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Gatekeeping the Gatekeepers: The Need for a Licensing Requirement for Crowdfunding Portals in the Wake of the *DreamFunded Decision*

Nick Worden
University of Michigan Law School

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GATEKEEPING THE GATEKEEPERS: THE NEED FOR A LICENSING REQUIREMENT FOR CROWDFUNDING PORTALS IN THE WAKE OF THE *DREAMFUNDED* DECISION

Nick Worden*

ABSTRACT

Most people are familiar with crowdfunding sites such as Kickstarter and GoFundMe—sites that allow users to part with their money in exchange for products or donate their capital to organizations they believe in. However, these sites have one trait in common: they do not offer contributors equity or a promise for future profits. For a long time, selling equity meant complying with the costly requirements of federal securities laws, which was cost-prohibitive for many small businesses; it was illegal for businesses to offer equity over a site in the way businesses on Kickstarter offered products. The Jumpstart Our Business Startups (JOBS) Act changed that. Small businesses, initially precluded from raising capital through the promise of equity, could do so now. However, the passage of the JOBS Act came with a number of requirements for businesses trying to sell equity via crowdfunding. In particular, these businesses could not offer their equity through just any Internet site. They had to do so through a registered intermediary—a gatekeeper to the equity crowdfunding scene. These intermediaries came in two types: broker-dealers (a familiar party in securities law) and a new statutorily created entity called a “funding portal.” Funding portals have many requirements imposed on them, but unlike broker-dealers, they are not required to be licensed to act as an intermediary.

The absence of a licensing requirement for funding portals is problematic. The first litigated case involving a funding portal, Department of Enforcement v. DreamFunded Marketplace, LLC, presented that the lack of a licensing requirement threatens the twin purposes of the JOBS Act: capital formation and investor protection.

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TABLE OF CONTENTS

| | |
|---|-----|
| INTRODUCTION..... | 252 |
| I. FUNDING PORTAL REQUIREMENTS AND HOW DREAMFUNDED RAN AFOUL OF THEM | 255 |
| A. <i>Background of the Creation, Purpose, and Requirements for Funding Portals</i> | 255 |
| 1. Funding Portals as Communication Hubs | 257 |
| 2. Funding Portals as Gatekeepers | 258 |
| 3. A Funding Portal was Meant to be Cost-Effective..... | 260 |
| B. <i>DreamFunded and How it Ran Afoul of these Requirements</i> | 261 |
| 1. Violations of the Most Basic Requirements for Funding Portals | 262 |
| 2. Expulsion by Misrepresentation..... | 264 |
| 3. Expulsion by Evasion..... | 267 |
| 4. Aggravating and Mitigating Factors | 269 |
| II. WITHOUT AN EDUCATIONAL MECHANISM, THE TWIN PURPOSES OF THE JOBS ACT ARE THWARTED | 270 |
| A. <i>A Licensing Requirement and Investor Protection</i> | 270 |
| B. <i>A Licensing Requirement and Capital Formation</i> | 274 |
| III. POSSIBILITY FOR AN EDUCATIONAL REQUIREMENT | 277 |
| A. <i>Funding Portals Should be Aware that the Securities Industry is a Regulated Body</i> | 278 |
| B. <i>Funding Portals Need to Be Aware of their Gatekeeping Role: The Basic Requirements</i> | 280 |
| C. <i>Funding Portals Need to Understand their Gatekeeping Role: The Ambiguous Requirements</i> | 281 |
| CONCLUSION | 281 |

INTRODUCTION

“Tell me about DreamFunded,” a television reporter for San Francisco’s local CBS station asked Manuel Fernandez, CEO and co-founder of DreamFunded.¹ “It allows entrepreneurs to be able to raise money from everyone, not just the rich anymore. And so that also allows people to have equity in their company, so therefore if it grows, people can do well,” Mr. Fernandez responded. The reporter clarified: “So it’s like a crowdfunding platform?”² “Crowdfunding

1. KPIX CBS SF Bay Area, *Manny Fernandez on DreamFunded*, YOUTUBE (Mar. 10, 2017), https://www.youtube.com/watch?v=5J8Qr_SF0fQ (interview with Manuel Fernandez); DreamFunded, *Manny Fernandez, Co-Founder/CEO*, <https://www.dreamfunded.com/manny-fernandez> (last visited Dec. 31, 2019).

2. *Id.*

for equity, yes,” Fernandez replied, “[Investors] are getting a return on their investment . . . instead of just getting a T-shirt.”³

This exchange marks a shift in “crowdfunding.” Crowdfunding is a way for startups, small businesses, and charities to raise capital over the internet from the public by soliciting small sums of contributions from many contributors.⁴ These small contributions add up. The sheer quantity of transactions often produces enough funding for the capital raisers to finance their goals.

There are different variants of crowdfunding, which correspond to the goals of these entities. Rewards-based crowdfunding, for example, promises contributors a token of a crowdfunding company’s appreciation—such as a future product or a T-shirt.⁵ Kickstarter is best-known for this type of transaction, where a contributor might receive a promise for a robot-building kit in exchange for their pledge of \$59 or more.⁶ Another variant is donation-based crowdfunding, where contributors donate their capital to fund a worthy cause.⁷ GoFundMe exemplifies this type of approach, where, for example, members of the public can donate to after-school chess programs in Chicago.⁸ Despite their differences, these crowdfunding devices all have one thing in common: they do not promise profits.

Initially, companies could not offer contributors profits over crowdfunding platforms unless they complied with the demanding reporting requirements of the federal securities laws. As I will discuss, any time a company sells a stake in its future profits, it is offering a security; offering a security triggers federal securities laws.⁹ The cost to comply with these laws is extensive.¹⁰ Smaller companies were deterred from offering securities as a way to raise money because of the high cost of compliance. Thus, the potential to offer securities through crowdfunding remained untapped.¹¹

Congress changed this restriction with the passage of Title III of the Jumpstart Our Business Act of 2012 (JOBS Act).¹² Title III carved out an ex-

3. *Id.*

4. *See, e.g.*, DAVID M. FREEDMAN & MATTHEW R. NUTTING, A BRIEF HISTORY OF CROWDFUNDING INCLUDING REWARDS, DONATION, DEBT, AND EQUITY PLATFORMS IN THE USA, FREEDMAN-CHICAGO.COM, <https://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf> (last updated Nov. 5, 2015).

5. *Id.*

6. *Robotics Construction Kit by Geek Club*, KICKSTARTER, <https://www.kickstarter.com/projects/geekclub/geek-club-diy-robotics-kit?ref=section-homepage-view-more-discovery-p3> (last visited Dec. 31, 2019).

7. *Id.*

8. *See, e.g.*, *Grade School Chess Team – South Side of Chicago*, GOFUNDME, <https://www.gofundme.com/f/grade-school-chess-team-south-side-of-chicago> (last visited Dec. 31, 2019).

9. *See infra* Part I.A.

10. *See id.*

11. *See* FREEDMAN & NUTTING, *supra* note 4.

12. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

emption for crowdfunding issuers from the public offering rules of the Securities Act.¹³ Under the JOBS Act, crowdfunding companies could offer shares in their profits without subjecting themselves to the high costs of federal securities laws.

But this change came at a new cost for crowdfunding issuers: they had to offer their securities through a registered intermediary.¹⁴ These intermediaries could be one of two types—either a broker-dealer or a new legislative vehicle called a “funding portal.” Funding portals were designed with two purposes in mind: to protect investors and to reduce the costs for issuers.

The Securities and Exchange Commission (SEC) was charged with drafting the new rules for funding portal intermediaries but punted its drafting responsibility to the Financial Industry Regulatory Authority (FINRA). After a three-year waiting period, the SEC adopted FINRA’s rules. Notably, the SEC decided “not to impose any licensing, testing, or qualification requirements for associated persons of funding portals.”¹⁵ Punting again, the SEC determined that FINRA was “well-positioned” to determine if a licensing requirement would be necessary for funding portal operators.¹⁶

Three years after the rules took effect, FINRA brought the first litigated enforcement action against a funding portal and its operator in *Department of Enforcement v. DreamFunded Marketplace, LLC*.¹⁷ FINRA’s complaint contained ten causes of action and led to a 148-page decision.¹⁸

The operator, Manuel Fernandez, violated some of the most basic funding portal rules. For his violations, Mr. Fernandez was barred from ever working with a funding portal, and his funding portal DreamFunded was expelled from FINRA membership. The decision equated these sanctions to the securities law equivalent of capital punishment.

Mr. Fernandez’s violations point to a gap in the regulatory framework: the need for a licensing requirement for associated persons of funding portals. Without a licensing requirement, the motivations of the JOBS Act are thwarted.¹⁹

This Note argues the lack of a licensing requirement for funding portal operators increases compliance costs for funding portals, passing those costs onto issuers and inhibiting investor protection—the twin purposes of the JOBS Act. Part I is broken up into two sections. The first section provides a background for what funding portals are and the requirements imposed on them by law. The

13. *Id.*

14. *See infra* Part I.A.

15. Crowdfunding, 80 Fed. Reg. 71,387, 71,430 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274) [hereinafter Crowdfunding Rules Adopting Release].

16. *See infra* note 70.

17. *See Dep’t. of Enft v. DreamFunded Marketplace (DreamFunded)*, Disciplinary Proceeding No. 2017053428201, 2019 WL 3231289 at *8 (June 5, 2019).

18. *Id.*

19. *See infra* note 176.

second section presents how DreamFunded failed to comply as a funding portal. Part II discusses why the *DreamFunded* decision will increase compliance costs for issuers and lead to less investor protection. Part III addresses the problems in Part II by offering a framework for a licensing requirement motivated by the *DreamFunded* decision.

I. FUNDING PORTAL REQUIREMENTS AND HOW DREAMFUNDED RAN AFOUL OF THEM

A. *Background of the Creation, Purpose, and Requirements for Funding Portals*

In general, if a company wants to offer and sell any kind of security²⁰ to the public, they must comply with the demanding registration and reporting requirements of Section 5 of the Securities Act.²¹ Publicly offering securities is expensive—costing millions of dollars in legal and accounting fees.²² Thus, the cost of complying with these laws may outweigh the benefit for those who cannot afford to comply such as small businesses with few or no assets.²³ Such small businesses wishing to offer equity in their company may be cost-prohibited from doing so.

Fortunately, the securities laws provide exemptions from Section 5, making offering securities more affordable.²⁴ The exemptions available to businesses attempting to offer and sell securities through crowdfunding, however, were not legal until Congress passed the JOBS Act in April of 2012.²⁵ Title III of the JOBS Act, also known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (CROWDFUND Act), created an exemption from Section 5 for crowdfunding issuers.²⁶

20. See Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (West 2012) (statutory definition of a security).

21. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 29–30 (2012) [hereinafter *Crowdfunding and the Federal Securities Laws*] (describing Section 5 of the Securities Act as a “morass of prohibitions, exceptions, conditions, and exceptions to exceptions . . .”).

22. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1467 (2013).

23. See Bradford, *supra* note 21, at 7 (“Securities-based crowdfunding is practicable only if a new exemption is created”).

24. See 15 U.S.C. § 77d (West 2015) (“The provisions of section 5 shall not apply to . . .”).

25. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§301–05, 126 Stat. 306, 315–23 (2012) (codified in scattered sections of 15 U.S.C.) [hereinafter CROWDFUND Act]; Bradford, *supra* note 21, at 10.

26. See CROWDFUND Act.

Today, issuers can raise money through equity crowdfunding, so long as they raise no more than \$1.07 million over a 12-month period,²⁷ among other requirements.²⁸ A crowdfunding issuer must file a Form C with the SEC for each offering of securities.²⁹ The Form C must contain biographical and financial information of the issuer, the target amount of securities being sold and at what price, and a self-imposed deadline by the issuer to reach the targeted amount.³⁰

Aside from filing a Form C, one of the key requirements for a crowdfunding issuer is that they must offer their securities through one of two intermediaries: a broker-dealer or a “funding portal.”³¹ While broker-dealers have served a role in some crowdfunding offerings,³² their incentive to act as an intermediary may be diminished given the low amount of potential commissions involved and the risk of liability.³³ In the first three years of equity crowdfunding, 90% of crowdfunding offerings occurred through funding portals.³⁴

Funding portals are the main vehicle for crowdfunding offerings, and they serve three important functions. First, they provide a forum for crowdfunding securities offerings to take place.³⁵ Second, they act as gatekeepers, curating what information and which issuers make it on their site.³⁶ Third, they were designed with efficiency in mind, providing a low-cost way for crowdfunding

27. The original JOBS Act contemplated \$1 million, but this was increased to account for inflation. *See* 17 C.F.R. 227.201(t) Instruction 7 (2019).

28. *See* Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(6)(B)(i) (West 2015) (requiring that the maximum amount a crowdfunding issuer raise from an investor with an annual income or a net worth of under \$100,000 be “the greater of \$2000 or 5 percent of the annual income or net worth of such investor . . .”).

29. Crowdfunding Rules Adopting Release, *supra* note 15, at 71, 421.

30. *See* 17 C.F.R. § 227.201 (2017).

31. *See* Securities Act of 1933, 15 U.S.C. § 77d(a)(6)(C) (West 2015).

32. *See* SEC. & EXCH. COMM’N, REPORT TO THE COMMISSION REGULATION CROWDFUNDING 27 (June 18, 2019), https://www.sec.gov/regulation-crowdfunding-2019_0.pdf [hereinafter REPORT TO THE COMMISSION] (“In addition, nine registered broker-dealers participated in at least one crowdfunding offering . . .”).

33. *See* Stuart R. Cohn, *The New Crowdfunding Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012) (predicting that broker-dealers will not have an incentive to participate in crowdfunding offerings); REPORT TO THE COMMISSION, *supra* note 32, at 27 (“Most offerings (just under 90%) were conducted through funding portals, suggesting specialization in the market.”). In terms of liability risk, an intermediary might face a Rule 10b-5 action under the Securities and Exchange Act of 1934 or negligence at common law. *See* Cohn, *supra*, at 1441 n.23.

34. REPORT TO THE COMMISSION, *supra* note 32, at 3, 27.

35. *See* Van S. Wiltz, *Will the JOBS Act Jump-Start the Video Game Industry? Crowdfunding Start-Up Capital*, 16 TUL. J. TECH. & INTELL. PROP. 141, 164 n.117 (2013) (calling a funding portal the initial forum for a crowdfunding transaction).

36. *See generally* Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV. 885 (2018).

issuers to market their securities.³⁷ These functions are reflected by the three legal texts that impose requirements on them: the CROWDFUND Act, the Crowdfunding Rules Adopting Release (both passed through notice and comment rulemaking by the SEC),³⁸ and the FINRA Funding Portal Rules (approved by SEC).³⁹

These three functions—providing a forum, gatekeeping, and cost-saving—are discussed in turn.

1. Funding Portals as Communication Hubs

Funding portals are the forums for crowdfunding offerings. This purpose is made clear by the fact that intermediaries exist as the only forum for issuers to offer and sell their securities.⁴⁰ The idea behind this forum function was to create a space for the “wisdom of the crowd” to discuss an offering, determine its merits, and choose whether or not to invest.⁴¹ The SEC believed that conducting an offering through one intermediary would help prevent information dilution about an offering and increase intermediary compliance with the rules.⁴² The crowdfunding rules mandate that funding portals must provide “channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary’s platform.”⁴³ The reason behind this rule is to give investors a “centralized and transparent” forum to discuss their potential investment.⁴⁴

By making funding portals the forum for offerings, the JOBS Act envisioned funding portals acting as neutral “bulletin boards,” providing a place for securities offerings but not assisting in the offerings themselves.⁴⁵ This purpose is clear from their definition; Congress defined funding portals not by what they are, but by what they are not allowed to do.⁴⁶ Funding portals are not allowed to offer investment advice or recommendations; they may not solicit purchases, sales, or offers to buy securities that are displayed on their platforms; they may not compensate employees, agents, or other persons based on the sale of securi-

37. See Patrick Archambault, Note, *How the SEC’s Crowdfunding Rules for Funding Portals Save the Two-Headed Snake: Drawing the Proper Balance Between Integrity and Cost*, 49 SUFFOLK U. L. REV. 61, 64 (2016).

38. See generally Crowdfunding Rules Adopting Release, *supra* note 15.

39. See Order Approving FINRA Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and Rule 4518., 81 Fed. Reg. 4931 (Jan. 28, 2016).

40. See Regulation Crowdfunding Rule 100, 17 C.F.R. § 227.100 (2017).

41. See Crowdfunding Rules Adopting Release, *supra* note 15, at 71, 388.

42. *Id.* at 31.

43. See Regulation Crowdfunding Rule 303(c), 17 C.F.R. § 227.303(c) (2018).

44. See Crowdfunding Rules Adopting Release, *supra* note 15, at 71, 446.

45. See Cohn, *supra* note 33, at 1439.

46. See Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80) (2018) (n.b. the JOBS Act inadvertently defined “emerging growth company” under the exact same section as “funding portal”).

ties displayed or referenced on its website or portal; nor may they hold, manage, possess, or otherwise handle investor funds or securities; and finally, funding portals may not engage in activity that the SEC may, within its discretion, find inappropriate.⁴⁷

To further facilitate its forum function, the JOBS Act imposes a 21-day waiting requirement (enforced by funding portals) for issuers to sell a security, allowing a window for investors to discuss and analyze the offering on the website and share their views.⁴⁸

2. Funding Portals as Gatekeepers

Funding portals are gatekeepers designed to protect investors against fraud.⁴⁹ Intermediaries themselves were added into the JOBS Act because of concerns raised in the Senate that the fraud protections in the House bill were insufficient to protect investors.⁵⁰ In connection with this gatekeeping function, the JOBS Act mandates that intermediaries must “take measures to reduce the risk of fraud” with respect to crowdfunding offerings and sales.⁵¹ At a minimum, the JOBS Act requires that funding portals conduct background checks on the control persons of every issuer on its site to ensure that the issuer or its officers have not committed any violations of the securities laws.⁵² Notably, a funding portal must have a “reasonable basis for believing” that an issuer is in compliance with the relevant legal requirements; if they do not have that reasonable basis, a funding portal must deny that issuer access to their platform.⁵³

To protect investors against fraud, funding portals are also required to perform ongoing review of the information provided by their issuers. They must establish and maintain a system for supervising issuers that is “reasonably designed” to achieve compliance with the laws associated with them.⁵⁴ They are also prohibited from making available or distributing a “false, exaggerated, promissory, or misleading statement or claim.”⁵⁵ Mimicking the language of Rule 10b-5 securities fraud actions, funding portals are prohibited from “effecting any transaction in, or inducing the purchase or sale of any security by means

47. See 15 U.S.C. §§ 78c(a)(80)(A)-(E).

48. See Securities Act of 1933 § 4A(a)(6), 15 U.S.C. § 77d-1(a)(6) (2018).

49. See Schwartz, *supra* note 36, at 926.

50. See Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L. J. 177 (2013); see also Cohen, *supra* note 33, at 1439.

51. See Securities Act of 1933 § 4A(a)(5), 15 U.S.C. § 77d-1(a)(6) (2018).

52. See *id.*

53. Regulation Crowdfunding Rule 301(c)(2), 17 C.F.R. §§ 227.301(c)(2) (2018); Regulation Crowdfunding Rule 402(b)(10) (2018).

54. FINRA, FUNDING PORTAL RULE 300(a) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/300>.

55. FINRA, FUNDING PORTAL RULE 200(c)(2)(A)(i) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

of, or by aiding and abetting, any manipulative deceptive or fraudulent device of contrivance.”⁵⁶ In general, funding portals are held to a high ethical responsibility to “observe high standards of commercial honor and just and equitable principles of trade.”⁵⁷

In tandem with reviewing issuer information to protect investors, funding portals must maintain a level of neutrality with the issuers on their sites.⁵⁸ The CROWDFUND Act prohibits a funding portal’s directors or officers from having a financial interest in an issuer on the platform.⁵⁹ Additionally, funding portals are not allowed to handle investor funds.⁶⁰ During the offering period, an investor’s capital is held in escrow by a third party—not by the funding portal.⁶¹ An investor is allowed to request a return of their investment during the offering period, and only when the target amount is reached may a funding portal release the funds to the issuer.⁶² If the target amount is not reached, all of the existing investor’s funds are returned, and the offering closes.⁶³

Intermediaries also help investors by informing them. They are required to give notice to investors of any material change to the offering or the information about the offering provided by an issuer.⁶⁴ Funding portals must also retain records related to their business for five years.⁶⁵ This recordkeeping function allows for oversight of a funding portal’s performance of its gatekeeping role.⁶⁶

Funding portals also serve investors by providing educational materials and risk disclosures on their sites.⁶⁷ Yet even though they are responsible for educating investors, funding portals and their associated persons are neither required to be educated in the federal securities laws nor the requirements for

56. FINRA, FUNDING PORTAL RULE 200(b) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

57. FINRA, FUNDING PORTAL RULE 200(a) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

58. See Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 277 (2013).

59. See Securities Act § 4A(a)(11), 15 U.S.C. § 77d-1(a)(11) (2018); see also Heminway, *supra* note 50, at 197 (noting that the lack of financial interest “may constrain wrongful conduct by cutting off potential sources of conflicting interests”).

60. See Regulation Crowdfunding Rule 303(e)(2), 17 C.F.R. §§ 227.303(e)(2) (2018).

61. See *id.*

62. Securities Act § 4A(a)(7), 15 U.S.C. § 77d-1(a)(7) (2018).

63. See Crowdfunding Rule 201(g), 17 C.F.R. § 227.201(g) (2018) (“The target offering amount and the deadline to reach the target offering amount, including a statement that if the sum of the investment commitments does not equal or exceed the target offering amount at the offering deadline, no securities will be sold in the offering . . . investment commitments . . . will be returned . . .”).

64. Crowdfunding Rule 304(c)(1), 17 C.F.R. §§ 227.304(c)(1) (2018).

65. Crowdfunding Rule 404, 17 C.F.R. §§ 227.404 (2018).

66. Crowdfunding Rules Adopting Release, *supra* note 15, at 172–73.

67. Securities Act of 1933 § 4A(a)(3), 15 U.S.C. § 77d-1(a)(3) (2018).

funding portals and their associated persons.⁶⁸ The SEC considered whether to subject funding portals to a licensing requirement,⁶⁹ and ultimately decided to leave the issue of licensing to percolate for FINRA to determine whether one was necessary.⁷⁰

3. A Funding Portal was Meant to be Cost-Effective

A funding portal was meant to be cost-effective to decrease the initial cost of doing business for issuers.⁷¹ Funding portals are exempted from broker-dealer status (and the correlated, demanding requirements) so long as they meet three conditions:⁷² they must “remain subject to the examination, enforcement, and other rulemaking authority of the SEC”; they must be a member of FINRA;⁷³ and finally, funding portals must subject themselves to other requirements that the SEC deems appropriate.⁷⁴ Unlike the fourteen requirements for broker-dealer applicants, funding portal applicants must only meet five.⁷⁵ In addition to their requirement to have a supervisory system in place and keep records, applicants seeking to become funding portals must not have been subject to a disqualifying event; they must have established relationships with banks, escrow agents; and they must have disclosed all their sources of financ-

68. See *DreamFunded*, 2019 WL 3231289 at *6 (“[T]he applicable rules do not require [an associated person] to take any classes or training, or to take any licensing or qualifying examination to qualify to operate a funding portal.”)

69. Crowdfunding Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66,428, 66,460 (Nov. 5, 2013) (“121. The proposed rules do not independently establish licensing or other qualifications requirements for intermediaries and their associated persons . . . Would licensing or other qualifications for intermediaries and their associated persons be necessary, for example, to provide assurances that those persons are sufficiently and knowledgeable and qualified to operate funding portal?”) [hereinafter Crowdfunding Rules Proposing Release].

70. Crowdfunding Rules Adopting Release, *supra* note 15, at 115 (“We believe that [FINRA] is well positioned . . . to determine whether to propose additional requirements such as licensing, testing, or qualification requirements for associated persons of funding portals.”).

71. See *DreamFunded*, 2019 WL 3231289 at *73.

72. Jumpstart Our Business Startups Act § 304, 15 U.S.C. § 77c (2018).

73. See Securities Exchange Act of 1934 § 3(h)(1)(B), 15 U.S.C. § 78c(h)(1)(B) (noting that a funding portal is exempt from broker-dealer status if it “is a member of a national securities association registered under section 78o-3 of this title . . .,” and at the time of this writing, FINRA is the only such entity).

74. Jumpstart Our Business Startups Act § 304, 15 U.S.C. § 77c (2018).

75. See *Standards for Admission*, FINRA, <https://www.finra.org/rules-guidance/guidance/finra-standards-admission> (last visited Dec. 31, 2019) (standards for broker dealers); see also *FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms*, FINRA, <https://www.finra.org/rules-guidance/notices/13-34> (last visited Dec. 31, 2019) (“These five consolidated standards address a funding portal’s: (1) ability to comply with applicable federal securities laws, rules and regulations and FINRA’s Funding Portal Rules; (2) contractual or other arrangements and business relationships necessary to initiate operations; (3) supervisory system; (4) direct and indirect funding sources; and (5) recordkeeping system . . .”).

ing.⁷⁶ However, funding portals are not required to conduct due diligence on the issuers on their site, and they are entitled to rely on an issuer's representations, which reduces the costs of becoming a funding portal.⁷⁷

B. *DreamFunded and How it Ran Afoul of these Requirements*

DreamFunded, headed by CEO and co-creator Manuel Fernandez, was established in March 2016.⁷⁸ Its registration as a funding portal with FINRA began in July 2016 and ended in November 2017.⁷⁹ While DreamFunded was registered, it acted as an intermediary in fifteen crowdfunding offerings.⁸⁰ Over its lifetime, the portal itself raised a total of \$15,000 for two issuers.⁸¹ Because Fernandez was the CEO of DreamFunded, he constituted an "associated person" of the portal, and so was subject to FINRA enforcement.⁸² Fernandez had no experience working in the securities industry, nor was he required to have any.⁸³ However, he stated that he took courses at Stanford University in an executive education graduate school program and was a certified paralegal.⁸⁴

DreamFunded and Fernandez violated the laws and regulations for funding portals.⁸⁵ The decision, brought by the FINRA's Department of Enforcement, is the first litigated case of its kind involving a funding portal.⁸⁶ The case was heard before a three person panel, the Hearing Panel,⁸⁷ and dealt with three different offerings for three different companies: Company A, Company B, and Company C.⁸⁸ Company A was a social networking company, which allowed users to post content over different social media sites at the same time.⁸⁹ Com-

76. See FINRA, FUNDING PORTAL RULE 110(a)(9)(B) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/110>.

77. *DreamFunded*, 2019 WL 3231289 at *4.

78. *Id.* at *23.

79. *Id.* at *6.

80. *Id.* at *63.

81. *Id.* at *21.

82. FINRA, FUNDING PORTAL RULE 100(b)(1) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/100>.

83. *DreamFunded*, 2019 WL 3231289 at *6.

84. *Id.* at *19.

85. *See id.*

86. Joseph L. Zales et al., *Dream On—FINRA Issues Its First Litigated Enforcement Action Against a Crowdfunding Portal*, A.B.A. BUS. L. SECTION (Aug. 28, 2019), <https://businesslawtoday.org/2019/08/dream-finra-issues-first-litigated-enforcement-action-crowdfunding-portal/>.

87. *See Adjudications & Decisions*, FINRA, <https://www.finra.org/rules-guidance/adjudication-decisions> (last visited Jan. 14, 2020) ("[The Office of Hearing Officers] arranges a three-person panel to hear the case"); *Standards for Admission*, FINRA, <https://www.finra.org/rules-guidance/guidance/finra-standards-admission> (last visited Dec. 31, 2019) (setting standards for broker dealers).

88. *DreamFunded*, 2019 WL 3231289 at *27, *37, *39.

89. *Id.*

pany B produced an application that provided a library of self-help videos to users.⁹⁰ Unlike the other two offerings, Company C did not create an application but invented a new type of fire hose attached with a harness, which was invented to “lessen fatigue and decrease injuries to firefighters.”⁹¹

For their violations, DreamFunded was expelled from funding portal membership and Fernandez was barred from associating with any funding portal in the future.⁹² What did Fernandez and DreamFunded do to deserve “the securities industry equivalent of capital punishment”?⁹³

The complaint against DreamFunded and Fernandez contained ten causes of action, but only two of the counts led to Fernandez and his portal’s expulsion.⁹⁴ First, Fernandez failed to cooperate with FINRA by evading requests for information under FINRA Rule 8210⁹⁵ when he was suspected of violating the rules.⁹⁶ Second, the Hearing Panel imposed these extreme sanctions because Fernandez and DreamFunded violated 200(b) of the Funding Portal Rules: “effecting a securities transaction by any manipulative, deceptive, or fraudulent device or contrivance.”⁹⁷ Along with these larger violations, DreamFunded and Fernandez violated many of the basic requirements related to a funding portal’s gatekeeping function.⁹⁸

I will first discuss the basic violations that did not lead to Fernandez and his portal’s expulsion. Next, I will discuss the more egregious violations—the Rule 200(b) violation followed by the FINRA Rule 8210 evasion. Finally, as a transition to this Note’s principal argument, I will point to the aggravating and mitigating factors the Hearing Panel considered before sanctioning Fernandez and DreamFunded.

1. Violations of the Most Basic Requirements for Funding Portals

DreamFunded displayed “a systemic compliance breakdown,” especially with those requirements geared towards their gatekeeping function.⁹⁹ Neither DreamFunded nor Fernandez conducted background checks on the issuers on their site, in violation of their statutory mandate to do so.¹⁰⁰ Further, “[respond-

90. *Id.* at *37.

91. *Id.* at *39.

92. *Id.* at *9, *12 (the first and third causes of action, respectively).

93. *Id.* at *106 (quoting *Saad v. Sec. & Exch. Comm’n*, 718 F.3d 904, 906 (D.C. Cir. 2013)).

94. *Id.* at *9, *12.

95. *See infra* note 156 (noting that an 8210 request is effectively a subpoena).

96. *DreamFunded*, 2019 WL 3231289, at *110.

97. *Id.* at *111.

98. *See discussion infra* Part I.B.1; *DreamFunded*, 2019 WL 3231289, at *111.

99. *DreamFunded*, 2019 WL 3231289, at *110.

100. *Id.* at *111.

ents] failed to implement written policies and procedures reasonably designed to achieve compliance.”¹⁰¹

This systemic compliance breakdown is best exemplified by the offering for Company A on the DreamFunded site.¹⁰² Company A made an offering for 100,000 securities for a target amount of \$10,000 on October 28, 2016 with a closing date of September 26, 2017.¹⁰³ Company A’s Form C was inadequate in several respects. It did not tell investors how they could get their money back except through a “future merger or acquisition” and had no financial statement attached.¹⁰⁴ Fernandez did not review the company’s Form C, but nevertheless allowed the offering on the site.¹⁰⁵

Over the course of five months, Company A’s CEO made three material amendments to the offering’s Form C, which triggered Fernandez’s obligation to notify investors.¹⁰⁶ A notice to investors must state that an investor’s commitment will be canceled unless the investor reconfirms within five days.¹⁰⁷ The first two amendments, made in January 2017, changed the number of securities being offered, the voting power in the company, and the date of organization.¹⁰⁸ Nevertheless, Fernandez provided no notice to investors and was even unaware he had to do so.¹⁰⁹

After the first two amendments to the offering’s Form C, the CEO of Company A asked Fernandez to lower the target amount of the offering from \$10,000 to \$4,500.¹¹⁰ Fernandez was informed by his attorney that Company A would need to file a change in their Form C in order to lower the target amount.¹¹¹ Soon afterward, the CEO of Company A informed Fernandez that he wanted to close the offering at an even lower amount because “his account was overdrawn.”¹¹² At this point, the Hearing Panel found that Fernandez would have had a “reasonable basis” to believe that, “at a minimum, there were investor protection concerns.”¹¹³ This would trigger an obligation by Fernandez

101. *Id.* at *112; *see also* Crowdfunding Rule 403(a), 17 C.F.R. § 227.403(a) (2020).

102. A similar fact pattern to the one described *infra* Section I.B.1 also occurred with Company B. *See DreamFunded*, 2019 WL 3231289 at *38–39.

103. *DreamFunded*, 2019 WL 3231289 at *30.

104. *Id.* at *29.

105. *Id.*

106. *See id.* at *30; Regulation Crowdfunding Rule 304(c), 17 C.F.R. § 227.304(c) (2018).

107. Regulation Crowdfunding Rule 304, 17 C.F.R. § 227.304.

108. *DreamFunded*, 2019 WL 3231289 at *30.

109. *See id.* at *108.

110. *Id.* at *31.

111. *Id.*

112. *Id.*

113. *Id.*

to boot the offering off the site.¹¹⁴ Yet, Fernandez allowed the issuer's offering to remain.¹¹⁵

In June 2017, Company A filed a third amendment to its Form C, lowering the target amount of the offering from \$10,000 to \$4,000.¹¹⁶ Again, Fernandez provided no notice of the change to the investors of Company A.¹¹⁷ The offering closed a week after Company A made this last amendment and three months before it was scheduled to close (September 2017).¹¹⁸ Fernandez provided investors no notice of the early closing date.¹¹⁹

A month later, Fernandez emailed his attorney asking if he had violated any of the rules associated with Company A.¹²⁰ His attorney responded, “[i]t looks like it.”¹²¹ Fernandez tried to fix the issue retroactively by asking investors in Company A if they wanted their money returned.¹²² Most investors reconfirmed that they did not, except for one person.¹²³ Fernandez and DreamFunded produced no evidence that they returned this individual's investment.¹²⁴

In addition to failing to perform its most basic gatekeeping role, DreamFunded “failed to give investors required notice and information,” and lacked a “system for complying with the notice requirements . . . depriving investors of information necessary to protect their rights.”¹²⁵ This systemic compliance breakdown, however, was not what prompted FINRA to bar DreamFunded and Fernandez from association.

2. Expulsion by Misrepresentation

DreamFunded and Fernandez's path to expulsion began when a staff member of the FINRA Membership Application Program (MAP) group noticed a clip of Company C on YouTube.¹²⁶ The clip came from a show on CNBC called “Make Me a Millionaire Inventor,” which is a Shark Tank-style show where inventors pitch their products to potential investors.¹²⁷ DreamFunded

114. Regulation Crowdfunding Rule 301(c)(1), 17 C.F.R. § 227.301(c)(1) (2018); *DreamFunded*, 2019 WL 3231289 at *31.

115. *DreamFunded*, 2019 WL 3231289 at *31.

116. *Id.* at *33.

117. *Id.*

118. *Id.*

119. *Id.*

120. *See id.* at *34.

121. *Id.*

122. *Id.* at *35.

123. *Id.*

124. *Id.*

125. *Id.* at *112.

126. *Id.* at *7.

127. *See CNBC's 'Make Me a Millionaire Inventor' Returns for Season 2 on Thursday, October 6th at 10PM ET/PT*, CNBC (Sep. 19, 2016, 11:47 AM), <https://www.cnbc.com/2016/09/19/>

was advertised as “a crowdfunding platform that [had] invested \$100 million in startups.”¹²⁸ However, the show was produced in January 2016—prior to when the crowdfunding rules took effect and prior to when DreamFunded registered as a funding portal.

During the video, Fernandez heard a pitch for a new type of firehose and information about the potential market for the product.¹²⁹ After hearing the pitch, one of the hosts of the show asked Fernandez if he was going to make an offer.¹³⁰ Fernandez responded: “OK. I’ll make you an offer on behalf of DreamFunded.com. Million dollars for 30% of the company. How’s that sound?”¹³¹

After the pitch and Fernandez’s offer, Company C became an issuer on DreamFunded’s portal.¹³² When the show came out, Fernandez advertised it everywhere he could: on the DreamFunded site, on YouTube, and on his personal Twitter feed.¹³³

The offer presented an initial issue for the portal: officers and directors of a funding portal, like Fernandez, are not allowed to have a financial stake in the issuers on their site.¹³⁴ In November 2016, the MAP staff member sent an email to Fernandez asking about each of the fifteen offerings on the site and specifically, whether the funding portal or any of its officers or directors had invested in the offerings.¹³⁵ Fernandez responded that two offerings, Company B and Company C, had been given “verbal, non-binding agreements” that indicated that DreamFunded “would be invested in investing.”¹³⁶ MAP pressed further, and in January 2017, Fernandez said that after more investigation, he had decided not to invest in either.¹³⁷ This seemed to allay concerns—if there was no investment by an officer or director of the funding portal, there was no violation.¹³⁸

Moving past this first issue, the video presented a new potential rule violation: the clip where Fernandez appeared to make an offer to Company C could be considered “false and misleading” because Fernandez had not in fact invest-

cnbcs-make-me-a-millionaire-inventor-returns-for-season-two-on-thursday-october-6th-at-10pm-etpt.html.

128. *DreamFunded*, 2019 WL 3231289 at *40 (internal quotations omitted).

129. *Id.* at *39.

130. *Id.* at *40.

131. *Id.* (internal quotations omitted).

132. *See id.* at *21 (“The program was filmed months before the Portal’s crowdfunding platform was even in operation . . .”).

133. *Id.* at *20.

134. Securities Act of 1933 § 4A(a)(11), 15 U.S.C. § 77d-1(a)(11) (2018).

135. *DreamFunded*, 2019 WL 3231289 at *42.

136. *Id.* (internal quotations omitted).

137. *Id.*

138. *Id.*

ed in Company C.¹³⁹ The video was on the DreamFunded website, Facebook, and Twitter until February 2017.¹⁴⁰ In April, MAP received an email from Fernandez's attorney, who stated that the video had been taken down.¹⁴¹ Despite this assurance, the video appeared again on the website months later in September 2017 and surfaced periodically from the fall of 2016 until the spring of 2017.¹⁴²

The video contained "two falsehoods," and Fernandez had knowledge of both.¹⁴³ First, the video misrepresented that Fernandez had invested over \$100 million in startups, and second that Fernandez had invested in Company C.¹⁴⁴ Neither was true, and the Hearing Panel concluded that the misrepresentation "greatly inflated Fernandez's wealth, ability to raise capital, and investment savvy" as well as that "an investment in Company C would be a good investment."¹⁴⁵ This violation was what the Hearing Panel found to be the "truly culpable," distinguishing it from all of the other violations.¹⁴⁶

Along with these falsehoods, the Hearing Panel found that Fernandez and DreamFunded misrepresented that they had performed due diligence akin to that of more sophisticated intermediaries.¹⁴⁷ Fernandez represented on the DreamFunded site that he had a deal-flow screening team for each offering that "recognizes the best practices guide as outlined by the Angel Capital Association."¹⁴⁸ Fernandez also claimed that "DreamFunded ha[d] recruited a world-class investment committee to review the due diligence previously completed by angel groups and VC [venture capital] partners to assure each deal sourced from a third party me[t] DreamFunded standards for anticipated investment performance."¹⁴⁹ In reality, however, Fernandez had no screening team or process for "evaluating issuers or their offerings."¹⁵⁰ As he disclosed in an on-the-record interview with FINRA officials, Fernandez likely met with the issuer's founder, did some online research, and looked at their LinkedIn profile.¹⁵¹ Fernandez's description of his due diligence "was false and misleading," and he knew or recklessly disregarded the risk that his due diligence representations

139. FINRA, FUNDING PORTAL RULE 200(c)(2)(A)(i) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

140. *DreamFunded*, 2019 WL 3231289 at *44.

141. *Id.*

142. *Id.* at *111.

143. *Id.* at *88.

144. *Id.*

145. *Id.*

146. *Id.* at *105.

147. *Id.* at *89–90.

148. *Id.* at *89 (internal quotations omitted). See ANGEL CAPITAL ASS'N, <http://angelcapitalassociation.org/> (last visited Jan. 7, 2020).

149. *DreamFunded*, 2019 WL 3231289 at *89 (internal quotations omitted).

150. *Id.* at *90.

151. *See id.*

would mislead investors about the thoroughness of his investigation.¹⁵² While DreamFunded was not required to perform due diligence,¹⁵³ Fernandez's description of his due diligence he did not in fact perform was materially misleading to investors.¹⁵⁴

Because of all of these misrepresentations, "which involve[d] no reliance on others," Fernandez and his funding portal were barred from association with FINRA.¹⁵⁵

3. Expulsion by Evasion

Leading up to the hearing, the FINRA MAP office and the Office of Fraud Detection and Market Intelligence (OFDMI) made several Rule 8210 requests investigating DreamFunded and Fernandez. A Rule 8210 request allows FINRA to investigate and require persons under its jurisdiction to produce documents and be subjected to investigation.¹⁵⁶ Fernandez fought the notice, sometimes indicating that he was going to comply and at other times challenging FINRA's jurisdiction.¹⁵⁷

After the initial Rule 8210 requests for documents, Fernandez had an on-the-record interview with FINRA's OFDMI on October 20, 2017.¹⁵⁸ On October 24, OFDMI initiated another Rule 8210 request for financial records, bank account statements, and investor agreements.¹⁵⁹ In early November, while this new request was ongoing, Fernandez began settlement discussions with FINRA¹⁶⁰ and unregistered DreamFunded as a funding portal.¹⁶¹

In mid-December, Fernandez's counsel negotiated an extension for the production of documents and another on the record interview with OFDMI (and Enforcement).¹⁶² FINRA granted an extension to January 5, 2018 for the request for documents and another interview for January 18, 2018.¹⁶³

152. *Id.*

153. *Id.* at *4.

154. *See id.* at *90.

155. *Id.* at *111.

156. *See* FINRA, RULE 8210(a) (2013), <https://www.finra.org/rules-guidance/rulebooks/finra-rules/8210> ("FINRA staff shall have the right to: (1) require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically . . . and to testify at a location specified by FINRA staff . . . and (2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation . . .").

157. *DreamFunded*, 2019 WL 3231289 at *8.

158. *See id.* at *24–25.

159. *See id.* at *74.

160. *See id.* at *53.

161. *See id.* *24.

162. *Id.* at *53.

163. *Id.*

On January 5, 2018 counsel for Fernandez produced a limited number of documents, stating that his client, Fernandez, had not given him what he needed.¹⁶⁴ The production of documents was extended again to January 19.¹⁶⁵

On January 19, counsel asked OFDMI for another extension, citing that his client had medical issues.¹⁶⁶ Fernandez may have been sick, but maybe not as sick as he let on—he spent the weekend at the Sundance Film Festival and posing with a famous NFL football quarterback on Twitter.¹⁶⁷

“[Apparently] unaware of Fernandez’s weekend travels,” FINRA granted a final extension to January 29 for the production of documents.¹⁶⁸ On January 25, Fernandez’s counsel alerted FINRA that he no longer represented Fernandez; FINRA promptly sent Fernandez an email, reminding him of his obligation to respond by January 29.¹⁶⁹ Fernandez replied on January 29, asking for another extension.¹⁷⁰ FINRA responded that Fernandez had been given three extensions over three months for the October 24 request and that if he did not produce documents by February 6, Enforcement would file a complaint.¹⁷¹ On February 6, Fernandez produced no documents and emailed Enforcement saying, “[t]oday I am getting back to work, and to me, it does not make sense that you want all the docs today, a day after I just returned to work.”¹⁷²

Enforcement filed a complaint on February 23, 2018.¹⁷³ Addressing the complaint, the Hearing Panel applied the FINRA Sanction Guidelines.¹⁷⁴ The panel found that the standard for a complete failure to respond to a Rule 8210 request is a bar.¹⁷⁵

The Hearing Panel assessed Fernandez and DreamFunded’s Rule 8210 evasion based on three considerations: first, the importance of the information that was requested but not provided; second, the number of requests made, the time it took the respondent to respond, and the degree of pressure needed to get a response; and third, whether there were one or more valid reasons for the deficiency in the response.¹⁷⁶

First, the Hearing Panel deemed the Rule 8210 information “critical” to Enforcement’s investigation because the information sought—bank statements—

164. *Id.* at *81.

165. *See id.*

166. *Id.* at *53, *81.

167. *Id.* at *54.

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.* at *55.

172. *Id.*

173. *Id.*

174. FINRA, SANCTION GUIDELINES (2019), https://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

175. *DreamFunded*, 2019 WL 3231289 at *105.

176. *Id.*

would have been used to determine if “Fernandez had misused investor funds intended for investment in the DreamFunded Portal.”¹⁷⁷ Without all the bank statements, it would be impossible to know whether Fernandez used his personal account and the portal’s account interchangeably.¹⁷⁸ Second, the Hearing Panel found the degree of pressure was “high” because of the number of requests and number of extensions “over the course of several months.”¹⁷⁹ Finally, the Hearing Panel found that there was no valid reason for Fernandez’s lack of response; they concluded the opposite was true—Fernandez had claimed to be sick when he was traveling.¹⁸⁰

[F]or [failing] to comply fully and completely to the Rule 8210 request,” DreamFunded was expelled as a funding portal and Fernandez was barred from associating with “any funding portal FINRA member.”¹⁸¹

4. Aggravating and Mitigating Factors

The Hearing Panel discussed the aggravating and mitigating factors that were relevant to Enforcement’s case against Fernandez and DreamFunded. In particular, the decision concluded that Fernandez’s attempt to blame his lawyers for “failing to make documents available to FINRA staff,” his “false and misleading information given to regulatory inquiries,” and his “attempts to delay the investigation” all served as aggravating factors for his sanctions. However, the Hearing Panel noted:

To some degree, [DreamFunded and Fernandez]’s violations may be partly attributable to the lack of experience and training. It became clear at the hearing that, despite several years of promoting the creation of the equity crowdfunding marketplace, *Fernandez did not have a good grasp of even the most basic rules governing crowdfunding and funding portals*. He testified, for example, that he never understood that he was an associated person of the DreamFunded Portal until his current attorney told him that a couple months into the hearing.¹⁸²

The panel was quick to note, however, that “[t]his potentially mitigating factor [was] outweighed . . . by Fernandez’s pattern of providing false and misleading information to regulators.”¹⁸³ Fernandez’s egregious violations, far from being a one-off case, display a deep regulatory flaw in the system: a lack of an educational mechanism for funding portals’ associated persons.

177. *Id.* at *107.

178. *Id.*

179. *Id.*

180. *Id.* at *107.

181. *Id.* at *110.

182. *Id.* at *108 (emphasis added).

183. *Id.*

II. WITHOUT AN EDUCATIONAL MECHANISM, THE TWIN PURPOSES OF THE JOBS ACT ARE THWARTED

The *DreamFunded* decision sends two messages that, when taken together, demonstrate a need for an educational mechanism for funding portals in order to preserve the goals of Title III of the JOBS Act (also known as the CROWDFUND Act). The CROWDFUND Act has two goals: capital formation and investor protection.¹⁸⁴

DreamFunded's first message aligns with the first purpose of the JOBS Act: investor protection. The decision shows us that a funding portal can violate their gatekeeping role because they either do not appreciate their role or are ignorant of it. That is a troubling signal for investor protection, given that crowdfunding investors are retail investors, not accredited investors.¹⁸⁵ The need for investor protection is high, but the bar for the gatekeepers responsible for investor protection is low. Therefore, in order to serve the goal of investor protection, I argue that a licensing requirement should be implemented to increase the bar for gatekeepers.

The second message goes to capital formation. There are two types of funding portals: those that wish to comply with the regulations and those that do not or will not. The *DreamFunded* decision generates an increased cost for both.¹⁸⁶ These increased costs will be passed onto issuers, threatening the “capital formation” purpose of the JOBS Act. A licensing requirement on funding portals would meet the *DreamFunded* decision head-on, reducing the prohibitive cost to intermediaries and, by extension, issuers.

I will discuss each of these two messages in turn because they both point to the need for a licensing requirement.

A. A Licensing Requirement and Investor Protection

The JOBS Act made it clear that the role of crowdfunding intermediaries was to serve a gatekeeping function to protect investors.¹⁸⁷ There is no question: the rules are complicated.¹⁸⁸ But even as complicated as they are, the rules are designed with the purpose of protecting investors.¹⁸⁹ The kind of investors that crowdfunding offerings attract, like the ones at issue in the *DreamFunded* decision, are in particular need of protection. They are, by and large, unaccredited—making them less able to “fend for themselves.”¹⁹⁰ The theory behind

184. See CROWDFUND Act, *supra* note 25 (“[A]n Act to increase American job creation and economic growth by improving access to the public capital markets.”).

185. See REPORT TO THE COMMISSION, *supra* note 32, at 22.

186. See discussion *infra* Part II.

187. See *supra* Part I.A.

188. See *DreamFunded*, 2019 WL 3231289 at *8.

189. See James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 119 (2017).

190. *Sec. & Exch. Comm’n v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

securities laws is that the less informed and the less sophisticated an investor is, the more likely it will be that an issuer will take advantage of them.¹⁹¹ This means that the types of investors at issue in *DreamFunded* were in particular need of a gatekeeper to protect them against abuse. However, DreamFunded and Fernandez recklessly failed to serve the investors on their site.

Consider the two violations that independently led to Fernandez's expulsion. First, Fernandez failed to respond to a Rule 8210 inquiry, systematically evading enforcement. Second, he posted, and continued to post, an offering that he did not intend to complete for a company hosted on his website, violating the funding portal rules.¹⁹² These are relatively easy requirements to meet. Ultimately, all Enforcement was requesting from Fernandez was bank statements. And taking down a video from YouTube, Twitter, or a site under Fernandez's direct control would not have been difficult. Fernandez's failure to comply with these basic requirements shows a deep misunderstanding of, and lack of appreciation for, his role as a gatekeeper. Fernandez did not even know he was an associated person of a funding portal until his lawyer at the hearing told him.¹⁹³ How can someone act as a gatekeeper unless they know that they are a gatekeeper?

Now consider Fernandez's state of mind: he was either a bad actor who recklessly disregarded his gatekeeping responsibilities or a well-intentioned one severely misinformed of his role. I will discuss the facts that point to both possibilities and why each one leads to the need for a licensing requirement.

In all likelihood, Fernandez was simply a bad actor, evading enforcement when he was backed up against a wall. It was his culpability that led to his sanctions, not the violations themselves.¹⁹⁴ The facts of the case suggested that Fernandez's portal was not succeeding, which is what motivated Fernandez to post the Company C video clip.¹⁹⁵ Fernandez posted the fake investment for \$1 million in Company C to boost publicity for his site, and likely didn't care that he was responsible for protecting investors.¹⁹⁶ After taking down the video clip, Fernandez posted it again, likely for the same promotional reason. He ran from FINRA enforcement, misrepresenting that he was sick, and he failed to produce the most basic information that would allow FINRA to "perform its regulatory mission."¹⁹⁷

If Fernandez was a bad actor, it makes the need for a licensing requirement all the more necessary. A licensing requirement would serve as a filtering

191. *See id.*

192. *See DreamFunded*, 2019 WL 3231289 at *11; *see* FINRA, FUNDING PORTAL RULE 200(b) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

193. *See DreamFunded*, 2019 WL 3231289 at *108.

194. *Id.* at *95.

195. *Id.* at *67 ("[T]he model has not worked for us.").

196. *Id.* at *41 ("[Fernandez's] purpose in posting the video clip with the \$1 million offer was to generate publicity.").

197. *Id.* at *107.

mechanism, keeping out actors like Fernandez. Licensing requirements increase compliance with the rules and will necessarily filter out some bad actors at the outset. The fact that Fernandez and DreamFunded were allowed to register with FINRA demonstrates that some fraudulent actors are making it through the vetting process. And further, FINRA began its investigation of Fernandez because they had just dealt with a funding portal with a financial interest in its issuer.¹⁹⁸ This other case may have been less extreme than *DreamFunded*, but it suggests another example of a funding portal recklessly disregarding its gatekeeping role. An absence of a financial interest in an issuer is a crucial requirement for a funding portal to serve as a “neutral third party.”¹⁹⁹ The need to prevent funding portals from violating this requirement is necessary to safeguard investors, and a licensing mechanism would filter out some bad actors who will break the rules.

But let us look at Fernandez in the most positive light and assume that he was not a bad actor but was simply misinformed about his role as a gatekeeper. There are some facts that point in this direction. Fernandez commented on the proposed rules for equity crowdfunding before they took effect, praising a high barrier to entry for funding portals.²⁰⁰ Further, when Fernandez reviewed his attorney’s prepared policies and procedures for DreamFunded’s site, he did not believe they applied to him or the portal.²⁰¹ When Fernandez established DreamFunded, his relationship with FINRA suggested a desire to comply with the rules.²⁰² From these facts, it appears that Fernandez was simply misinformed of his role as a gatekeeper.

If Fernandez was simply misinformed of his role, he violated the relevant rules in such a systemic way that demands an educational requirement even for non-complying actors who are well-intentioned. He did not conduct background checks for the control persons of the issuers on his site, providing no screening to protect investors.²⁰³ He did not keep records, saying that he did not consider them “important.”²⁰⁴ The offerings for Company A and Company B closed early, and Fernandez disbursed the funds for those offerings without

198. *Id.* at *41.

199. *See* Baritot, *supra* note 58, at 277.

200. Manny Fernandez, File No. S7-09-13, Comment on Proposed Rule Crowdfunding (Jan. 8, 2014), <https://www.sec.gov/comments/s7-09-13/s70913-105.htm> (“I think the proposed rules [for Crowdfunding] provides [sic] a high barrier to equity crowdfunding portals aka funding portals. Which is good because it will stop anyone from potentially creating a funding portal over a weekend.”).

201. *DreamFunded*, 2019 WL 3231289 at *133 ([T]he [policies were] drafted at a very high level When [Fernandez] looked at them, he testified that they looked ‘more like [a] brokerage firm[’s [document] or something. I don’t think it really applies here.’”).

202. *Id.* at *61 (“[FINRA staff] advised Fernandez of aspects of its website that were inconsistent with regulatory requirements, and Fernandez made changes to the website in response.”).

203. *Id.* at *124–25.

204. *Id.* at *12.

providing investors the required notice.²⁰⁵ However, once he was aware of his misstep, he attempted to remedy it by contacting investors.²⁰⁶ This suggests that a well-intentioned Fernandez would have acted differently had he been informed of his role as a gatekeeper. He may have wanted to comply with the rules, but without an understanding of his role, he could not carry out his obligations. An educational requirement that appraised Fernandez of his role would have solved this issue. If Fernandez's intent was to conform with the rules, an educational requirement would have better informed him of his obligations. If he had been better informed of his obligations, the chances that Fernandez would have complied would have been higher. Given how much of a gap there was between what Fernandez was expected to do and what he actually did, an educational requirement could have prevented his misstep and could have prevented his bar. Thus, it should have been required at the outset.

Whether Fernandez was a bad actor or simply acted out of ignorance, one thing is clear: with a licensing requirement in place, the chances that he would have complied with his role would have been higher. Fernandez stepped into a complex regulatory regime that put him at the center of investor protection, yet he failed to appreciate this responsibility. The JOBS Act created funding portals specifically to protect investors, so funding portals must appreciate their role as gatekeepers. If funding portals do not appreciate their role, the regulatory structure will collapse under its own weight due to well-intentioned and bad actors alike.

Fernandez represents a case study in the need for a licensing requirement, but he likely does not stand alone in his noncompliance. While he presented the first fact pattern of how far a funding portal can stray from the path, there is a "culture of noncompliance" in the security crowdfunding space.²⁰⁷ Issuers are generally not meeting their most basic and simple requirements,²⁰⁸ and intermediaries, as the gatekeepers, are to blame. While data is still emerging, this culture of noncompliance "begs the question" of a pattern of extreme fraud that may be a smoking gun for even further cases like *DreamFunded*.²⁰⁹ There is "considerable latency in fraud schemes,"²¹⁰ but we should not wait to find out.

205. See *id.* at *33, *39.

206. See *id.* at *35.

207. See generally, Mercer Bullard, *Crowdfunding's Culture of Noncompliance: An Empirical Analysis*, 24 LEWIS & CLARK L. REV. (forthcoming 2020).

208. See *id.* ("In almost half of the first 362 offerings in the sample, the issuer failed to file at least one of the 4 required financial statements or obtain the required level review for their financial statements. Only 61 percent of issuers filed their mandatory initial annual report; only 37 percent filed it on time. Barely one quarter of issuers that were required to file two annual reports did so. Only 15 percent of successful issuers filed the required report on the final amount raised, most issuer's electronically filed data include substantial deviations from the data in their financial statements, and one platform may be violating the prohibition against crowdfunding portal's providing advice.").

209. *Id.*

210. See REPORT TO THE COMMISSION, *supra* note 32, at 13.

If funding portals are the gatekeepers against fraud, a licensing requirement is necessary to preserve the first purpose of the JOBS Act: investor protection.

B. *A Licensing Requirement and Capital Formation*

Funding portals have one source of customer revenue: the issuers on their site. Funding portals charge the issuers on their site either in the form of equity in the issuing company or in the form of fees.²¹¹ If compliance costs for crowd-funding intermediaries increase, those costs will have to be passed on to issuers, thwarting the capital formation purpose of the JOBS Act.²¹²

I will argue that the *DreamFunded* decision will increase compliance costs for intermediaries, which will be passed on to issuers. A licensing requirement solves these increased costs. While a licensing requirement will surely add to the startup costs of intermediaries, it will greatly offset that cost by decreasing increased compliance costs in the wake of *DreamFunded*. A licensing requirement will increase the reputation of funding portals generally, creating a more efficient market for equity crowdfunding. I will begin by discussing why *DreamFunded* increases costs for funding portals.

DreamFunded increases compliance costs for funding portals because the decision implies a due diligence requirement for funding portals. While the Hearing Panel decision stated multiple times that there “is no due diligence” requirement for funding portals,²¹³ their ruling strongly implied one.²¹⁴ The Hearing Panel likely reiterated that there was no diligence requirement for funding portals in order to allay concerns that compliance costs would increase. But in doing so, they created ambiguity as to what is necessary for funding portal compliance. A funding portal must have a “reasonable basis” for believing that a crowdfunding issuer is in compliance with the laws and regulations, or they must remove that issuer or the offering from the site.²¹⁵ This reasonable basis standard has long hinted at the possibility of a due diligence requirement, but this opinion magnifies that possibility.²¹⁶ In order to achieve compliance, the

211. See generally, Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543 (2017) (comparing the various costs that intermediaries charge issuers).

212. See REPORT TO THE COMMISSION, *supra* note 32, at 33–34 (stating that costs that intermediaries incur complying with FINRA Funding Portal Rules are passed onto issuers “in the form of higher fees.”).

213. See, e.g., *DreamFunded*, 2019 WL 3231289 at *11 (“Intermediaries like the Dream-Funded Portal, however, have no duty to conduct due diligence . . .”).

214. See Bullard, *supra* note 207 (manuscript at 33–34).

215. See Crowdfunding Rule 301, 17 C.F.R. § 227.301 (2017).

216. C. Steven Bradford, *Online Arbitration as a Remedy for Crowdfunding Fraud*, 45 FLA. ST. U. L. REV. 1165, 1177 (2018) (“[The reasonable basis standard] is loaded with ambiguity and liability risk, but it may impose an affirmative due diligence obligation on the crowdfunding intermediary.” (emphasis in original)).

decision implied that Fernandez needed a system of review in place.²¹⁷ A system of review smacks of due diligence. Further, the Hearing Panel also created a line drawing problem for funding portals to review their issuer's Form C. While there is no "duty to probe [errors and gaps] in an issuer's statements," an "accumulation" of those errors and gaps would lead to a funding portal having a reasonable basis to deny access to the issuer.²¹⁸ From this, a duty to assess an issuer's Form C can be implied.²¹⁹ The inherent ambiguity in what constitutes a "reasonable basis" will likely put crowdfunding portals on notice that they may have to do more than what they are doing now.²²⁰ It is likely that funding portals will overcompensate than undercompensate, because noncompliance means they will be subjected to FINRA's enforcement and have to hire the expertise of attorneys—adding costs.

On top of an ambiguous due diligence requirement, the decision attached a violation that will add further costs for intermediaries: 200(a) of the Funding Portal Rules.²²¹ Rule 200(a) is an ethical obligation to "observe high standards of commercial honor and just and equitable principles of trade" and is identical to the ethical standard for broker-dealers in FINRA Rule 2010.²²² In *DreamFunded*, the rule was attached to everything from Fernandez's failure to completely respond to a Rule 8210 request, his failure to provide investors with investment confirmations, to the misleading real-estate tombstones on the portal website he posted. Everything that DreamFunded did appears to be considered against the standards of "commercial honor and just and equitable principles of trade." When words are used to describe every possible situation, they lose their meaning. And when the words attach liability to nearly every kind of violation without a clear pattern, the words create ambiguity. Ambiguity increases uncertainty, and thus costs.²²³ These costs for intermediaries will have to be passed onto their only type of customer: issuers.

217. See Bullard, *supra* note 207 (manuscript at 34) ("[The Hearing Panel] made it clear that a portal has an obligation to 'review' these [financial materials of the issuer] and strongly implied that such a review was necessary to be able to form a 'reasonable basis' under Rule 301.").

218. *Id.* (citing *DreamFunded*, 2019 WL 3231289).

219. *Id.* ("At a minimum, [the Hearing Panel] believed that the portal must 'look at' an issuer's Form C and deny access if it uncover facially inadequate compliance.") (citing *DreamFunded*, 2019 WL 3231289 at *93 n.596 ("Arguably, because Fernandez did not even look at the company's Form C, Respondent's had no basis for believing Company A was in compliance.")).

220. *Id.* at 35 ("It is very likely that every crowdfunding intermediary has permitted offerings that, under the Panel's standard, would require denying access to one or more issuers. [The *DreamFunded* decision] may cause intermediaries to mend their ways.").

221. *DreamFunded*, 2019 WL 3231289, at *82 (first cause of action), *84 (second cause of action), *91 (third cause of action), *94 (fifth cause of action), *98 (sixth cause of action), *99 (seventh and eighth causes of action), *100 (ninth cause of action), *101 (tenth cause of action).

222. See FINRA, FUNDING PORTAL RULE 200(a) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/200>.

223. See, e.g., Bradford, *supra* note 217, at 1177.

Clarity is the solution to all of this cost-adding confusion. Funding portals need to have an idea of what they are responsible for in order to stay on the right side of FINRA's enforcement arm. FINRA sent a mixed message to funding portals: that they do not have a due diligence requirement while at the same time expecting something that looks a lot like a due diligence requirement. At the same time, they created a line drawing problem for reviewing issuers' Form Cs for "gaps and errors." How many "gaps and errors" are too many? A funding portal wishing to comply with its rules and regulations will have an incentive to do more, rather than less, in order to comply. This will lead to otherwise lean-operating funding portals to waste resources doing more than what they may have to do to remain in compliance. Additionally, the ambiguous and meaningless standard for what constitutes "high standards of commercial honor and just and equitable principles of trade" needs to be better defined.

A licensing requirement would dispel confusion, reducing these costs for intermediaries and, by extension, issuers. By providing a vetting measure for funding portals at the outset, their obligations as intermediaries will become clearer. Without it, funding portals will either (a) not follow the rules leading to more enforcement actions (as discussed in Part II.A) or (b) be stymied by the ambiguity, overspending to comply. A licensing requirement would reduce the ambiguity in the *DreamFunded* decision, reducing costs for intermediary non-compliance in the form of fewer enforcement actions and for intermediary compliance in the form of better-defined standards. Reducing costs for intermediaries will benefit issuers and, by extension, the equity crowdfunding market as a whole.

In addition, a licensing requirement would lower costs to the entire system by increasing the reputation of those funding portals not already in compliance. As it stands, most crowdfunding offerings are conducted through the three largest funding portals.²²⁴ Most issuers, it seems, prefer to operate through these three funding portals as opposed to the other forty-five.²²⁵ This suggests that there could be a reputational disparity among intermediaries. Some issuers may prefer to offer their securities through the best intermediaries as opposed to other, less reputable intermediaries. Since the start of Regulation Crowdfunding, seven funding portals have left the market.²²⁶ The SEC suggests that this might be due to an inability for "small intermediaries [to] attract sufficient deal flow to sustain their business model."²²⁷ If that were the case, these "smaller intermediaries" could offer a more competitive price structure to issuers, siphoning off issuers from the bigger funding portals and creating a competitive market. In-

224. REPORT TO THE COMMISSION, *supra* note 32, at 27 ("The majority of initiated and completed offerings were conducted through the three largest funding portals.").

225. See *Funding Portals We Regulate*, FINRA, <https://www.finra.org/about/funding-portals-we-regulate> (last visited Dec. 30, 2019) (FINRA regulates a total of 48 non-suspended funding portals).

226. See REPORT TO THE COMMISSION, *supra* note 32, at 27 n. 67.

227. *Id.* at 27.

stead, we see them priced out, which suggests that issuers place a reputational premium on those three largest funding portals.

Funding portals at the bottom will benefit the most from a reputational boost created by a licensing requirement, which will help the crowdfunding market as a whole. It is highly likely that the three largest crowdfunding portals are already disproportionately in compliance with the laws and regulations they are required to follow.²²⁸ By virtue of not being one of the big players in crowdfunding, issuers already may look at those less reputable funding portals with skepticism. If you aren't at the top, then you must be doing something wrong. Additionally, in the wake of the *DreamFunded* decision and the egregious mistakes by Fernandez and his portal, an issuer may question how much latent noncompliance exists among funding portals, further incentivizing a premium to go with the funding portals that get it right. A licensing requirement would add a credibility boost to those intermediaries that do not share the reputation of the three largest intermediaries. With this reputational increase, smaller players would at least be able to attract more issuers away with the promise of lower prices. These lower prices would increase competition in the funding portal market, decreasing costs for issuers across the board.

In summary, a licensing requirement will reduce costs for funding portals to the benefit of issuers. First, a licensing requirement will clarify the standards in *DreamFunded*, decreasing costs to funding portals across the board. Second, a licensing requirement will increase the reputation of all funding portals but especially those that are not at the top. This will allow less reputable intermediaries to swipe issuers from the top in the form of lower fees, increasing competition in the equity funding marketplace. One of the two purposes of the JOBS Act is capital formation, and a licensing requirement advances that purpose.

Now that I have discussed why a licensing requirement is necessary, I will discuss a potential framework to design one.

III. POSSIBILITY FOR AN EDUCATIONAL REQUIREMENT

A licensing requirement needs to serve two purposes. First, it cannot be more costly to funding portals than for broker-dealers, as Congress intended.²²⁹ Second, it must solve the issues presented by the *DreamFunded* decision.

A possible licensing requirement for funding portals must cost less than the preexisting requirements for broker-dealers to meet the first purpose. As it stands, a compliance officer for a broker dealer must pass either a Series 14 Exam or a combination of three exams: the Securities Industry Essentials (SIE)

228. If they were not, we would see FINRA enforcement actions and significantly less business given to them by issuers. But that isn't the case.

229. See *DreamFunded*, 2019 WL 3231289 at *85 ("Congress imposed fewer obligations on intermediaries handling crowdfunding offerings than on broker-dealers in other kinds of offerings out of a desire to create a means of raising capital that is less burdensome and less expensive for small enterprises.").

exam, the Series 7 Exam, and the Series 24 Exam.²³⁰ All of these tests are multiple-choice format and have a relatively low cost.²³¹ They also vary in length but are relatively short.²³² The tests cover a wide range of information about securities regulation from investment banking to general supervision to Sales-Practice Rules.²³³ At a high level, these exams test three basic things broker-dealers should know: the securities industry as a regulated body, a broker-dealer's role in it, and what FINRA and the law expect of them. Broker-dealers are also required to continually educate themselves to keep up with the securities industry.²³⁴

To meet the issues presented by the *DreamFunded* decision, I propose that funding portals be subject to similar, though less burdensome licensing requirements. Specifically, the licensing requirement should do what the qualification exams do for broker-dealers: inform them of the securities industry in general, what a funding portal's role is in it, and what the law and FINRA expect of them. Like a broker-dealer, a funding portal should be required to designate a compliance officer to take and pass the exam before registering. In the *DreamFunded* case, where Fernandez was the chief compliance officer at the time of registration, this would have meant that Fernandez would have taken the exam.

The following three elements should be covered on a funding portal exam: the securities industry as a regulated body, a funding portal's place in it, and what FINRA and the law expect of funding portals.

A. *Funding Portals Should be Aware that the Securities Industry is a Regulated Body*

A licensing requirement would provide funding portals with a general knowledge of the securities industry as a regulated body. Funding portals do not exist in a vacuum—the securities industry is highly complex and regulated. FINRA Staff acknowledged that funding portals are “new to regulation and

230. See *FINRA Qualification Exam Frequently Asked Questions*, FINRA, <https://www.finra.org/registration-exams-ce/qualification-exams/faq> (last visited Feb. 1, 2020) (“What are the registration and qualification requirements for a FINRA-registered firm’s chief compliance officer (CCO)?”).

231. The costs of the exams are: SIE (\$60), Series 7 (\$245), Series 14 (\$350), and Series 24 (\$120). See *FINRA Qualification Exams*, FINRA, <https://www.finra.org/registration-exams-ce/qualification-exams> (last visited Feb. 1, 2020).

232. The time for the exams is: SIE (1 hour and 45 minutes), Series 7 (3 hours and 45 minutes), Series 14 (3 hours), and Series 24 (3 hours and 45 minutes). See *FINRA Qualification Exams*, FINRA, <https://www.finra.org/registration-exams-ce/qualification-exams> (last visited Feb. 1, 2020).

233. FINRA, COMPLIANCE OFFICIAL QUALIFICATION EXAMINATION (TEST SERIES 14) CONTENT OUTLINE (2018), https://www.finra.org/sites/default/files/Series_14_Outline.pdf.

234. Mark P. Cussen, *How to Keep Up Your Continuing Education*, INVESTOPEDIA, <https://www.investopedia.com/articles/professionaleducation/07/continuing-education.asp> (last updated May 31, 2018).

oversight.”²³⁵ Unlike other regulated entities such as broker-dealers, funding portals may not appreciate what it means to be a regulated entity. This likely led to Fernandez’s misunderstanding that he was required to comply with FINRA’s Rule 8210 request. Despite that it is clear that funding portals must submit to FINRA’s regulatory arm,²³⁶ some funding portals (like DreamFund-ed) may not understand their place in the regulated industry.

Apart from providing a general background of the securities industry as a regulated body, a licensing requirement would help funding portals understand the role of regulators such as FINRA. Fernandez misunderstood the FINRA MAP staff member’s role as a regulatory enforcer.²³⁷ The basic reason for all of this regulation is based out a concern for investor protection. Having a basic understanding of what it means to be a regulated entity and why FINRA and the SEC exist would appraise actors like Fernandez of that concern.

Armed with a knowledge of the securities industry as a regulated body and the regulators within it, Fernandez would have been better notified of his obligations. Whether this knowledge would have led to his compliance can never be known. However, it likely would have increased the chance that Fernandez would have complied.

To better notify actors such as Fernandez going forward, a licensing exam could take the form of questions from a test that FINRA has already designed: The Securities Essentials Exam (SIE). The SIE covers:

[Basic] securities industry information including concepts fundamental to working in the industry, such as types of products and their risks; the structure of the securities industry markets, regulatory agencies and their functions; and prohibited practices.²³⁸

FINRA need not adopt wholesale the SIE for funding portals but could modify it to suit funding portals as a section in a larger modified exam. Regardless of what action FINRA may decide, this section would allay FINRA’s concerns that funding portals are new to regulation as well as increase compliance among actors who, like Fernandez, did not appreciate their place in the regulated securities market.

235. REPORT TO THE COMMISSION, *supra* note 32, at 33.

236. See Jumpstart Our Business Startups Act § 304, 15 U.S.C. § 78c(h)(1)(A) (2018).

237. See *DreamFunded*, 2019 WL 3231289 at *47 (“[The FINRA staff member] expressed regret at the hearing that she had not made it clearer to Fernandez that MAP staff had opened a for cause examination. Fernandez may not have appreciated the change in SV’s role.”).

238. See *Securities Industry Essentials (SIE) Exam*, FINRA, <https://www.finra.org/registration-exams-ce/qualification-exams/securities-industry-essentials-exam> (last visited Feb. 1, 2020) (“*Your First Step to a Career in the Securities Industry*” (emphasis in original)).

B. *Funding Portals Need to Be Aware of their Gatekeeping Role:
The Basic Requirements*

Funding portals are charged with acting as gatekeepers for issuers, so they need to understand their role at the most basic level. While the SEC notes that “funding portals are generally aware of their compliance and recordkeeping obligations,”²³⁹ other independent research suggests otherwise.²⁴⁰ Further, while the SEC notes that it is aware of only four FINRA actions involving funding portals, this represents almost ten percent of all funding portals in the market. Recognizing the latency of fraud, that is a high percentage of known noncompliance. If the regulatory structure surrounding equity crowdfunding expects gatekeepers such as Fernandez to serve their role, funding portals need to be aware of their most basic requirements.

The *DreamFunded* decision may not be the only case of funding portal non-compliance, but it serves as an example of a severe breakdown of the most basic requirements. Fernandez did not keep records, did not conduct background checks on the issuers on his site, nor did he provide notice or confirmation to the investors who had invested on his site. DreamFunded operated without an understanding of the most basic requirements for the entire year and a half they were registered as a funding portal. If Fernandez had this basic understanding, he likely would have understood that he needed to keep records for his business instead of throwing them away. The chances that he would have conducted more thorough background checks of the issuers on his site rather than just interviewing issuers and looking at their LinkedIn accounts would have also increased.

The basic requirements for funding portals are clear, and they are easily assessed. Because there are no current qualification exams specific to funding portals, FINRA would need to create these new sections.

To assess these basic requirements, FINRA could create multiple-choice questions that test a funding portal’s compliance officer on the portal’s basic obligations—using *DreamFunded* as a model. If a licensing exam contained these questions, the chances that intermediaries would understand their basic requirements would increase, and cases like *DreamFunded*, which represent a “systemic compliance breakdown,”²⁴¹ would be a thing of the past. Without understanding their most basic requirements, it will be incredibly challenging for funding portals (if not impossible) to understand some of the more ambiguous requirements.

239. See REPORT TO THE COMMISSION, *supra* note 32, at 33.

240. See Bullard, *supra* note 207, at 27 (“[Issuer’s] overall 56 percent rate of compliance under a very liberal standard shows that neither [issuers] nor intermediaries are confirming that even the simplest, most objective filing requirements have been satisfied.”).

241. *DreamFunded*, 2019 WL 3231289 at *110.

*C. Funding Portals Need to Understand their Gatekeeping Role:
The Ambiguous Requirements*

In addition to the most basic requirements, a funding portal is subject to more ambiguous standards. Funding portals must have a “reasonable basis”²⁴² that the issuers on their sites are in compliance, and funding portals must observe “high standards of commercial honor and just and equitable principles of trade.”²⁴³ It is unclear what these standards mean for funding portals and, as discussed,²⁴⁴ ambiguity adds cost.

The *DreamFunded* decision established ambiguous standards for funding portals. As discussed, Fernandez failed to meet the most basic requirements, but this section would have the effect of providing clarity to those funding portals already doing the basics but trying to comply with ambiguous standards. Without clarity for these standards, funding portals will overcompensate by doing more than necessary to comply.

A licensing requirement would reduce ambiguity by requiring FINRA to better define its standards. FINRA would have to develop guidelines identifying what they believe funding portals are required to do to have a “reasonable basis” and what high degrees of “commercial honor” mean. Having only four cases of noncompliance as guidance, funding portal intermediaries cannot be expected to know what they are required to do to meet these ambiguous standards. Clarity could be gained by posing hypotheticals to funding portals regarding what would be needed for a “reasonable basis.” These questions could take the form of various situations FINRA previously encountered. Implementing these questions would have two beneficial effects. First, it would force FINRA, *a priori*, to grapple with and apply its own standards. Second, it would give funding portals advanced notice of the kinds of situations they are likely to encounter and what they are expected to do in those situations.

To reduce ambiguity, FINRA could base questions of their standards around the situations they have handled in the three years since Reg CF took effect. The cost to FINRA to make these questions would likely be insubstantial given their expertise in creating exams and the countless hours of advice they have already given to intermediaries seeking to comply with their requirements.

CONCLUSION

Equity crowdfunding, envisioned by the JOBS Act Title III, has two purposes: investor protection and capital formation. Regulation Crowdfunding placed intermediaries at the center of these purposes, making them the arbiter to serve investor protection and capital formation. In order to meet their gatekeep-

242. Regulation Crowdfunding Rule 302, 17 C.F.R. § 227.302 (2018).

243. FINRA, FUNDING PORTAL RULE 200(a) (2016), <https://www.finra.org/rules-guidance/rulebooks/funding-portal-rules/300>.

244. *See supra* Part II.B.

ing functions, intermediary funding portals are expected to understand and comply with “around 1,000 pages of regulations”²⁴⁵ Yet the regulations provide no licensing requirement to gatekeep the gatekeepers.

The recent *DreamFunded* decision presents a threat to both of those purposes. This was the first litigated case where a funding portal substantially failed to meet its gatekeeper requirements. The decision presents two issues for each of the JOBS Act’s twin purposes of investor protection and capital formation. Each issue points to the need for a licensing requirement. First, funding portals can register and operate without understanding that they are regulated entities and what they are expected to do. How can investors be protected if a gatekeeper charged with investor protection is unaware of its role? Second, because of the language in the decision in response to Fernandez’s violations, even generally compliant funding portals are left facing ambiguity with regard to their responsibilities under the JOBS Act. This ambiguity creates costs that will be passed onto issuers, threatening the second purpose: capital formation. A licensing requirement for funding portals would solve both of these issues. Without gatekeeping the gatekeepers, equity crowdfunding is just a dream.

245. See WEFUNDER, <https://help.wefunder.com/#/getting-started-for-investors/304624-what-kind-of-companies-are-on-wefunder> (“Is Wefunder regulated?”) (last visited Jan. 25, 2020).