

# Lessons From Recent FINRA Actions Against Funding Portals

By **Peter LaVigne and Christopher Grobbel** (June 1, 2022)

On May 4, the Financial Industry Regulatory Authority announced that it had fined two FINRA-registered funding portals a combined \$1.75 million for failing to comply with securities laws and rules designed to protect crowdfunding investors.[1]



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Funding portals are a creature of Sections 4(6) and 4A(a) of the Securities Act, added by the 2012 Jumpstart Our Business Startups Act. They are regulated by FINRA and, along with registered brokers, can act as intermediaries, which are required to play a role in connection with any offering by a crowdfunding issuer, under Section 4(a)(6) and Regulation CF, the U.S. Securities and Exchange Commission's crowdfunding rules.

In its announcement, FINRA said that the enforcement actions against the two funding portals, Wefunder Portal LLC and StartEngine Capital LLC, originated from FINRA's examination program. The funding portals entered into separate letters of acceptance, waiver and consent, or AWCs, to resolve the enforcement actions.



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In the AWC, Wefunder agreed to censure, payment of a \$1.4 million fine and an undertaking to retain an independent consultant to conduct a comprehensive review of the adequacy of Wefunder's compliance with applicable federal securities laws and regulations, Regulation CF Rules and FINRA Funding Portal Rules.[2]

In the AWC, StartEngine agreed to censure, a \$350,000 fine and an undertaking to certify to FINRA — within 60 days of the acceptance of the AWC — that StartEngine has established and implemented policies, procedures and internal controls reasonably designed to address and remediate the issues identified in the AWC.[3]

## The Wefunder AWC Findings

***In 39 offerings, Wefunder helped issuers exceed the Regulation CF maximum and improperly induced the sale of securities outside the crowdfunding exemption.***

In those offerings, Wefunder raised approximately \$20 million more, in the aggregate, than the maximum amount permitted by Regulation CF. Rather than return the extra money to investors, Wefunder identified accredited investors who had invested in the crowdfunding and notified them that their investments were now being sold under Rule 506(c) of Regulation D under the Securities Act, which permits offerings using general solicitation.

***Wefunder failed to promptly transmit or return investor funds.***

Funding portals are required by Rule 303(e) of Regulation CF to cause their qualified third-party bank to either transmit funds to the issuer upon a successful completion of the offering or return the funds to investors upon cancellation of the offering.

Instead, for offerings that were canceled or oversubscribed, Wefunder directed the funds to an escrow account held by its parent. Investors could then use funds in the parent's account

to invest in a separate offering through Wefunder or make a withdrawal.

In addition, Wefunder maintained two dormant crowdfunding escrow accounts which together held \$290,000. Wefunder was unable to identify the source and intended destination of all the funds held in the accounts.

***Wefunder made investment recommendations and solicited investments.***

Wefunder regularly sent emails, drafted by the firm's email team, to individual investors recommending and soliciting investments in particular offerings on its platform. Over a five-year period, this totaled over a million emails containing language recommending or soliciting investments. Rule 402(a) of Regulation CF prohibits a funding portal from offering investment advice or recommendations or soliciting purchases of the securities offered on its platform.

***Wefunder posted misleading communications on its platform.***

During the relevant period, Wefunder identified a lead investor for nearly all the offerings on its website. Wefunder made statements about the lead investors that were exaggerated and misleading, including statements that the lead investor "has vetted the startup," "fights for you," is "incentivized to maximize the value of the company" and "is meant to advocate for investors." FINRA found that Wefunder had taken no action to verify whether the statements were true.

***Wefunder failed to establish and maintain a reasonable supervisory system.***

In particular, FINRA found that Wefunder lacked a reasonable system to track investor funds. "The firm employed a manual, labor-intensive process for tracking and directing investor funds to issuers, back to investors or elsewhere, that relied almost entirely on one person. That person had no accounting or finance training and was overwhelmed with other work."

**The StartEngine Findings**

***StartEngine included misleading communications on its website prepared by issuers in two offerings.***

The first issuer provided exaggerated information including a video about its product, a home robot that claimed that it could independently perform tasks such as waking sleeping family members, smoothly responding to voice comments, teaching a child piano and art, projecting a video call onto a wall, patrolling a home for potential intruders, adjusting a thermostat and playing peek-a-boo with a child.

The issuer's principal posted a comment on the message board for the offering that the shipping of retail units was imminent. StartEngine left the descriptions on the issuer's offering page despite information that the robot could not yet perform most of those tasks, even after seeing videos demonstrating that the prototype robot was not functional or ready for mass production.

The second issuer was a basketball team formed to play in a new professional league. The issuer made misstatements about the timeline for league play, which StartEngine did not correct despite learning from published news articles that the timeline was not realistic.

### ***StartEngine posted misleading investment trackers.***

For nearly a year between 2016 and 2017, StartEngine maintained a public-facing tracker on each of its offering pages purporting to display the total number of investors that had committed funds to the offering.

The trackers were misleading because they counted each individual investment as a unique investor, even if the same individual made multiple investments. The tracker also counted some investors who were associated with the issuer, creating a misleading impression of outside interest.

### ***StartEngine failed to reasonably supervise issuer communications included on its website.***

Even though StartEngine revised its written supervisory procedures in 2017 to include a list of prelaunch red flags requiring increased scrutiny of a potential crowdfunding issuer, StartEngine failed to investigate red flags that should have been raised with respect to statements made by another issuer.

## **Four Lessons From the Funding Portal AWCs**

### ***Don't Act Like a Broker if You're Not a Broker***

Being registered as a funding portal does not give the funding portal the authorization to act as a broker or dealer, except within the narrow confines of the activities prescribed by Regulation CF. Wefunder violated Section 15(a)(1) of the Securities Exchange Act, which requires registration of a broker or dealer that effects transactions in securities or induces or attempts to induce the purchase or sale of securities, in two ways.

First, when Wefunder converted some investors in Regulation CF offerings to Rule 506 offerings, it induced the issuers to sell to those investors in a Rule 506 offering, and, by redirecting the funds to the Rule 506 offering, it effected transactions in securities.

Wefunder was not directly compensated for Rule 506 sales, but it received indirect compensation from the fact that it could attract crowdfunding business by offering issuers a way to raise more money than the Regulation CF maximum. Because Wefunder was not registered as a broker, FINRA found that this activity violated Section 15(a)(1) of the Exchange Act.

Second, FINRA found that when Wefunder sent emails to prospective investors making investment recommendations or soliciting investments, in violation of Rule 402(a) of Regulation CF, it was inducing or attempting to induce the purchase of a security without being registered as a broker or dealer, also in violation of Section 15(a)(1) of the Exchange Act.

The lesson here is: Funding portal, stay in your lane. Don't engage in broker activities outside the scope of your registration.

### ***Keep Track of the Money***

FINRA found that when offerings were canceled or oversubscribed, in some instances Wefunder directed the qualified third party to transmit the funds from the canceled offering or oversubscribed amount to an escrow account held by Wefunder's parent.

It is fair to assume that this direction was intentional, especially given the fact that investors were then given the option to use the funds in the parent's escrow account to invest in a separate offering through Wefunder or make a withdrawal.

When the rule tells you that funds from canceled offerings or excess funds from oversubscribed offerings are to be returned to investors, do that. Don't send the money instead to an escrow account not in the control of the investors or the qualified third party. That's the easy part.

What's more interesting is what was going on in Wefunder's financial operations. As noted in the FINRA findings, the process for tracking and directing investor funds was being done manually by one guy with no accounting or finance training.

In an internal email, one officer wrote to another about the that the one-man tracking office was failing the team. This led, among other things, to the inability to account for the \$290,000 contained in two dormant escrow accounts.

Wefunder also failed to supervise access to its bank accounts by a former officer. Although no investor funds were withdrawn by him, his continued access put investor funds at risk.

A key element of a funding portal's responsibilities is to keep track of investors' money and to direct the qualified third party selected for the offering to transmit the money either to the issuer or back to investors in the right amounts, depending on the outcome of the offering. That function needs to be professionally staffed, using appropriately automated systems reasonably designed to permit the funding portal to track and direct funds as required by Regulation CF.

### ***Gatekeepers Gotta Gatekeep***

When the SEC voted to adopt Regulation CF on Oct. 30, 2015, SEC Commissioner Luis Aguilar said this in his statement in support of the rulemaking:

Importantly, regulation crowdfunding also provides a framework to govern how crowdfunding intermediaries — such as a registered broker-dealer or a funding portal — can conduct securities offerings. Because these intermediaries essentially act as "gatekeepers" for these offerings, this framework should provide additional investor protection.

The SEC intended for intermediaries, including funding portals, to perform a major gatekeeping function not only to make sure that investor funds are maintained in escrow pending the conclusion of the offering, but also to prevent against fraud and material misstatements in the offering. Rule 301(c)(2) requires the intermediary to deny access to its platform if it has a reasonable basis for believing that the offering presents the potential for fraud or otherwise raises concerns about investor protection.

FINRA's Funding Portal Rule 200(c)(3) provides that:

[N]o funding portal member may include on its website any issuer communication that the funding portal member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

FINRA found that StartEngine allowed three issuers to make statements on their offering

pages that were false or exaggerated, despite evidence in the possession of StartEngine that the information was false or at least sufficiently suspect to require additional due diligence.

When the disparity between what the issuer is saying about itself and what funding portal personnel see and hear, as in the case of the robot, is significant, the funding portal has a duty to protect investors from investing on the basis of false information.

If the funding portal has a reasonable basis for believing that the offering raises concerns about investor protection, including apparent material misstatements, it is required to deny or discontinue access to its platform by the issuer.

### ***And One More***

FINRA is watching.

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[1] <https://www.finra.org/media-center/newsreleases/2022/finra-fines-for-crowdfunding-rule-violations>.

[2] <https://www.finra.org/sites/default/files/2022-05/Wefunder-2021071940801.pdf>.

[3] <https://www.finra.org/sites/default/files/2022-05/StartEngine-matter.pdf>.