “Bank Secrecy Act” or “BSA”) requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering.”).

51. “Suspicious activity” is a term of art in AML and refers to unusual transactions that a financial institution concludes are indicative of money laundering, terrorist financing, fraud, or other criminal activity. See 31 C.F.R. § 1023.320(a)(2), discussed *infra* at III(a).

52. 31 U.S.C. § 310 (2012).

53. 31 U.S.C. § 310(b)(2); 31 C.F.R. § 1010.520(b) (2014).

54. 31 C.F.R. § 1010.520(b)(1). See generally 31 U.S.C. § 310(b)(2)(B).

55. 31 C.F.R. § 1010.100(xx). Avoiding the \$10,000 threshold is not the only circumstance under which a SAR should be filed, it is simply a well-known example of suspicious activity. See, e.g., Fin. Crimes Enforcement Network, *Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative*, 5–6 (November 2003), available at http://www.fincen.gov/statutes_regs/files/sarnarrcompletguidfinal_112003.pdf (providing examples of suspicious activity typologies, including apparent evasion of reporting requirements).

56. See 31 U.S.C. 310(b)(2)(B); 31 C.F.R. § 1010.520(b).

57. Fin. Crimes Enforcement Network, *Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative*, 3 (November 2003), available at <http://www.fincen>

Among other purposes, this comprehensive system of suspicious activity reporting serves as a barrier to illicit funds generated abroad being transferred into the United States, and as a barrier to legitimate funds within the United States being transferred abroad to fund criminal and/or terrorist activities. It is important that all significant participants in the financial system be subject to similar AML obligations so as to avoid any chink in the armor that would allow foreign funds to gain an easy foothold in the United States banking system, or conversely, to allow an easy departure point for domestic funds to be transferred abroad.⁵⁸ This is especially important given the risk-based approach discussed in Part III, below.

PART III: AML REQUIREMENTS FOR FUNDING PORTALS

A. *Specific Requirements*

There are three main requirements to a funding portal's AML program. First, a funding portal must implement an effective Customer Identification Program ("CI Program"), which itself has three components: a) collecting identifying information about the investor, issuer, and the issuer's directors, officers and 20% or more shareholders; b) taking reasonable steps to ensure this data is genuine (not a false identity); and c) conducting a background check on the issuer and its significant personnel to determine potential fraud or terrorism risks.⁵⁹

Second, a funding portal must maintain a program to monitor and report suspected money laundering activity to FinCEN ("SAR Program").⁶⁰ Specifically, a transaction (or series of transactions) requires reporting if it is conducted or attempted through the funding portal, it involves at least \$5,000, and the funding portal "knows, suspects, or has reason to suspect" that the transaction (or series of transactions): involves funds derived from illegal activity; is designed to evade a mandatory reporting requirement; has no apparent business or lawful purpose based on available information; and/or is in furtherance of criminal activity or terrorism.⁶¹ In other words, if a transaction (or a series of transactions) involves at least \$5,000 and looks suspicious or has no apparent legitimate purpose, then it should be reported to FinCEN.⁶²

.gov/statutes_regs/files/sarnarrcompletguidfinal_112003.pdf (explaining, generally, the purpose of SARs in law enforcement investigations).

58. The regulations promulgated under Chapter X address a wide range of financial industries, from banking and insurance, to casinos, to dealers of precious metals, stones, or jewels. *See generally* 31 C.F.R. Subt. B Ch. X (2013).

59. 31 C.F.R. § 1023.220(a)(2); Regulation Crowdfunding, *supra* note 2, at 66556. Notably, the proposed regulations only explicitly require a background check for fraud and terrorism; however, a more general criminal background check (to include, for example, trafficking of narcotics, weapons, or people) would be advisable from an AML standpoint.

60. Regulation Crowdfunding, *supra* note 2, at 66492.

61. 31 C.F.R. § 1023.320(a)(2); Regulation Crowdfunding, *supra* note 2, at 66492.

62. *Id.*

Third, a funding portal must maintain a system for complying with requests for information from FinCEN and other law enforcement agencies (a “314(a) Requirement”).⁶³ Such requests will typically ask whether the funding portal maintains any relationships with a given individual or entity, and if so, to provide certain information about the individual or entity’s account activity.⁶⁴ FinCEN requests may also be follow-up inquiries on a prior SAR filing in order to obtain additional information.⁶⁵ A funding portal can comply with the 314(a) Requirement by designating a point person, providing that person’s contact information to FinCEN, and ensuring that information requests are completed in a timely manner.⁶⁶

B. Introduction to a “Risk-Based Approach”

Implementing CI and SAR Programs that comply with regulatory requirements while containing costs is a universal challenge faced by financial institutions. A leading approach to tackling this challenge is to utilize a risk-based approach, which allocates AML resources based on the level of risk associated with a given customer, transaction profile, or line of business.⁶⁷ By dedicating increased AML resources to an otherwise higher risk activity, the financial institution can essentially reduce the risk of the given activity down to acceptable levels. The goal is not to prohibit higher risk activities entirely, but rather to ensure that appropriate risk mitigation strategies are implemented when necessary.⁶⁸ Guidance from the Financial Action Task Force (“FATF”) states that “[c]ompetent authorities expect financial institutions to put in place effective policies, program[]s, procedures and systems to mitigate the risk and acknowledge that even with effective systems not every suspect transaction will necessarily be detected.”⁶⁹ That said, it is important to note that while the risk-based approach encourages efficient allocation of understandably scarce resources,

63. Regulation Crowdfunding, *supra* note 2, at 66491–92 (discussing the “314(a) Requirement,” so named due to section 314(a) of the PATRIOT Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001 PL 107–56, 115 Stat 272 (2001))).

64. *Id.*

65. See Suspicious Activity Report Supporting Documentation (FIN-2007-G003), FIN. CRIMES ENFORCEMENT NETWORK (June 13, 2007), http://www.fincen.gov/statutes_regs/guidance/html/Supporting_Documentation_Guidance.html.

66. 31 C.F.R. § 1023.520 (referring to § 1010.520, especially §§ 1010.520(b) (discussing information production responsibilities in general) and 1010.520(b)(3)(iii) (discussing contact person)); Regulation Crowdfunding, *supra* note 2, at 66491–92.

67. See FIN. ACTION TASK FORCE, GUIDANCE ON THE RISK-BASED APPROACH TO COMBATING MONEY LAUNDERING AND TERRORIST FINANCING: HIGH LEVEL PRINCIPLES AND PROCEDURES (2007), [hereinafter FATF RISK-BASED GUIDANCE]. Note that FATF is an inter-governmental body that promulgates recommendations on effective AML controls. FATF reports are cited in Regulation Crowdfunding in support of the proposed AML requirements.

68. *Id.* at 2.39.

69. *Id.* at 2.33.

an overall failure to dedicate sufficient resources to an AML program cannot justify systemic failures in AML monitoring.⁷⁰

There are two reinforcing motivations for compliance with these AML requirements: the civic duty to deter criminal activity (a carrot) and the desire to avoid costly civil or criminal sanctions for failure to monitor and report (a stick).⁷¹ It is important to keep the carrot in mind; however, it is the stick that is probably most influential from a business perspective. Under FINRA guidelines, a funding portal must develop and implement an AML program *reasonably designed* to achieve compliance with the Bank Secrecy Act.⁷² The Bank Secrecy Act requires that a funding portal report transactions that it “knows, suspects, or has reason to suspect” are related to money laundering.⁷³ In effect, the SAR Program must be reasonably designed to comply with a should-have-known standard.⁷⁴

C. Implementing a Risk-Based Approach for Funding Portals

A risk-based approach sets forth at least two sets of procedures: standard and enhanced.⁷⁵ The standard procedures serve two purposes. First, standard procedures should be designed to detect and prevent blatant money laundering. This ensures that obvious violations are not overlooked. Second, standard procedures serve as a screening method to identify higher risk customers and transactions that require enhanced diligence.⁷⁶ To this end, funding portals should conduct a risk assessment

70. STAFF OF PERM. S. SUBCOMM. ON INVESTIGATIONS, 112TH CONG., REP. ON U.S. VULNERABILITIES TO MONEY LAUNDERING, DRUGS, AND TERRORIST FINANCING: HSBC CASE HISTORY 10 (2012) (discussing the role of severe AML deficiencies in levying a \$1.9 billion fine, including an unacceptable backlog, insufficient staffing, and inappropriate risk assessments).

71. See 31 C.F.R. §§ 1010.820, 1010.840 (2012) (discussing civil and criminal penalties).

72. *FINRA Manual*, FIN. INDUS. REGULATORY AUTH., Rule 3310 (2014), available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607 (last visited Dec. 14, 2013) (emphasis added).

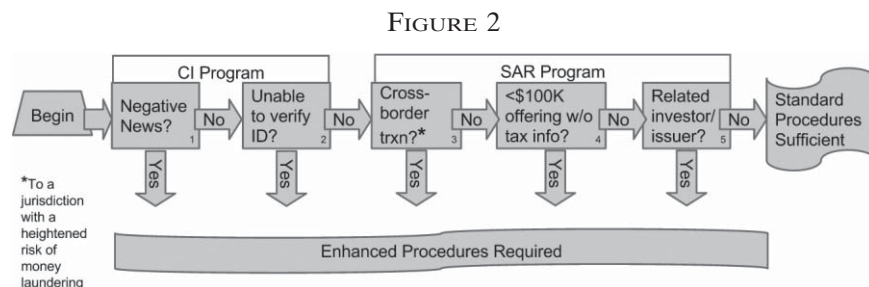
73. 31 C.F.R. § 1023.320(a)(2) (2014).

74. *Anti-Money Laundering Source Tool for Broker-Dealers*, U.S. SEC. & EXCH. COMM’N, (June 20, 2012), <http://www.sec.gov/about/offices/ocie/amlsourcetool.htm#3> (requiring “policies and procedures that can be reasonably expected to detect and cause the reporting of transactions under 31 U.S.C. 5318(g) and the implementing regulations thereunder.”); FATF Risk-Based Guidance, *supra* note 67, at 1.13 (“[R]egulators, law enforcement and judicial authorities must take into account and give due consideration to a financial institution’s well-reasoned risk-based approach.”). Note that although some civil penalties apply for negligent violations, most civil penalties and all criminal penalties only apply to willful violations. See 31 C.F.R. § 1010.820(h) (discussing negligent violations); § 1010.820 (a)–(g), § 1010.840 (discussing willful violations); see also *Bank Secrecy Act Anti-Money Laundering Examination Manual*, FED. FIN. INSTS. EXAMINATION COUNCIL App’x R, https://www.ffeec.gov/bsa_aml_infobase/pages_manual/OLM_018.htm (last visited Sept. 25, 2014) (providing that enforcement action will be taken if a financial institution fails to “establish and maintain a reasonably designed BSA Program”).

75. See FATF RISK-BASED GUIDANCE, *supra* note 67, at 1.11.

76. See *id.*

by determining which aspects of their crowdfunding business are most vulnerable to money laundering.⁷⁷ From there, the funding portal should distill these vulnerabilities into specific characteristics that can be used in an automated transaction monitoring system to flag unusual transactions.⁷⁸ Figure 2, below, illustrates some suggested characteristics that should be considered.⁷⁹ Any questions answered in the affirmative should lead to enhanced diligence of the customer and/or transaction.



The first question asks whether the mandatory background check required of the issuer, its directors, officers, and 20% or more shareholders produced any negative news or derogatory information. The second question asks whether the funding portal is unable to verify the identifying information provided by its investors and issuers.⁸⁰ Identification of derogatory information or an inability to verify identity should lead to enhanced procedures. These two questions generally fall under the heading of the funding portal's CI Program; however, the CI Program and SAR Program do not operate in isolation.

The third question asks whether the offering will ultimately fund an emerging growth company abroad, even if the issuer will technically be domestic. If so, and the intended destination is a high-risk (or perhaps even medium-risk) jurisdiction for money laundering,⁸¹ then enhanced

77. *See id.* at 1.12.

78. FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 74.

79. *See generally id.* at Appendix F: Money Laundering and Terrorist Financing “Red Flags”; *Special NASD Notice to Members 02-21*, NAT’L ASS’N SEC. DEALERS 10-11 (April 2002), available at <http://www.sec.gov/about/offices/ocie/aml2007/nasd-ntm-02-21.pdf> (providing a list of red flags for broker-dealers).

80. *See* 31 C.F.R. § 1023.220(a)(2)(ii) (2011) (discussing “documentary” methods for verifying customer identification, such as government-issued documents, and “non-documentary” methods, such as credit reporting agencies).

81. *Advisory on the FATF-Identified Jurisdictions with AML/CFT Deficiencies*, FIN-2013-A008 (2013) FIN. CRIMES ENFORCEMENT NETWORK, http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-A008.html; FATF Public Statement, *High Risk and Non-Cooperative Jurisdictions* (October 18, 2013), available at <http://www.fatf-gafi.org/topics/high-risk-and-non-cooperative-jurisdictions/documents/fatf-public-statement-oct-2013.html>; *see, e.g.*, BUREAU OF INT’L NARCOTICS AND LAW ENFORCEMENT AFFAIRS, *International Narcotics Control Strategy Report* (2013), available at <http://www.state.gov/j/inl/rls/nrcrpt/2013/vol2/204062.html>.

procedures should be undertaken. Although the issuer could lie about the intended destination, the need to disclose the company's business plan and intended use of funds should provide some assurance of truthful answers. If all the information provided by the issuer is false, then the bank or qualifying third party that actually conducts the transaction should be able to easily identify the inconsistency when the actual funds transfer occurs.⁸²

The fourth question asks whether the issuer's target offering is \$100,000 or less *and* the issuer is unable to provide tax returns for the prior year. Such offerings present a heightened risk because the financial statements of the company have not undergone external review; they are simply "certified" by an executive of the issuer, and there are no tax returns to corroborate this information.⁸³ The fifth question asks whether 75% or more of the money raised in the offering is provided by investors that have a connection to the issuer.⁸⁴ Specifically, text-matching software could compare the names, addresses, telephone numbers, and email addresses of the respective customers to determine connections. This protects against the crowdfunding transaction being used as a façade for cycling money to make it appear legitimate. If an issuer can raise 75% or more of the needed capital from parties that it already knows, why bother with the expense of crowdfunding?⁸⁵ A final consideration is that if FinCEN or another law enforcement agency requests information on a particular customer or transaction, the funding portal should take note and conduct enhanced review of that customer and/or activity.

Funding portals should periodically review these risk factors and calibrate them for effectiveness. For example, the 75% funding-by-related-persons threshold described in the fifth question above is intended as an educated starting point for transaction monitoring. Funding portals should consider testing thresholds above and below 75%. More specifically, assume that a 75% threshold results in eight SARs being filed for every ten red-flagged transactions. To test the 75% threshold, the financial institution can test a 50% matching threshold. If the 50% matching threshold results in significantly more red-flagged transactions, but a substantial decrease in the rate of SAR filings, that *suggests* that 75% is an appropriate threshold. In other words, casting a wider net (by decreasing the threshold to red-flag more transactions) did not yield a correspondingly larger catch. Alternatively, if the decrease to 50% resulted in an increase in the SAR-filing rate, the funding portal should consider perma-

82. Regulation Crowdfunding, *supra* note 2, at 66491 (providing that banks and other financial institutions involved in the crowdfunding process have their own AML requirements, independent of the obligations on funding portals).

83. JOBS Act § 302 (codified at 15 U.S.C. § 77d-1(b)(1)(D)(i)).

84. *See, e.g.*, FIN. ACTION TASK FORCE, MONEY LAUNDERING AND FINANCING IN THE SECURITIES SECTOR 33 (Oct. 2009) (Case study 10: Activity of Wash Trading).

85. This concern may be mitigated upon enhanced review if the investors are unaccredited and crowdfunding is the only exemption available under the circumstances.

nently decreasing the threshold to 50% (or lower) because casting a wider net resulted in a material increase in the catch.

These quantitative results are, however, not absolute; funding portals should also consider qualitative components. The law requires that a SAR be filed if *inter alia* a transaction “has no business or apparent lawful purpose.”⁸⁶ Investors may be idiosyncratic, superstitious, or otherwise not entirely rational in their behavior.⁸⁷ Even for entirely legitimate transactions, it is not always possible to sufficiently articulate a business or apparent lawful purpose, so casting a wider net will almost certainly raise the number of SARs filed. Funding portals should therefore analyze the quality of the SARs filed under the broadened threshold to determine whether the increased SAR filings are primarily due to specific criminal concerns, or simply an inability to explain customer behavior. If the former, it suggests that the lowered threshold (50%) is effective and should remain. If the latter, it suggests that the lowered threshold may not be effective and a higher threshold could be tested. This is not to say that inexplicable transactions are not suspicious and should not be reported, but when evaluating the effectiveness of a threshold, there is room for reasonable subjective analysis.

D. *Enhanced Procedures*

When enhanced procedures are triggered, the precise scope and depth of additional investigation required will depend on which heightened risk factor(s) triggered the application of enhanced procedures. The following steps provide a rough outline of procedures that would be appropriate at the enhanced stage, but are probably not necessary under standard circumstances. First, a background check on the investors (not just the issuer) would be appropriate to screen for criminal or terrorist involvement.⁸⁸ Second, an in-depth review of the offering materials should be undertaken, including a review of external sources to corroborate claims made in the offerings. For example, the funding portal should review the issuer’s website, check for independent news articles, identify the presence or absence of independent third-party endorsements or accreditations of the issuer’s activities (or intended activities), and survey Google Maps satellite images of locations in which the issuer claims to operate.

Third, the issuer’s financial statements should be reviewed in depth for irregularities and opportunities for verification via independent sources.

86. 31 C.F.R. § 1023.320(a)(2).

87. Michael S. Barr et al., *The Case for Behaviorally Informed Regulation*, in *NEW PERSPECTIVES ON REGULATION* 25, 25–26 (David Moss & John Cisternino eds., 2009) (discussing the empirically documented tendencies of financial consumers to depart from objectively rational behavior).

88. World-Check is an industry-standard resource for this type of background check. See generally *Accelus World-Check*, THOMPSON REUTERS, <http://accelus.thomsonreuters.com/products/world-check> (last visited Nov. 30, 2014).

Fourth, a review of the issuer's offering history should be conducted, including a review of offerings conducted through other funding portals, in order to identify suspicious patterns. While much of this information should be publicly available, section 314(b) of the PATRIOT Act allows financial institutions to share customer information with other financial institutions for anti-money laundering and counter-terrorism purposes.⁸⁹

*E. Obligation to Report Suspicious Activity and
(Potentially) Deny Access to Platform*

If a funding portal has identified money laundering concerns, it has an obligation to file a SAR with FinCEN.⁹⁰ The funding portal may also have an obligation to deny or revoke access to its platform; however, this is unclear from the proposed SEC regulations and general FinCEN guidance. The proposed regulations only require that a funding portal deny access to its platform if it believes that the issuer "presents the potential for fraud or otherwise raises concerns regarding investor protection."⁹¹ Money laundering arguably does not usually raise investor protection concerns because the investor is often either paid back in full without knowledge of the illicit source of money, or is in collusion with the issuer.

More generally, there is little guidance available as to when a financial institution of any sort is required to terminate a customer's account based on money laundering concerns.⁹² FinCEN acknowledges that this is an area of significant uncertainty, yet makes no real attempt to offer any concrete guidance: "A filing of a SAR, on its own, should not be the basis for terminating a customer relationship."⁹³ Rather, FinCEN opaquely instructs that "a determination should be made with the knowledge of the facts and circumstances giving rise to the SAR filing, as well as other available information that could tend to impact on such a decision."⁹⁴ Even when a financial institution has an obligation to directly notify appropriate law enforcement authorities because the activity identified "requires immediate attention," there is no explicit requirement for account termination or denial of access.⁹⁵

89. PATRIOT Act, 31 C.F.R. § 1010.540(b) (2011).

90. 31 C.F.R. § 1023.320.

91. Regulation Crowdfunding, *supra* note 2, §§ 227.301, 227.503.

92. See *Frequently Asked Bank Secrecy Act (BSA) Questions*, FIN. CRIMES ENFORCEMENT NETWORK, (last visited Dec. 13, 2013) (quoting Fin. Crimes Enforcement Network, *The SAR Activity Rev. Trends Tips & Issues*, at 27 (October 2000)). See generally 31 C.F.R. Subt. B, Chapter X (lacking any mention of general account termination requirements); OFFICE OF THE COMPTROLLER OF THE CURRENCY, *Money Laundering: A Banker's Guide to Avoiding Problems* (December 2001) (lacking any mention of general account termination requirements).

93. FIN. CRIMES ENFORCEMENT NETWORK, *supra* note 92 (quoting Fin. Crimes Enforcement Network, *The SAR Activity Rev. Trends Tips & Issues*, at 27 (October 2000)).

94. *Id.*

95. 31 C.F.R. § 1023.320(b)(3) ("In situations involving violations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, the broker-

Despite the lack of regulatory guidance, funding portals should prepare a reasonable set of criteria under which they will terminate an existing account. First, funding portals should consider the strength of evidence of suspicious activity. For example, a criminal conviction should weigh more heavily in favor of account termination than a negative news article that reports on rumored wrongdoing. While a funding portal may file a SAR based on a negative news report, the portal may reasonably prefer to let the judicial process run its course before terminating the customer's account.

Second, a funding portal should consider the nature of the suspected activity in light of basic morality, civic duty, and reputational risk. A funding portal could be more inclined to terminate the account of a customer suspected of, for example, large-scale human trafficking or terrorism, than a customer suspected of small-time drug dealing.

Third, a funding portal should consider its nexus to the suspected activity, and be more inclined to terminate the account of a customer suspected of utilizing crowdfunding in furtherance of criminal activity. For example, an issuer suspected of trafficking in narcotics under the guise of crowdfunding (as discussed in the introduction) probably warrants termination. On the other hand, a suspected narcotics trafficker who is making a bona fide investment in a legitimate crowdfunding enterprise probably does not represent as strong of a case for termination. Both scenarios probably represent suspicious activity that should be reported to FinCEN, but the active use of the funding portal in furtherance of the illicit activity in the former example weighs more heavily in favor of account termination.

Funding portals should consider the preceding factors in combination when making account termination determinations. It is probably appropriate to terminate the account of a suspected arms trafficker who appears to be using crowdfunding in furtherance his criminal activity, even in the absence of formal charges. On the other hand, it may not be necessary to terminate the account of a customer convicted of tax evasion if there does not appear to be a nexus between the tax evasion and crowdfunding.

When notifying a customer of account termination, funding portals should be cognizant of the legal requirement that SARs be kept confidential and may not be revealed to the customer about whom the SAR was filed.⁹⁶ Funding portals should develop a fairly sterile process for notifying customers of account termination without disclosing the existence of a SAR. Portals should also be prepared to handle subsequent inquiries (especially by phone) from customers upset about their account termination. This requires careful employee training and customer service recordkeep-

dealer *shall* immediately notify by telephone an appropriate law enforcement authority in addition to filing timely a SAR-SF.”) (emphasis added).

96. 31 C.F.R. § 1023.320(e)(1)(i) (“No broker-dealer, and no director, officer, employee, or agent of any broker-dealer, shall disclose a SAR or any information that would reveal the existence of a SAR.”).

ing (to avoid disclosing notations on a customer's account regarding suspicious activity).

Finally, a law enforcement agency may occasionally request that a financial institution keep a suspicious account open so as to assist in an ongoing investigation.⁹⁷ Financial institutions are not bound to honor this request; however, it is generally advisable to comply within reason.⁹⁸ To the extent practicable, a financial institution should request written documentation from the law enforcement agency making the request, including the requested duration and general purpose.⁹⁹

IV. CONCLUSION

Crowdfunding is an innovative way for emerging growth companies to obtain necessary financing to expand nascent operations. Containing costs on funding portals will be an important aspect of keeping the system as a whole financially viable. The suggestions in this Note are designed to serve as an AML outline for funding portals to achieve regulatory compliance while containing costs. However, AML is not a static field and funding portals will need to undertake routine reviews of their risk-based approach to ensure that the underlying risk assessments remain appropriate. Finally, it is important to consider that AML programs are effective as much through deterrence as they are through monitoring and reporting. By including AML requirements in its proposed regulations, the SEC has ensured that funding portals will not become an obvious target for potential money launderers. The rest is up to funding portals to ensure effective, efficient AML programs.

97. *See Requests by Law Enforcement for Financial Institutions to Maintain Accounts (FIN-2007-G002)*, FIN. CRIMES ENFORCEMENT NETWORK (June 13, 2007), available at <http://www.sec.gov/about/offices/ocie/aml2007/fin-2007-g002.pdf>.

98. *Id.*

99. *Id.*

