ARTICLES

Protecting the Crowd and Raising Capital Through the CROWDFUND Act

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INTRODUCTION

You are an entrepreneur with an innovative business idea, but you have no assets. You need cash to bring your idea to the production line, but no bank or wealthy investor will listen. Would you think it possible to raise over $200 million from five million strangers using just your idea, a website, and social media? That is exactly what happened in 2009 when marketing executives Michael Migliozzi II and Brian Flatow solicited individual investors using their website, BuyABeerCompany.com, to fund a potential purchase of beer company Pabst Blue Ribbon.1 The average pledge from individuals was just $40,2 and in return, investors were promised “a certificate of ownership as well as beer of a value equal to the amount invested.”3 Their lawyer said it was just a harmless experiment,4 one that yielded remarkable results in displaying the “power of crowdfunding.”5 The Securities and Exchange Commission (S.E.C.)

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2. Ackerman, supra note 1.


stepped in to halt the campaign because it violated securities law, but the message was clear: business ideas can be funded by connecting the entrepreneur to the masses through the Internet and social media platforms. Entrepreneurs and investors took notice of the event, and in July 2010, the Sustainable Economies Law Center sent a petition to the S.E.C. requesting a federal securities exemption for small businesses seeking up to $100,000 in funding with individual investments of $100.7

Congress could not ignore the economic potential of this untapped resource, and (for once) is attempting to position itself in front of social media transformations. In September 2011, North Carolina Republican Representative Patrick McHenry chaired a congressional hearing to discuss crowdfunding and capital formation for small businesses. On September 15, 2011, McHenry introduced The Entrepreneur Access to Capital Act. During the same month, President Barack Obama unveiled his American Jobs Act, which was designed to increase job growth throughout the country and included a number of proposals that focused on entrepreneurial development. The White House blog highlighted a number of these proposals, and placed its proposal for a crowdfunding exemption from securities registration at the top of its list. Subsequent bills presented in the Senate advanced the debate further. The Jumpstart Our Business Startups Act, commonly referred to as the JOBS Act, is an amalgamation of the prior proposals and it passed both the House and Senate with

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11. Id.
Title III of the JOBS Act is called the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,” or in shorter form, the CROWDFUND Act.  The bill was signed into law on April 5, 2012, and stands to revolutionize small business and entrepreneurial capital-raising by permitting any individual to invest in private companies over the Internet with limited regulatory hurdles.

Crowdfunding represents the natural convergence of microfinance and crowdsourcing and refers to the raising of capital through a large number of small individual investments. The investors who make up “the Crowd” have grown at an incredible pace thanks to increasing global access to the Internet and the rise in popularity of e-commerce platforms. While crowdfunding in the form of charitable contribution and political fundraising is not a new concept, the notion of equity crowdfunding, where investors have an expectation of profit, is a young solution to the financing problems that small businesses and entrepreneurs face. Prior to the JOBS Act, the regulatory environment did not permit the equity-crowdfunding model. Momentum to create legislation to exempt crowdfunding securities from cost-prohibitive regulatory hurdles swelled as the urgency for job creation grew, and lawmakers have spent the last two years brainstorming ways to promote crowdfunding investing as a responsible capital raising avenue and potential jumpstart to the economy.

The political momentum comes in response to an issue that has beleaguered entrepreneurs for years: finding adequate financing to grow. Without sufficient funds, potential innovations and growth industries never surpass the idea stage. The regulatory scheme prior to the JOBS Act, as

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13. § 301, 126 Stat. at 315.
14. See Ackerman & Favole, supra note 12.
15. See id.; see also infra Part II.E.
16. See Bradford, supra note 5, at 27–28. Microfinance involves the lending of small amounts of money to individuals who cannot secure bank lending, and crowdsourcing is the pooling of contributions from a large number of people, typically over the Internet. See infra Part I.B.
17. See infra Part I.A.
18. See infra Part I.B.
19. See infra Part I.D.
20. See infra Part II.
21. See infra Part I.D.
well as the inherent market risks of start-ups, limited the options for financing available to venture capital firms or angel investors.22

In November 2011, the House of Representatives passed H.R. 2930 by a wide margin.23 The bill received surprising bipartisan support, as 407 members of the House of Representatives voted in favor of the bill, while just 17 voted against it.24 H.R. 2930 marked the first legislative attempt at crowdfunding, and subsequent bills with the same intent to permit crowdfunding capital raising are currently being discussed in the Senate.25

The JOBS Act, as cemented into law, will create a new and largely unexplored market for raising capital. Part I of this Article introduces the Crowd and the crowdfunding concept, and also discusses the U.S. legal framework that has yet to account for the global influence of the Crowd. Part II analyzes the JOBS Act and the proposals that led to its creation. Part III analyzes crowdfunding concerns and the efforts to balance investor protection with capital raising.

Throughout this Article, the term “entrepreneur” includes any individual or individuals with a potential revenue-producing idea in search of funding to grow. The term “small business” applies to individuals that have already begun business operations, but may need financing in order to grow. Both are positioned as crowdfunding investing beneficiaries.

This Article was written and published prior to the promulgation of any S.E.C. regulation for the CROWDFUND Act. Congress directed the S.E.C. to release its rules relating to the CROWDFUND Act by December 31, 2012.26 But that deadline has passed, so the waiting game continues.27

22. See infra Part I.D.
25. See infra II.A.
PROTECTING THE CROWD

I. WHAT IS CROWDFUNDING?

A. The Crowd

The Crowd consists of individuals connected to other individuals through the Internet. The Crowd’s influence draws exclusively from the aggregate and has altered the fundamental constructs of all societies connected to the Internet.\(^28\) In a short period of time, the Crowd has created an entirely new paradigm from which to view the world: it has overcome oppressive governments, produced new industries, and shaped the social and commercial avenues in which we interact.

Because access to the Internet is often synonymous with economic growth, the Crowd will continue to grow at an astounding pace.\(^29\) The world’s Internet user growth expanded over 500% between 2000 and 2011.\(^30\) The number of individuals with Internet access around the world was recently estimated at 2.4 billion, representing roughly one-third of the world’s population.\(^31\) Asia expects to see the largest Internet usage growth, as India and China pursue ways to increase their country’s connectivity. The number of Internet users in China, for example, grew from 22.5 million in 2000 to 420 million in 2010.\(^32\) Of course, not all of those individuals have capital to contribute, and thus not all can be considered part of the Crowd as it relates to e-commerce, but the potential is there for each individual, when they have the funds, to contribute to an entrepreneurial investment either in their own community or across the globe.

The global Crowd has grown into a dominant commercial force, and has fueled phenomenal economic expansion over the Internet.\(^33\) Increased global Internet access, combined with the arrival of secure money transfer platforms, have allowed e-commerce to evolve into one of the fastest growing industries. Websites such as Amazon, eBay, Craigslist, and Listia all depend on the Crowd for their business.\(^34\) The exploding “app”

\(^{31}\) Id.
\(^{33}\) See Burkett, supra note 28, at 72 n.55.
\(^{34}\) See Jeff Howe, \textit{Crowdsourcing: Why the Power of the Crowd is Driving the Future of Business} 121 (2008) (“What’s clear is that online communities are leading to an increase in bridging social capital on a broad, global level.”).
industry, which includes the various applications available to consumers through cellphones, most notably the iPhone, is, in many ways, dependent on the Crowd for its revenue. In just five years, the industry has, as iPhone usage has spread across the globe, grown into a multibillion dollar industry that employs roughly half a million people

B. Crowdfunding, Charities, and Investing

Crowdfunding is the derivative of microfinance and crowdsourcing, two innovations that have grown impressively along with the Internet.\footnote{Bradford, supra note 5, at 27.} Microfinance, or microcredit, is the “providing [of] very small loans without collateral at full-cost interest rates that [are] repayable in frequent instalments [sic].”\footnote{UNITED NATIONS DEVELOPMENT PROGRAMME, ESSENTIALS: MICROFINANCE 1 (1999).} It was developed in the 1970s by nongovernmental organizations and banks located in developing countries such as Indonesia, Bangladesh, and Bolivia.\footnote{Id. (stating that these banks “demonstrated that the poor majority, who are generally excluded from the formal financial sector, can, in fact, be a market niche for innovative banking services that are commercially sustainable.”).} Mohammed Yunus won the 2006 Nobel Peace Prize for his pioneering of microfinance, and his bank, Grameen Bank of Bangladesh, has lent over $9 billion in the past thirty years to micro-entrepreneurs in 37 countries.\footnote{Susanna Khavul, Microfinance: Creating Opportunities for the Poor?, THE NEELEY SCHOOL OF BUSINESS, 57 (2010), available at http://www.neeley.tcu.edu/uploadedFiles/Academic_Departments/Management/zol003102949pp.pdf.} Microfinance is often considered a financial innovation “that has as its primary aim poverty alleviation.”\footnote{Michael S. Barr, Microfinance and Financial Development, 26 MICH. J. INT’L L. 271, 273 (2004).}
some ways, crowdfunding is the inverse of microfinance; instead of one institution making loans to thousands of individuals, crowdfunding allows thousands of individuals to make contributions to a single entrepreneur or small business.

Crowdsourcing exists “when a profit oriented firm outsources specific tasks essential for the making or sale of its product to the general public (the crowd) in the form of an open call over the internet” in an effort to solicit the contributions of individuals for “free or for significantly less than that contribution is worth.” One of the best-known examples of the power of crowdsourcing is Wikipedia. The online encyclopedia is built on contributions of thousands of individuals and, while it does not possess the traditional informational oversight, it is considered surprisingly reliable. Other products created by crowdsourcing contributions include the Google search engine algorithm and the Linux operating system.

Crowdfunding investing, or equity crowdfunding, is often described as a blend of social media and venture capital. Social media has enabled much of the recent growth of crowdsourcing by serving as a vehicle to connect entrepreneurs and investors. As the Crowd grows at an astounding pace, it becomes easier for individuals to connect and share information with both friends and strangers. The potential for crowdfunding increases with this flow of information. Social media platforms stand to be the major vehicle for entrepreneurs to access the power of the Crowd, just as Facebook and Twitter helped Michael

44. Id. at 19.
46. See Bradford, supra note 5, at 27–28.
47. See, e.g., David Coursey, Crowd Funding an Option for Start-Ups?, FORBES (Nov. 8, 2011, 3:40 PM), http://www.forbes.com/sites/davidcoursey/2011/11/08/crowd-funding-an-option-for-start-ups; KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 91 (2010) (“[T]he emerging incarnation of crowdfunding is a result of many ongoing socio-economic trends, the removal of a number of inefficiencies which have plagued capital allocation for most of our history, and will be accompanied by force-multipliers derived from modern day social networking combined with some techniques which are better understood and applied in the financial sector.”).
48. See Howe, supra note 34, at 121 (“What’s clear is that online communities are leading to an increase in bridging social capital on a broad, global level.”).
49. See id. (“The architecture of social networking sites encourages connections between, as well as among, friend groups. In this way they are almost tailored to build up stocks of bridging social capital.”).
Migliozzi II and Brian Flatow raise over $200 million to fund their Pabst Blue Ribbon takeover idea.50

Luke Lang, co-founder of the United Kingdom crowdfunding website Crowdcube,51 calls crowdfunding a way to “‘democratize investment.’”52 This idea of allowing any individual with capital to invest in start-ups is appealing to lower net worth investors, as these investments are typically only available to the wealthy. Opening these contribution opportunities to anyone with access to a computer and capital makes the crowdfunding investing industry attractive to the American investor. In some ways, the interest in crowdfunding can be compared to the individual investor’s attraction to the IPO market, from which individual investors are typically precluded from investing. Investors may view an IPO as an exciting new idea that they want to be a part of and see grow, and individuals may be similarly drawn to the entrepreneurial enterprises in the crowdfunding industry.

According to Gartner Research, the crowdfunding industry as a whole raised a total of $1.6 billion in 2009, and Gartner expects this amount to swell to $6.2 billion by 2013.53 There are a number of crowdfunding websites currently available to investors, and while each platform has slight variations in its business model,54 each seeks to connect entrepreneurs and investors.

While this Article uses the terms crowdfunding and crowdfunding investing somewhat interchangeably, the latter represents the for-profit model, thus a distinction is necessary. Social media allows individuals to build relationships and, as many websites currently operating prove, social fundraising can be an effective tool to raise money. Contributing to a cause and investing in that cause are notably separate, the distinction being the

54. See Bradford, supra note 5, at 31–42 (Professor Bradford separates the current crowdfunding platforms into the following models: the donation model, the reward model, the pre-purchase model, the lending model, and the equity model); GPlus, supra note 53 (discussing the leading crowdfunding models and their variations, referencing: Kickstarter, Indiegogo, ProFounder, and FirstGiving).
expectation of profit. Contributing involves some benefit on the part of the donor in simply giving his or her money away to a start-up that he or she would like to see grow. The donor will likely only reach this benefit by contributing to individuals with whom he or she has some sort of relationship, whether it be family, friends, or even public forum acquaintances known only by username. Or perhaps the idea itself is so novel that the investor views the charitable contribution and his or her benevolence as warranted for the greater good of society.55

Investing, on the other hand, is done by individuals who care significantly less about the entrepreneur’s well-being, whose benevolence is irrelevant, and who likely want little to do with the entrepreneurial process. Instead, investors are primarily motivated by the return on their investment. While this impersonal approach is certainly not true of all investors, when you invite the Crowd, the result will be an average investor that builds a portfolio of crowdfunded investments and waits for their return. It is likely impossible for a start-up entrepreneur to create personal relationships with all of his or her investors, assuming the crowdfunding investing results in a large group of investors.56

Within the U.S. crowdfunding industry, there are two distinct models that are currently used, with the key difference being the expectation of investment return. Donation-based crowdfunding involves investors who do not expect any return on their investment, and is more analogous to charitable contributions than typical equity investing.57 The sites offering this type of crowdfunding include Kickstarter, RocketHub, IndieGoGo, Crowdrise, and Peerbackers.58 On these sites, entrepreneurs have raised up to $900,000 for an individual project, and the Pabst Blue Ribbon experiment provides an example that the possibilities are even greater.59 In 2010, Kickstarter, which permits crowdfunding fundraising with no equity investment available for investors, raised $27 million among roughly 3,910 successful projects and 386,373 individual contributions.60 The average contribution of Kickstarter contributors during the year was approximately

55. See Bradford, supra note 5, at 31–42.
56. Id.
58. Id.
59. Id.; see Ackerman, supra note 1.
Kickstarter offers no ownership or equity portions to the contributors, and the website takes roughly 5%, with Amazon charging another 3–5%.62 This donation model calls for individuals to make donations to an entrepreneur, and the donor benefits from seeing the business grow in size, and in some situations, the contributor will receive future rewards.63 Even when there is no expectation of profit, it is clear that the Crowd can raise significant and stimulating capital to help entrepreneurs and small businesses.

The second major model, investment-based crowdfunding, includes an expectation of profit by the investor. As a result, it is generating the most attention in Washington because of its enormous potential to facilitate the access to capital for entrepreneurs and small business. ProFounder and Bolstr currently employ this platform,64 but regulatory restrictions limit an entrepreneur’s crowd to family and friends.65 The result is a more community-based crowdfunding model that does not reach the weight of the Crowd. Entrepreneurs and small businesses using ProFounder were able to raise as much as $60,000 through this investment model, with an average investment of $1,500.66 While this model with the present regulatory restrictions may work for some entrepreneurs and small businesses, such as those with large pre-existing social networks or wealthy family and friends, it is not an ideal option for most issuers and fails to capture the full potential of the Crowd.

This Article focuses on the profit-seeking model, where investors seek financial returns on their investment. This is the approach that has the most potential for crowdfunding growth and invokes the most regulatory questions.

C. Current Regulatory Environment for Crowdfunding Investing

While crowdfunding in the form of political or charitable fundraising, or even contributing capital for the promise of a product in return, is

61. See id.
63. Shulga, supra note 57.
65. See Thomas Lee Hazen, Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure, 90 N.C. L. Rev. 1735, 1744 (2012) (stating that crowdfunding sites may be subject to requirements for registration); see, e.g., Marcia Kaplan, Crowdfunding: 5 Things You Should Know, CROWDSOURCING.ORG (Nov. 24, 2011), http://www.crowdsourcing.org/document/crowdfunding-5-things-you-should-know/8688 (state regulators recently forced ProFounderr to cease operations as they were operating as a broker without being a licensed broker-dealer).
66. Shulga, supra note 57.
currently permitted and practiced by many groups, crowdfunding with the expectation of a return on investment is prohibited under federal and state securities laws. Typically, an entrepreneur cannot sell a security without first registering it with the S.E.C. if that issuance fits the definition of a security as defined by case law.\textsuperscript{67} As a result, the capital raising options for entrepreneurs and small business are limited.

The definition of a security is broad and, as the Supreme Court established in \textit{S.E.C. v. W. J. Howey Co.}, a security is any contract that is (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) arising solely from the efforts of a promoter or third party.\textsuperscript{68} This test has been refined over the years and the question is now “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”\textsuperscript{69} If a company offers to sell a security, and does so without using an available exemption, the issuer must follow the applicable regulations established by the Securities Act of 1933.\textsuperscript{70} Any sale under the Securities Act of 1933 means that the issuer must abide by the applicable periodic reporting regulations established in the Securities Exchange Act of 1934.\textsuperscript{71} These acts, combined with subsequent federal securities regulation, focus on requiring adequate disclosures in order to inform potential investors.\textsuperscript{72} Section 5 of the 1933 Act, codified in 15 U.S.C. § 77e, makes it unlawful to offer or sell securities without providing the proper disclosure documents, which include a registration statement and a prospectus.\textsuperscript{73} The registration statement and prospectus are detailed documents that provide information about the issuer’s business operations, plans to use the funds, audited financial statements, and other information in an effort to fully inform the investor about the risk he or she is undertaking by purchasing the security.\textsuperscript{74} This cost of registering your security and the administrative burden that accompanies registration is prohibitive for entrepreneurs and small businesses, and is therefore an unlikely capital raising option.\textsuperscript{75}

\textsuperscript{68} Howey, 328 U.S. at 298.
\textsuperscript{69} SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973); see also Bradford, \textit{supra} note 5, at 31.
\textsuperscript{70} Act of May 27, 1933, ch. 38, 48 Stat. 74, 74 (1934) (codified at 15 U.S.C. § 77(a)).
\textsuperscript{71} Act of June 6, 1934, ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 77(a)).
\textsuperscript{72} Hazen, \textit{supra} note 65, at 1741. Professor Hazen points out that this emphasis on disclosure is based on Justice Brandeis’ belief that the best disinfectant is sunlight. \textit{Id.} at 1741 n.30.
\textsuperscript{73} 15 U.S.C. § 77e; Hazen, \textit{supra} note 65, at 1742.
\textsuperscript{74} Hazen, \textit{supra} note 65, at 1742.
\textsuperscript{75} Bradford, \textit{supra} note 5, at 42–43.
If a company fails to register under the 1933 Act, and does not take advantage of any available exemptions, the reporting requirements under the 1934 Act can be triggered by two separate events: the company either lists its securities on a major exchange or the issuer has more than $10 million in assets and more than 500 shareholders.\footnote{15 U.S.C. § 78l(g) (requiring issuers with more than $1 million in assets and greater than 500 shareholders to register); 17 C.F.R. § 240.12g-1 (2012) (raising the asset threshold from $1 million to $10 million); Hazen, supra note 65, at 1742–45.}

The exemptions available to entrepreneurs and small businesses under the current regulatory structure are either cost-prohibitive or severely limit the investing pools to ineffectively small crowds.\footnote{Bradford, supra note 5, at 44–48. Section 4(2), Rule 506, and Section 4(5) are restricted to sophisticated investors and prohibit general advertising or solicitation, which has been defined to be any non-preexisting relationship. Id. Rules 504 and 505 are also restricted by this general solicitation limitation.} Regulation A and Regulation D of the Securities Act of 1933 are the key exemptions available to small issuers, but neither is suitable to effectively reach the Crowd.

Regulation A exempts public offerings that do not exceed $5 million over a twelve month period.\footnote{James D. Cox et al., Securities Regulation: Cases and Materials 319 (6th ed. 2009).} Scholars refer to it as the mini-registration, and it was designed specifically for small businesses. The registration requirements for Registration A offerings are less demanding than the requirements under the 1933 Act, and as a result they are less costly.\footnote{See id.} This includes bad-actor disqualifications, which require that the exemption is not available if the issuer, or anyone directly related to the offering, has been convicted of a securities offense or similar offenses.\footnote{Thomas Lee Hazen & David L. Ratner, Securities Regulation in a Nutshell 76 (9th ed. 2006).} This exemption even provides the issuer an opportunity to “test the waters” as a way to gauge investor interest in its new issuance.\footnote{Cox et al., supra note 78, at 321. Investor reception is essential to a successful public offering because poor reception can have lasting effects on potential investor confidence and the issuer’s ability to raise capital in the future.} The appeal of Regulation A lies in its limited disclosure requirements, which call for an “‘offering circular’” that is significantly less troublesome than the typical registration statement.\footnote{Hazen & Ratner, supra note 81, at 77.} Additionally, the issuer raising capital under Regulation A is not required to provide audited financial statements and is exempt from the standard periodic reporting obligations of the 1934 Act, further reducing the burden of capital raising.\footnote{Id.}
Perhaps the greatest advantage of Regulation A for small business issuers in the crowdfunding context is the absence of any general solicitation restriction.85 This general solicitation restriction, which is common among the federal securities registration exemptions, means that the issuer can only sell shares to individuals with whom he or she has a pre-existing relationship.86 In theory, if there is a general solicitation exemption, a potential issuer could reach out to an existing Facebook, MySpace, or LinkedIn network and solicit investments from already established contacts, as these connections would represent a pre-existing relationship. However, the capital raising power of the Crowd will not be reached solely through an existing network.

Some crowdfunding platforms have attempted to abide by the general solicitation restriction, limiting the Crowd to investors of which the issuer has a pre-existing relationship.87 ProFounder’s revenue-sharing model utilizes this exemption, and charges issuers fees to file the appropriate forms with federal and state regulators.88 State laws often cap the number of investors that may participate.89 Limiting the potential investor group in such a manner severely restricts the power of the Crowd. Therefore the exemption is an unrealistic solution. Despite efforts to make this exemption more available to small issuers,90 the exemption is still considered underutilized due to the inability to preempt state laws, which forces issuers into state registration and the associated costs.91

Regulation A disclosure costs, however, averaged $40,000–$60,000 in 1997 and may still be prohibitive to many small businesses and entrepreneurs seeking to utilize the crowdfunding investing industry.92 It is likely that Regulation A will be more beneficial for small businesses and entrepreneurs once they pass their initial stages of financing, whether that comes from crowdfunding or not. At the very least, it highlights the commitment to loosen restrictions to the issuance market, and to create a smaller-scale IPO market.

85. COX ET AL., supra note 78, at 323.
86. HAZEN & RATNER, supra note 81, at 77; Bradford, supra note 5, at 47–48.
88. Shulga, supra note 57; Bradford, supra note 5 at 47-48.
89. Shulga, supra note 57.
90. In 1992, the offering size was increased from $1.5 million to $5 million. HAZEN & RATNER, supra note 81, at 77. The agency also relaxed the disclosure and solicitation limitations of the bill. Id. ("[T]he SEC significantly liberalized Regulation A . . . [by] allowing the disclosures in the offering circular to be made in question-and-answer rather than narrative form, [by] allowing the issuer to solicit ‘indications of interest’ from potential investors before filing the offering circular, and [by] permitting offers to be made immediately after the filing of the offering statement.").
91. COX ET AL., supra note 78, at 323.
92. See id. at 319 (Regulation A is an “underutilized alternative to Regulation D.”).
Regulation D also addresses small and private offerings and is more frequently used than Regulation A. With Regulation D, Rule 504 exempts offerings under $1 million, but is restricted by the general solicitation limitation, unless the sale is to accredited investors. The Crowd is predominantly built from unaccredited investors, and as a result, Rules 504, 505, and 506 are not feasible channels to reach the Crowd. Both Rules 505 and 506, which exempt sales up to $5 million to 35 unaccredited investors and an unlimited number of accredited investors, are also restricted by general solicitation restrictions.

Section 3(a)(11) of the 1933 Act exempts solely intrastate offerings from registration. In order to qualify under this exemption, the issuer must “[1] be incorporated in the state in which the securities are being sold; [2] carry out a significant amount of its business in that state; and [3] make offers and sales only to residents of that state.”

If crowdfunding were to

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94. COX ET AL., supra note 78, at 323. An accredited investor is defined as
1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
3. a charitable organization, corporation, or partnership with assets exceeding $5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person;
7. a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

95. 17 C.F.R. § 230.502(c)–505(b) (2012).
97. Id. The actual text reads:
Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.
be narrowed to state-by-state Crowds, this might be a feasible way to exempt for-profit crowdfunding investing. Of course, by limiting the crowds, you severely restrict the capital power of the masses.

There are also ongoing attempts to increase the registration threshold, currently at 500 equity holders, by amending Section 12(g) of the 1934 Act.\(^98\) This threshold, when reached, forces the private company to register with the S.E.C. and to comply with all of the reporting requirements of the 1934 Act.\(^99\) Allowing private companies to avoid this costly undertaking allows for more efficient capital raising, and perhaps will make it more likely for companies to sell equity shares to raise money as previous cost burdens are lifted.

Because crowdfunding is most likely to be executed over the Internet, maintaining this state exemption will be administratively difficult. First, under the intrastate exemption, the issuer must confirm the residence of each investor, and if just one of the investors is not a state resident, then the exemption may be lost.\(^100\) Secondly, if an investor resells the security to an out-of-state purchaser, then the exemption is likely defeated.\(^101\) Lastly, if the issuer grows its business, which is the likely goal of crowdfunding, and a substantial portion of its revenues come from out of state, then the exemption may not be available.\(^102\)

\[D. \text{ The Momentum Behind Crowdfunding}\]

Crowdfunding has the ability to alleviate financing limitations primarily for two groups of businesspeople: budding entrepreneurs in search of capital to transform an idea into a revenue-producing product or service, and small businesses that need financing to either maintain operations or to grow their businesses. Both groups face challenges in our country’s current lending environment.

Entrepreneurs face significant challenges in obtaining adequate financing to fund their expansion and to help their ideas get off the ground.\(^103\) While the perception is that entrepreneurs rely heavily on

\(^98.\) News Bulletin: Legislative Action on Exchange Act Registration Thresholds, Morrison & Foerster, June 21, 2011, available at http://www.mofo.com/files/Uploads/Images/110621-Legislative-Action-on-Exchange-Act-Registration-Thresholds.pdf. There are two bills that were in the House of Representatives, one called for an increase to 1,000 equity holders, the other to 2,000 equity holders. Id.

\(^99.\) Id.

\(^100.\) Id.

\(^101.\) Id.

\(^102.\) Id.

\(^103.\) See Andy Cosh et al., Outside Entrepreneurial Capital, 119 ECON. J. 1494, 1530 (2009) (“Small firms without significant assets have difficulty obtaining bank finance.
family, friends, venture capital firms, or angel investors to secure funding for their ideas, economists suggest that bank lending is the most used source of financing by start-ups.\footnote{104} Because of this dependence on bank financing, and the severe harm recently inflicted upon the U.S. banking industry, entrepreneurs’ options for financing are limited.\footnote{105} Additionally, venture capital firms and angel investors are often not willing to expose themselves to the inherent risks that are involved with start-up investing.\footnote{106}

Entrepreneurs in search of financing are often isolated not only because of their size, but often because of their location. Venture capital firms are typically much closer geographically to their investments, with some studies showing an average of just 70 miles between the lead venture capital firm and the target firm.\footnote{107} Locations such as Silicon Valley, Boston, Seattle, Denver, New York, and Austin contain not only the venture capital leaders but also many industry experts.\footnote{108} Economists have found a strong correlation between the geographic proximity of the investor and the investment.\footnote{109} Crowdfunding, on the other hand, connects Young, high growth innovative firms without significant assets or profits seek capital from venture capital funds but venture capital is not widely available and rejection rates are quite high.”).\footnote{104 Alicia M. Robb & David T. Robinson, The Capital Structure Decisions of New Firms, THE KAUFFMAN FIRM SURVEY, Nov. 2008, available at http://www.kauffman.org/uploadedfiles/Capital_Structure_Decisions_New_Firms.pdf. This study tracked nearly 5,000 firms beginning in 2004 and through their first few years of operation to draw conclusions on financing decisions made by entrepreneurs. See also Policy Brief: Financing SMEs and Entrepreneurs, ORG. FOR ECON. CO-OPERATION & DEV., Nov. 2006, available at http://www.oecd.org/dataoecd/53/27/37704120.pdf (stating that among OECD countries, small and medium-sized enterprises, as well as entrepreneurs, are more likely to be dependent on bank financing than any other type of lending).}

Venture capital raising was also hard hit by the recent financial crisis, and some would say it never recovered from the Internet bubble in 2000. \footnote{105 See The Cost of Repair: A Battered Finance Sector Means Slower Growth, THE ECONOMIST, Oct. 7, 2010, http://www.economist.com/node/17173933 (discussing how “new firms borrow seven times as much from banks as they do from friends and family”).}

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Venture capital raising was also hard hit by the recent financial crisis, and some would say it never recovered from the Internet bubble in 2000. \footnote{108 See Sorenson & Stuart, supra note 107, at 26 (“[A] lead VC . . . is more likely to form a syndicate relationship with [a] potential partner . . . if they are geographically proximate.”). Other studies have shown that “[v]enture capitalists invest in companies 10
investors and entrepreneurs who are located in different parts of the
globe,\textsuperscript{110} and has the potential to stimulate job growth internationally.

Small businesses account for roughly half of American employment
and are essential to job creation.\textsuperscript{111} Empirical evidence suggests that the
current economic environment, slowly healing in the wake of the 2008
financial crisis, has harmed small businesses at a disproportionately high
rate, in turn contributing disproportionately to the country’s high
unemployment rate.\textsuperscript{112} Large businesses have access to capital markets to
raise money, while small businesses are dependent on bank financing, and
as a result, are vulnerable to “credit crunch” scenarios.\textsuperscript{113} So, as banks
tighten their lending standards, the finances of small businesses are
squeezed the hardest and they are forced to close their doors or reduce
staff. As job creation persists as a high priority for legislators and
economists, crowdfunding is viewed as an alternative to this dependence on
bank lending.

Some even view the crowdfunding legislation as a mechanism to
neuter Wall Street banks’ hold on the capital markets industry because

\textsuperscript{110} See Ajay Agrawal et al., \textit{The Geography of Crowdfunding}, NAT’L BUREAU OF
from Sellaband’s crowdfuding website that analyzed 4,712 investments over a roughly
three-year period and showed that the mean distance between the investor and the
entrepreneur was 3,000 miles).

\textsuperscript{111} Ben S. Bernanke, \textit{Restoring the Flow of Credit to Small Businesses} at the
FEDERAL RESERVE MEETING SERIES: “Addressing the Financing Needs of Small
Businesses” (July 12, 2010). Bernanke addressed the job creation power of entrepreneurs
that grow into small businesses, stating “[n]ewer small businesses, those less than two years
old, are especially important: Over the past 20 years, these start-up enterprises accounted
for roughly one-quarter of gross job creation even though they employed less than 10
percent of the workforce.” \textit{Id.} (defining small businesses as any business that employs less
than 500 workers). Among the Organisation for Economic Co-operation and Development
(OECD) countries, medium and small businesses account for over 95 percent of all
enterprises, and reflect 60–70 percent of net job creation. \textit{Policy Brief: Financing SMEs
and Entrepreneurs, supra note 104.}

\textsuperscript{112} See Burcu Duygan-Bump et al., Financing Constraints and Unemployment:
(“[W]orkers are more likely to become unemployed if they work in sectors with high
external financial dependence. In these sectors the impact of the recession on the likelihood
of becoming unemployed is stronger for workers in smaller firms.”).

\textsuperscript{113} \textit{Id.} at 2–3, 18–19. The study also analyzed the current recession against the
Savings & Loan crisis in the early 1990s and the 2001 recession. The increase in
unemployment rate among small businesses was present in the early 1990s, as the Savings
& Loan crisis originated in banking, but was absent from the 2001 recession, which
originated in the technology sector. This comparison confirms the study’s conclusion that
the credit supply shock leads to disproportionately high small businesses layoffs. \textit{Id.}
permitting unaccredited investors to connect to businesses and entrepreneurs may eliminate a portion of the fees that banks charge in capital-raising transactions. However, it is likely that the investment banking industry can maintain its connection to all forms of capital raising by simply buying the crowdfunding investing platforms.

As a result of the increasing difficulties entrepreneurs and small businesses face in raising capital, as well as intensified political focus on job creation and its ties to potential crowdfunding issuers, momentum urging the S.E.C. to create an exemption that would allow for increases in crowdfunding investing is felt in many different mediums. Not surprisingly, the momentum is powerfully displayed on the platform through which crowdfunding would ultimately take place, the Internet. Proponents have created websites and blogs devoted to changing current regulations to allow for crowdfunding investing to take place more freely. More striking is the momentum in Washington, D.C., where the crowdfunding exemption has considerable traction and has given hope to a federally sanctioned cultivation of the crowdfunding industry, most recently in the form of the JOBS Act.

European lawmakers face the same problems of high unemployment that American lawmakers do, and likewise view crowdfunding as a potential remedy and economic stimulant. On September 28, 2011,

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116. While disclosure requirements in the U.S. are typically more expensive than in foreign jurisdictions, the administrative burdens likely still prohibit many small businesses and entrepreneurs from raising capital. Tim Kappel, Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?, 29 LOY. L.A. ENT. L. REV. 375, 383–84 (2009). There are similar exemptions in place in the European Union to permit small capital raising (under €2.5 million) without the burdens of repeated and costly disclosure, but these exemptions, as in the U.S., are limited by a general solicitation restriction. Tony Watts, Crowdfunding: Raising Funds from those You Know, KEYNOTES 4 (2011), available at http://opencoffee.3783750.n2.nabble.com/attachment/5040633/3/Crowdfunding%20Keynotes.pdf (“[A] word of warning: the rules have been designed to regulate and restrict any type of investment or potential investment being communicated to and sold to the public. Therefore, crowdfunding, which relies on many small investments being made by a large number of people, may be in conflict with these rules.”). Less specific to crowdfunding, the U.K. recently attempted to deregulate its public offering prospectus requirements making it easier for issuers to raise capital. McDERMOTT WILL & EMERY, DEREGULATION OF PUBLIC OFFERING PROSPECTUS REQUIREMENTS (2011), available at http://www.jdsupra.com/post/documentViewer.aspx?fid=371fba2-ef43-44cb-a34a-47e27396014. The Prospectus Directive being amended generally dictates when a company must disclose information to the public via a costly prospectus. The goals of these requirements are the same as the disclosure intentions in the U.S.: to protect investors through complete knowledge of their investment. Id. The amendments are designed to
Portugal hosted the first international crowdfunding event, with particular attention paid to crowdfunding investing. On November 18, 2011, at the Agorada convention in Bielsko-Biała, Poland, which was sponsored by the European Association of Development Agencies, issued a formal declaration on crowdfunding, proposing guidelines for the support of E.U. states for the future of crowdfunding. The declaration was short on regulatory details, but it did highlight broad goals for the crowdfunding industry and suggested a growing E.U. administrative commitment to crowdfunding cultivation. Following the commitment, a British company called Seedrs received regulatory approval to become the first equity crowdfunding platform in the world, and simultaneously, won a top entrepreneurial award in Europe. However, the issuances hosted on these particular platforms are not available to U.S. investors.

Due to the global nature of the Crowd, a concerted international effort to create crowdfunding channels seems prudent. The capital markets framework and securities regulation is currently inconsistent in its cross-border requirements, despite most freely traded companies being comprised of investors from around the world. The crowdfunding initiative should embrace the Crowd’s expansion by creating one set of requirements attainable by all investors and issuers around the world. If a registered intermediary is necessary, one agency should have the power to approve applications from worldwide participants. Without such inclusion, the Crowd will be limited in its ability to fund new businesses. The JOBS Act is a start toward this, but greater collaboration across the globe will increase the capital raising power of the Crowd.

reduce administrative burdens for issuers, particularly the smaller companies for which the costs prohibit capital raising. Specifically, the amendments increase the number of investors that triggers a prospectus requirement from 100 to 150, and also increases the offering size threshold from €2.5 million to €5 million. Id.


119. See AGORADA 2011, BIELSKO-BIALA DECLARATION, REALISING THE FULL POTENTIAL OF CROWDFUNDING INITIATIVES, supra note 118.


121. See generally Watts, supra note 116, at 4.
II. PENDING LEGISLATION — FOUR PROPOSALS IN SEARCH OF BALANCE

Four proposals for a federal securities exemption for crowdfunding were considered during the last congressional session, and the JOBS Act, passed in April 2012, represents an integration of the prior three submissions. Each proposal sought to balance investor protection with reducing regulatory hurdles for businesses raising capital through crowdfunding.

A. The Entrepreneur Access to Capital Act

In early November 2011, the House passed the first attempt at a viable crowdfunding law.\(^{122}\) The Entrepreneur Access to Capital Act, H.R. 2930, essentially creates a crowdfunding safe-haven within securities laws. There are, of course, essential restrictions with which the small business must comply. First, the issuer “may only raise a maximum of $1 million, or $2 million if the [issuer] provides potential investors with audited financial statements.”\(^{123}\) Secondly, each investor is limited to investing “the lesser of (1) $10,000 or (2) 10% of his or her annual income.”\(^{124}\) Lastly, the issuer must take a number of steps to limit the risk to investors, including (i) warning them of the speculative nature of the investment and the limitations on resale, (ii) requiring them to answer questions demonstrating their understanding of the risks, and (iii) providing notice to the SEC of the offering, including certain prescribed information.\(^{125}\)

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122. Jim Abrams, House Bills Ease SEC Rules on Raising Capital, SEATTLE TIMES, Nov. 3, 2011, http://seattletimes.com/html/politics/2016681283_apuscongresssecrules.html. As a supplement to the Entrepreneur Access to Capital Act, the House passed the Access to Capital for Job Creators Act, H.R. 2940, which amends section 4(2) of the 1933 Act to exclude the general solicitation limitation. Andrew Ledbetter, House Overwhelmingly Approves General Solicitation of Accredited Investors, VENTURE ALLEY BLOG (Nov. 8, 2011), http://www.theventurealley.com/startups/house-overwhelmingly-approves-general-solicitation-of-accredited-investors/ (discussing “transactions by an issuer not involving any public offering, whether or not such transactions involve general solicitation or general advertising”). The bill also requires the S.E.C. to amend the existing securities exemption Rule 506 of Regulation D to “[p]ermit general solicitation or general advertising in offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors; and [r]equire the issuer to take ‘reasonable steps’ to verify that purchasers of the securities are accredited investors.” Id.


124. Id.

125. Id.
Additionally, the bill acknowledges that online crowdfunding platforms will serve as the intermediary for this form of capital raising, a necessary step to establish reputable crowdfunding platforms that will set the operational standards for the flow of information. The bill incorporates bad-actor disqualifications, which essentially prohibit known securities violators from participating in the crowdfunding industry.

B. Democratizing Access to Capital Act

The second bill, S. 1791, is the Democratizing Access to Capital Act, which in November 2011 was introduced by Senator Scott Brown of Massachusetts. S. 1791 at its core is similar to H.R. 2930, but with three key alterations. First, S. 1791 reduces the possible individual investment from $10,000, or 10% of annual income, to $1,000 per person. Second, the language of S. 1791 states that in order to utilize the federal securities exemption provided in the bill, the capital raising must be done through a crowdfunding platform. Finally, S. 1791 requires that the issuer raising capital be registered in at least one state, perhaps opening the door for greater state regulatory oversight and appeasing the North American Securities Administration Association (NASAA).

C. Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011

The third draft of crowdfunding legislation was introduced by Senator Jeff Merkley of Oregon on December 9, 2011, titled Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, or S. 1790. This draft limits the investment amount per issuance to “$500 for those with income less than $50,000; up to 1% of annual income for those” with an income between $50,000 and $100,000; and up to 2% of annual income for individuals with an income greater than $100,000. S. 1790 also limits the amount an individual can spend per year to $2,000 for individuals with incomes under $50,000, up to 4% of annual income for individuals with an income between $50,000 and $100,000, and up to 8%


127. Id.


129. Id.

130. Id.


132. Id.
of annual income for those with an income greater than $100,000. This bill also contains a "funding portal," which is designed to screen issuers, educate investors, and track investor income levels, all subject to S.E.C. oversight.

D. Proposal from the States

Prior to the swift passage of the JOBS Act, the NASAA, a trade group for state regulators, appeared to be drafting a fourth bill, and outlined its key proposals in response to the bills currently in the Senate. The central tenet of the NASAA proposal is that it situates state regulators as the lead governing group over crowdfunding and any similar expansion of small business capital formation. At $500,000, the offering size limitation in the NASAA proposal is less than the House or Senate bills, and a single investor's contribution is capped at $1,000, regardless of the investor's income. In an effort to streamline state filings, the proposal has language that suggests the issuer will need to file with the state in which the business is located, and it is up to the state to "share the information with other states upon request."

State regulators are opposed to the pending legislation as they fear that preempting state regulation will result in inadequate protection of investor interests. The NASAA formed a committee to explore ways state regulators can help encourage capital raising for entrepreneurs, but warned of the possibility of fraud if states were excluded from the regulatory process under H.R. 2930. NASAA President Jack Herstein said that prohibiting state securities regulators from being notified and reviewing investment opportunities before they are offered to the public . . . will weaken investor protection . . . . Con artists will undoubtedly flock to

133. Id.
136. Esposti, supra note 7.
137. Hearings, supra note 135; Carleton, supra note 134.
138. Id.
crowdfunding websites, lured both by the increased dollar amount of investments and the fact that a tough cop has been taken off the beat. He also wrote a letter to Speaker of the House John Boehner and Minority Leader Nancy Pelosi, voicing his institution’s specific opposition to the initial crowdfunding bill, H.R. 2930. NASAA’s concerns about H.R. 2930 are (1) that the preemption of state law requires disclosures to protect investors; (2) the individual investment cap is not low enough to protect American households; and (3) that the aggregate offering cap of $2 million is too high, and a company that can raise that amount should be able to “comply with the applicable registration and filing requirements.”

NASAA argues that if federal disclosure requirements are relaxed in order to facilitate entrepreneur and small business financing, then state regulators are best positioned to oversee the new offering frontier, as they are the “undisputed leaders in criminal prosecutions of securities violators.” An argument to allow the federal exemption to avoid state regulations is that the administrative burden of complying with state regulations will be costly and prohibit many small businesses from being able to participate in any crowdfunding issuance. The regulatory questions that the bill invokes highlight the embryonic nature of this industry, and for many legislators, perhaps the need for closer scrutiny to the potentialities of crowdfunding capital raising.

E. Jumpstart Our Business Startups Act

Representative Stephen Fincher of Tennessee introduced the Jumpstart Our Business Startups Act, and it passed through the House and Senate in March 2012. The bipartisan support for the bill is impressive: it passed the Senate with a 73-26 vote, and the amended version passed the House

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140. Id.
142. Id.
143. Hearings, supra note 135 (Herstein adds that in 2010, “state securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions.”).
144. See Esposti, supra note 7.
145. See LAWTON & MAROM, supra note 47, at 71 (“Crowdfunding is in a very early and noticeably unsettled state.”).
The bill aims to ease capital raising for small companies through four mechanisms: (1) creating a new issuer class called “emerging growth company,” (2) eliminating the general solicitation restriction on private Rule 506 offerings, (3) raising the shareholder threshold that triggers costly S.E.C. reporting, and (4) creating a specific crowdfunding exemption.148

The new issuer classification will permit some small companies to execute an IPO in a more cost efficient and less burdensome manner. An “emerging growth company” must be a company that has “less than . . . $1 billion in annual revenue,” has been “publicly traded for less than five years,” has a “public float of shares worth less than . . . $700 million,” and has “not issued . . . $1 billion in debt over a three-year period.”149 Many companies that are considering an IPO fall into this new classification, and the easing of IPO administrative burdens will make the decision to go public more appealing to this new class.

The general solicitation restriction, which makes many federal securities exemptions designed for small businesses largely unattractive for crowdfunding purposes,150 will be lifted for Rule 506 of Regulation D, as long as all investors are accredited investors, and also allows general solicitation and advertising for Rule 144A resales.151 Additionally, the bill raises the Regulation A exemption, which is not limited to accredited investors, from $5 million to $50 million.152 This adjustment will make it easier for issuers to identify large investors, but does nothing to reach the unaccredited Crowd.

Section 12(g) of the Securities Exchange Act requires an issuer to register a class of securities with the S.E.C. if the shareholder base is larger than 500 investors and has more than $10 million in shareholder value.153

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149. JOBS Act Passes Congress, Heads to White House for Signature, supra note 148. The reduced burdens include: only two years of audited financial statements as opposed to three in their IPO filings, specific exclusions from executive compensation control portions of Dodd-Frank Act, safety from new financial accounting standards until a private company standard is set, and less audit company selection restrictions. Id.
150. See supra Part II.C.
151. JOBS Act Passes Congress, Heads to White House for Signature, supra note 148.
152. Id.
153. 17 C.F.R. § 240.12g-1 (2012); JOBS Act Passes Congress, Heads to White House for Signature, supra note 148.
The JOBS Act seeks to increase the shareholder threshold to 2,000 accredited or 500 unaccredited investors. This permits investors to stay private longer and avoid the accidental triggering of federal securities laws.

Most importantly to crowdfunding, the JOBS Act specifically carves out an exemption from federal securities laws for crowdfunded offerings. The exemption applies to crowdfunded offerings smaller than $1 million over a twelve month period, or smaller than $2 million if the issuer provides audited financial statements. The bill sets investor participation limits for individuals earning less than $100,000 in annual income at $2,000 or 5% of annual income (whichever is greater) and for individuals earning more than or equal to $100,000, at 10% of annual income or a maximum of $100,000. States and the NASAA as regulatory bodies are ignored in the bill as blue sky laws are generally preempted by JOBS Act. However, the states do retain enforcement capabilities if the issuer, investor, or funding portal commit fraud or engage in any unlawful activity.

Crowdfunding issuers must disclose potential investors.

Issuers that participate in crowdfunding will be required to file with the SEC and disclose to potential investors: (1) the issuer’s name, legal status, physical address and website; (2) the names of the directors, officers and shareholders with more than 20% ownership interest; (3) a description of the issuer and the issuer’s anticipated business plan; (4) a description of the issuer’s financial condition; (5) the intended purpose for the proceeds; (6) the target amount of the offering and the deadline to reach that amount; (7) the price or method of calculating the price of the securities to the public; (8) a description of the ownership and capital structure of the issuer; and (9) any other information that the SEC may require by rule to protect investors. These nine disclosures are mandatory.

The JOBS Act puts considerable responsibility on the intermediary, or “funding portal,” to verse compliance with crowdfunding regulations. The offerings must be executed through an S.E.C.-registered intermediary that

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157. *Id.*


159. *Id.* at 5.
will have a simpler registration process than typical brokers. The intermediary is required to warn investors of the “speculative nature generally applicable to investments in startups, emerging businesses, and small issuers,” and also warn them of the resale restrictions of one year. The specific resale restrictions generally do not apply to sales to accredited investors or back to the issuer. The intermediary must also ensure that each investor answers questions demonstrating an understanding of the risk of startup and illiquid investments. The intermediary is responsible for obtaining a background and securities enforcement history on each director, officer, and large shareholder, and is required to share that information to the potential investor. To avoid a conflict of interest, directors, officers, and partners of intermediaries are not permitted to have any financial interest in the issuer.

The bill permits the S.E.C. considerable discretion in determining what information must be disclosed and in what manner it must be done, but the White House is attempting to curb against an active rulemaking period.

President Obama signed the bill into law on April 5, 2012, and issued a statement “directing the Treasury Department, Small Business Administration and Department of Justice to closely monitor the implementation of this legislation to ensure that it is achieving its goals of enhancing access capital while maintaining appropriate investor protections.” It also required those agencies, in close consultation with the S.E.C., to report their progress and any recommendations to the White House. Additionally, a “consortium of crowdfunding companies” sent a letter to President Obama following the signing of the bill stating their commitment to working with the S.E.C. in developing an appropriate level of regulation, “including an enforceable code of conduct for crowdfunding platforms, standardized methods to ensure that investors do not exceed

160. Id.
162. SUTHERLAND ASBILL & BRENNAN LLP, supra note 158, at 6.
163. Id.
164. Id.
165. See id.
statutory limits, thorough vetting of companies raising funds through
crowdfunding, and an industry standard ‘Investors’ Bill of Rights.”

The JOBS Act instructs the S.E.C. to implement the legislation, after
proper rulemaking processes, by April 5, 2013. The S.E.C. should be
careful not to stifle the crowdfunding industry and potential job creation
with over-regulation. Instead, the agency should maintain its emphasis on
intermediary responsibility and let the market dictate the appropriate level
of regulations in order to maximize the capital raising possibilities of the
Crowd.

III. CROWDFUNDING CONCERNS: BALANCING ACCESS AND PROTECTION

A. Criticism and Response to Reduced Disclosure

Naturally, the JOBS Act and prior legislation proposals have received
a great deal of criticism, most of which reflects concerns over adequate
investor protection. The notion of reducing protections for investors that
typically have less capital to contribute runs counter to one of the basic
tenets of securities regulation: that regulators must protect individual
investors who cannot fend for themselves. The S.E.C.’s mission is to
protect investors and maintain market integrity, so the agency will not
likely support crowdfunding exemptions that allow for an acceptable
expected level of fraud. S.E.C. Chair Mary Schapiro has been an opponent
of reducing investor protections from the beginning of the crowdfunding’s
legislative momentum, and warned that the JOBS Act would increase fraud
and confidence in the marketplace would suffer, making capital raising
more challenging and expensive.

Investor protection is what drives financial regulatory procedures. Disclosure of the information and risks associated with a particular
investment protects investors, and much of the regulatory framework in place is designed to protect investors by providing them with access to information.\textsuperscript{174} Registering a security brings substantial legal fees in large part because of the difficulty in disclosing all material information to the investor through the Registration Statement, a thorough document that requires the issuer to disclose all material information to the company and offering.\textsuperscript{175} The screening process in place is prohibitive for many entrepreneurs and small businesses, as even the smallest offerings executed under Regulation A cost between $40,000 and $60,000,\textsuperscript{176} but the regulatory system is structured around ensuring a high level of disclosure to investors.

Securities law expert Professor Thomas Lee Hazen is also critical of the limited disclosure requirements of a crowdfunding exemption.\textsuperscript{177} He points out that while some arguments in favor of the crowdfunding legislation seem to rely on the old adage “good things come in small
packages, fraud can come in small packages, too.” As the influence of the Crowd is only impressive in its aggregation, the sum of fraud perpetrated on just a small portion of the Crowd could be damaging to the economy. Furthermore, Professor Hazen warns of the connectedness of individuals through online crowdfunding platforms enhancing the environment for fraud, as “the impersonal nature of the Internet would seem to call for more, rather than less, investor protection.” However, the modern stock market is equally impersonal and the advent of the online retail trading platforms has not resulted in increased disclosure requirements for the benefit of new retail participants. Both sophisticated and unsophisticated investors need some level of protection, but even the most sophisticated investors fall victim to fraud.

Many argue that the crowdfunding legislation, as it stands, opens the door for a significant amount of fraud and greater investor risk through inadequate disclosure. However, regulatory gaps are unavoidable even when the S.E.C. forces issuers listing on major exchanges to spend hundreds of thousands of dollars in pursuit of complete disclosure, and certainly they will be inescapable in the smaller issuances executed through the Crowd. It is also worth noting that among the $430 million raised between Kickstarter, Crowdcube, and Prosper Lending in the past few years, there have been “zero cases of fraud.” The “greed factor” that will be injected into the crowdfunding sphere when the JOBS Act legislation is implemented expects to change the dynamic of the crowdfunding as it has been experienced. The Crowd that will be enticed by equity investing will be drastically larger than that of the donation model. Kickstarter, which is often referenced as an example of the power of crowdfunding, is an unfair comparison, as equity options do not exist for issuers and investors. However, the financial incentive does not alter the motivations for fraud, and if the donation model has been successful at eliminating fraud, then equity investing can do the same.

The question then becomes a basic cost-benefit analysis: Are these regulatory gaps, which can cause many individuals to lose relatively small

178. Id. at 1765 (internal citations omitted).
179. Id. at 1766.
181. Popper, supra note 180.
amounts of money, tolerable? Are these risks outweighed by the benefit of economic growth and potential job creation from entrepreneurial and small businesses? As securities lawyer Mark Hiraide said before the Committee on Banking, Housing, and Urban Affairs and Subcommittee on Securities, Insurance, and Investment, “the challenge in adopting new legislation to stimulate early-stage capital formation is to maintain effective regulation over those [investing] professionals, while not imposing too high a regulatory barrier to entry, and to ensure that incentives are not inadvertently created that lead to the formation of unregulated securities markets.”183

It is difficult to perfectly align these two interests, as both sides contain unknown potentialities, the most extreme being the size and influence of the Crowd. There will be, as there always is in any industry with multiple transactions, some level of fraud. From the sub-prime crisis to the technology IPO boom to the elusiveness of insider trading, history has proven that regulators will always be a few steps behind the violators. The size and the power of the Crowd, and its willingness to contribute to crowdfunding enterprises are largely unknown, and cannot be understood without an attempt to open the crowdfunding investing doors. Of course, the participation of the Crowd will also largely depend on the enabling framework that is created, and regulators should be careful not to impose burdensome restrictions that kill the Crowd’s participation.

There are also concerns that venture capital or angel investors may be deterred from investing in that particular enterprise that has many unsophisticated investors with ownership or equity rights.184 With this potential lack of professional investors comes an absence of sophisticated investors who often take a mentoring approach in assisting entrepreneurs and small businesses towards maximum profitability.185 However, at the same time an increase in viable start-ups will be beneficial for the competitive landscape of venture capital bidding for the issuer. In addition, with a greater supply of possible investments, the venture capital market could grow as new wealth enters the industry. As additional start-ups are able to grow towards first production or expanded production, there will be a greater investment market for wealthy investors.


184. Esposti, supra note 7.

185. Id. Esposti suggests that crow sourcing of crowdfunding platforms will over time result in a suitable network community of cogent advice, similar to the advice a venture capital or angel investor might provide. Id.
B. More than One Path to Investor Protection

The Crowd is a new and emerging class of individuals with unique characteristics, which does not fit the mold of standard regulatory approaches. The S.E.C. should respect this and not impose overregulation of the Crowd that will choke the channels of capital raising.

The regulatory agencies may not be the appropriate groups to police the Crowd. They have not made a strong case in recent years for more of the oversight that they have been providing. Between the subprime mortgage crisis, Madoff, MF Global, and Robert Stanford, the last few years have proved that financial regulatory oversight is dangerously inefficient at regulating billion dollar transactions and entities. Is it fair to expect them to properly regulate small scale investments? Any smart investor will not “rely on the government or regulatory agencies to perform their due diligence,”186 and crowdfunding investing calls for increased communication among like-minded members of the Crowd.

The self-policing capabilities of the Crowd will play an equal role in oversight as the agencies, if not more. Current e-commerce companies such as eBay and Amazon permit users to rely, to some extent, on user reviews to police against fraud or misleading information.187 The Crowd’s participation in the rating system has proven effective in weeding out the fraudsters.188 The crowdfunding industry is different from that of most e-commerce companies, as the potential crowdfunding offerings will likely be considerably larger than the products which are being sold through e-commerce companies, but if the initial frauds can be tolerated, the end result will be a self-regulated framework with minimal administrative burdens for small businesses and entrepreneurs to raise capital.

The argument for transparency over disclosure is unique to the securities field, but is one that fits for the Crowd. Ryan Caldbeck, CEO of equity crowdfunding platform CircleUp, makes the transparency/disclosure distinction while stressing the inability of start-ups to bear the cost of audited financials, and instead urges self-policing of issuers through Internet forums.189 The Crowd has used forums and review systems in e-commerce sites in order to isolate risky sellers and promote established...
participants. Transparency initiated and promoted by the intermediaries is essential, and they have the financial incentive to see fraud minimized because without faith in the crowdfunding market, the industry will never progress.

Building confidence in the intermediary will be an important step to establishing a market in which investors can invest with confidence. The crowdfunding industry is preparing to promote confidence by establishing the Crowdfunding Accreditation for Platform Standards (CAPS), which reviews awards accreditation to funding portals based on interviews and reviews of their transactional processes. A more uniform and thoughtful set of accreditation standards established by the S.E.C. can help streamline this process and build market confidence. Permitting a group like CAPS to self-regulate can be effective because of their financial incentive in seeing this market succeed.

Self-policing in the form of forums and user reviews should be limited to the funding portal in order to maximize the quality and reliability of information. The crowdfunding platforms should resist the urge to engage social media sites, such as Twitter and Facebook, in direct participation as this will potentially welcome a flood of unverified, unreliable information. While social media sites can play an important role in maximizing the reach of the entrepreneur’s advertising, perhaps through verified user identification, regulations should be implemented by the S.E.C. to limit any misrepresentation or fraud.

A market-based approach to regulation will likely be more flexible than any S.E.C. restrictions that are established. If one intermediary fails by permitting high levels of fraud due to a certain inefficiency, CAPS or a similar private group should shift its criteria to avoid further failures, and simultaneously announce their changes to the Crowd. Open communication channels will let the Crowd know what risk factors are present in the changing crowdfunding market and they can adjust accordingly. Any failing crowdfunding platform will be forced out of the market, and trusted platforms will emerge as the market leaders for crowdfunding transactions. Investors are already limited in their loss capabilities through crowdfunding investing caps, but if investors do lose money consistently through crowdfunding initiatives they will simply remove themselves from the investor pool for future projects.

If fraud is a major deterrent in equity crowdfunding’s early days, investors may be more receptive to a funding portal owned by the state, who very well could be the ultimate enforcers if his or her investment falls victim to fraud. If creating the platforms themselves is not feasible, simply

190. See Hearings II, supra note 183.
accrediting or sponsoring a funding portal will be effective tools at communicating reliable platforms to the Crowd. Either way, creating a set of uniform standards or expectations for disclosure, whether that comes from the S.E.C., the state, or from a private intermediary, will help prevent the crime of misrepresentation and also ensure confidence in the market. Another way that intermediaries can ensure confidence in the market is by promoting a uniform set of best practices for issuers to achieve successful capital raising. Communication between the issuer and the Crowd of investors will be a challenge, but funding portals should streamline the process through required and scheduled disclosure of business developments to investors.

Additionally, states are uniquely positioned to be the enforcers of the JOBS Act deficiencies. Depending on the S.E.C.’s rulemaking, the states may become the sheriffs of this new capital-raising frontier. In a market where confidence is essential to survival and growth, states can help maintain market integrity. If the intermediaries cannot police themselves, or if the S.E.C. does not permit them to do so, the states can act as the intermediary for local business growth through investments from the Crowd. State specific accreditation standards for platforms may also be effective, as the states can compete with each other for tax revenues by experimenting with different intermediary requirements. Linking the enforcement and the funding portal will reassure the Crowd that their investments are safe.

States can also use the Act to achieve their own specific economic goals. For example, states could develop their own funding portals, perhaps in conjunction with local utility companies, to promote investments in renewable energy in order to reach their own greenhouse gas emission reduction goals established in their respective Renewable Portfolio Standards. Renewable energy projects are especially appealing to the Crowd because of the social benefit involved. For example, in the U.K., where equity-based crowdfunding is currently legal but not yet widespread, companies are attempting to use the crowdfunding method to fund wind turbine projects. The Crowd is drawn to such investments because of the combination of the profit-seeking and moral motivations.

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193. *Would You Invest a Fiver in a New Wind Turbine?*, BUSINESS GREEN (Apr. 20, 2012), http://www.businessgreen.com/bg/news/2169215/invest-fiver-wind-turbine/. Abundance Generation, a new equity crowdfunding website based in the U.K., and Resilient Energy launched the project to raise £1.3 million to build a wind turbine in Gloucestershire, England. *Id.* Abundance will raise the capital by offering bonds, and in return promising investors a share of the profits it makes generating green energy, which abundance expects to be a rate of return between 6.4% and 8.5% during the lifetime of the project. *Id.*
CONCLUSION

Public frustration over a stagnant economy, growing fervor over jobs creation, and expanded social media platforms have pushed the equity crowdfunding exemption into reality. The crowdfunding investing industry represents unchartered territory for both regulators and issuers, and in the early stages there certainly will be instances of fraud, but the net value of opening these channels of capital raising will be economic growth and job creation. The bridge between small businesses in need of financing and the individual unprofessional investors willing to contribute will not be built in a day. If the S.E.C. overregulates during the rulemaking period then the crowdfunding exemption will be stalled at the runway. Regulatory flexibility in the early stages of building the bridge will be essential to its long-term health, and permitting the Crowd to control itself, perhaps with the help of the states, will ensure that the entrepreneurs and small businesses across the country can choose crowdfunding as a viable capital-raising vehicle.

offering is open not only to individual investors, but also to pension plans, charities, and businesses. *Id.* The original investment will be paid back over the lifetime of the bond, or as a lump sum upon maturity. *Id.* The project is not yet complete, but Abundance Generation says that it expects to raise over £250 million through a number of green energy projects in the next twelve months. *Id.* This method of financing is expanding rapidly in Europe, and represents truly uncharted waters for community and Crowd-based investing. *Id.*