

SEC Focused on Enforcement in the Crowdfunding Space

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Following last year's drastic increase in the annual limits permitted for crowdfunding campaigns, the Securities and Exchange Commission (SEC) has increased its focus on the regulation of crowdfunding, particularly for antifraud measures targeted at startups and crowdfunding "gatekeepers." Companies, and especially startups, should be aware of greater likelihood of potential enforcement actions in this space.

Background

"Crowdfunding" refers to a financing mechanism, where small startups raise equity online by targeting large numbers of small investors. Crowdfunding was a key part of the 2012 Jumpstart Our Business Startups Act (JOBS) that passed under President Obama. The SEC promulgated rules relating to crowdfunding in 2015. Last year, the SEC raised annual limits for crowdfunding campaigns from \$1 million to \$5 million.

A key motivation behind the promulgation of crowdfunding through the JOBS Act was to facilitate small capital raises for startup operations. However, regulators are concerned about ensuring that there are adequate disclosures relating to any funds solicited through crowdfunding and preventing fraud during the capital raising process.

Accordingly, the crowdfunding rules promulgated by the SEC contain certain provisions designed to address investor protection. For example, Section 227.1 of the JOBS Act provides that companies must raise money through an SEC-registered intermediary — either a broker-dealer or a funding portal. Additionally, if funds are raised through a funding portal, then Section 227.4 of the JOBS Act mandates that the portal must be a member of the Financial Industry Regulatory Authority (FINRA) to allow for appropriate oversight. Finally, Section 227.5 of the JOBS Act provides that the portals must conduct background checks and determine whether disqualification issuers or offerings are warranted due to fraudulent conduct.

Fundanna Enforcement Action

On September 20, the SEC filed its first enforcement action against crowdfunding companies and related intermediaries since crowdfunding was authorized in 2016. Filed in the Eastern District of Michigan,^[1] the SEC's complaint alleged that two real estate investment entities, Transatlantic and 420 Real Estate, raised funds through a crowdfunding portal called TruCrowd, Inc (d.b.a. Fundanna) in violation of Securities Act Sections 4A(a)(5), 5(a), 5(c) and 17(a) and Exchange Act Section 10(b).

In addition to suing the real estate companies and the funding portal TruCrowd, the SEC also sued individual defendants Vincent Petrescu, Robert Shumake, Willard Jackson, and Nicole Birch. Mr. Petrescu, a CPA and TruCrowd founder and CEO, was sued in his capacity as the “gatekeeper” — *i.e.*, the individual under the SEC regulations who had responsibility for choosing which issuers could use the platform for their offerings. Defendants Shumake, Jackson, and Birch, however, were charged because they allegedly sold securities of the entities at issue. The SEC alleged that TransAtlantic raised over \$1 million through a campaign led by Shumake and Birch, and 420 Real Estate raised over \$800,000 through a campaign led by Shumake and Jackson. According to the complaint, investors were informed that the investments would be used by the entities at issue to acquire real estate that would be leased to cannabis-related businesses. However, according to the SEC, the funds were diverted for personal use.

The SEC alleged that Mr. Shumake’s prior criminal conviction was not disclosed, and he had previously pled guilty to two felony counts for accepting fees for mortgage audit services that were not provided. The SEC also alleged that Shumake was on probation — the terms of which forbade him from managing other people’s money — but violated that restriction by participating in the crowdfunding campaign. Finally, the SEC alleged that Petrescu knew (or should have known) of Shumake’s criminal history. The complaint alleged that Petrescu received correspondence from an individual who requested a “bad actor” check on Shumake, which was never run.

The SEC’s novel complaint demonstrates that the SEC intends to hold crowdfunders and gatekeepers accountable for fraud. Companies involved in crowdfunding should take proper precautions to make certain that policies and procedures are in place to ensure compliance with regulatory requirements, including requirements for gatekeepers to run background checks and to review whether offerings or issuers meet all regulatory requirements. The action is one to watch for resolution of questions in connection with crowdfunding, including those relating to what duties intermediaries have to entrepreneurs and investors engaging in crowdfunding.

If you are involved in crowdfunding as a broker-dealer, funding portal, or gatekeeper, please do not hesitate to reach out to Troutman Pepper’s White Collar Defense and Investigations Practice Group or Investment Management and Compliance Practice Group for assistance with any questions relating to, among other things, duties owed to investors, adoption of crowdfunding policies and procedures, or compliance with crowdfunding regulations.

[1] *SEC v. Shumake*, Civil Action No. 2:21-cv-12193 (E.D. Mich. Filed September 20, 2021).

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