

**MUCH ADO ABOUT NOTHING:  
WHY THE EQUITY CROWDFUNDING EXEMPTION WILL ONLY BE  
USEFUL TO A FEW, AND WHAT TO DO ABOUT IT**

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*Abstract*

*In 2012, Congress passed the Jumpstart Our Business Startups (JOBS) Act, which included several reforms aimed at accelerating growth in a flagging US economy, especially among small businesses. Perhaps the most notable and controversial portion of the Act was Title III, which outlined a new registration exemption to be added to US securities laws. Under the new exemption, small businesses would be permitted to sell a limited amount of securities to the public through a registered web portal, without the need for a full public registration of the securities offering. The SEC issued Proposed Rules for the new exemption on October 23, 2013.*

*This new process for issuing securities was designed to be similar to an existing type of online fundraising, known as crowdfunding, in which project creators solicit donations to fund a particular project, cause, or product. In these fundraising campaigns, donors are typically rewarded with product samples or other small rewards, though the donors have no continuing ownership or other legal rights in the project. There was a hope that permitting project creators to issue securities through similar portals would allow the creators to raise more substantial amounts of capital, as well as providing contributors with a legal right to the potential upside of new business ventures.*

*The reaction to the SEC's Proposed Rules was extremely mixed. Crowdfunding advocates and many in the startup community hailed the rules as an exciting step forward that would provide high-growth enterprises with easier access to capital and allow the public to participate in investment opportunities that had previously been available only to a limited number of investors. However, other*

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*commentators attacked the rules for being overly burdensome on issuers or removing important investor protections.*

*This note provides a brief overview of the practice of crowdfunding, as well as an overview of the Proposed Rules and an examination of their place in the US securities laws. This note then provides an analysis of the advantages and disadvantages of the Proposed Rules to potential issuers, and weighs those costs and benefits in light of alternative methods of raising capital. Finally, this note proposes several changes to the proposed rules that would allow issuers to raise capital more easily, while preserving the SEC's mandate to protect investors from fraud.*

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## **I. Introduction**

When the Jumpstart Our Business Startups (JOBS) Act was signed into law by President Obama on April 5, 2012, many actors in both the public and private sectors hoped that the Act would usher in positive change.<sup>2</sup> The U.S. economy had recently endured its worst economic crisis in nearly a century, and recovery had come slowly. The Act, designed to facilitate more widespread investment in “emerging growth companies,” had been hailed as an important first step in modernizing the U.S. system of capital formation and securities regulation, and constituted a highly visible piece of the Obama administration’s economic policy.<sup>3</sup> Though the Act itself is an amalgam of several independent proposals introduced by a diverse group of legislators with divergent motivations, its underlying dual purposes are clear: “to help ease the regulatory burden of capital raising for startups and smaller companies leading to increased

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<sup>2</sup> See, e.g., Eileen Brown, *US Crowdfund Act: Good News for Investors and Entrepreneurs*, ZDNET (Apr. 4, 2012, 9:42 AM), <http://www.zdnet.com/article/us-crowdfund-act-good-news-for-micro-investors-and-entrepreneurs> [<http://perma.cc/TE77-PUNP>].

<sup>3</sup> See Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 101, 126 Stat. 306, 307-08 (2012) (codified in scattered sections of 15 U.S.C.) (“The term ‘emerging growth company’ means an issuer that had total annual gross revenues of less than \$1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) during its most recently completed fiscal year.”); See also President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012) (“Now, because we’re still recovering from one of the worst recessions in our history, the last few years have been pretty tough on entrepreneurs. Credit has been tight. And no matter how good their ideas are, if an entrepreneur can’t get a loan from a bank or backing from investors, it’s almost impossible to get their businesses off the ground. And that’s why back in September, and again in my State of the Union, I called on Congress to remove a number of barriers that were preventing aspiring entrepreneurs from getting funding. And this is one useful and important step along that journey.”).

economic growth and job creation,”<sup>4</sup> and to extend venture capital investment opportunities to small investors.<sup>5</sup>

To this end, the JOBS Act contains a variety of provisions. It introduces a new regulatory category, the emerging growth company, for those businesses with gross revenues of less than \$1 billion,<sup>6</sup> exempts emerging growth companies from many of the regulatory and disclosure requirements otherwise required in the initial registration statement filed by public companies, and provides further relief after such a company goes public.<sup>7</sup> The JOBS Act further increases the number of shareholders a company may have before it is required to register its common stock with the SEC and become a publicly

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<sup>4</sup> Armstrong Teasdale LLP, *JOBS Act Eases Regulatory Burdens on Capital Raising*, NAT’L L. REV. (Apr. 18, 2012), <http://www.natlawreview.com/article/jobs-act-eases-regulatory-burdens-capital-raising> [<http://perma.cc/FSB7-BB9V>].

<sup>5</sup> 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) (“[H]igh net worth individuals can invest in businesses before the average family can. And that small business is limited on the amount of equity stakes they can provide investors and limited in the number of investors they can get. So, clearly, something has to be done to open these capital markets to the average investor . . . .”); *see also* Obama, *supra* note 3 (“Right now, [start-ups and small businesses] can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it’s time our laws did as well. Because of [the CROWDFUND Act], startups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.”).

<sup>6</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 101, 126 Stat. 306, 307-08 (2012) (codified in scattered sections of 15 U.S.C.A.).

<sup>7</sup> *Id.* at §§ 102-105 (“An emerging growth company shall be exempt from the requirements of subsections (a) and (b). . . . An emerging growth company—(A) need not present more than 2 years of audited financial statements in order for the registration statement of such emerging growth company with respect to an initial public offering of its common equity securities to be effective, and in any other registration statement to be filed with the Commission, an emerging growth company need not present selected financial data in accordance with section 229.301 of title 17, Code of Federal Regulations, for any period prior to the earliest audited period presented in connection with its initial public offering.”).

reporting company.<sup>8</sup> Under the Act, a company reaches the registration threshold only if it accumulates 500 or more “unaccredited” shareholders, or 2,000 total shareholders, including both accredited and unaccredited shareholders.<sup>9</sup> The JOBS Act also expands allowable activities under current registration exemptions, lifting the ban on general solicitation and advertising in specific kinds of private placements of securities,<sup>10</sup> and raising the limit for securities offerings exempted under Regulation A from \$5 million to \$50 million, thereby allowing larger fundraising efforts under this simplified regulation.<sup>11</sup>

Perhaps the most noteworthy and controversial portion of the JOBS Act, however, is Title III, known as the CROWDFUND Act.<sup>12</sup> As its name suggests, this section of the Act seeks to legalize and regulate equity crowdfunding.<sup>13</sup> While companies have been using crowdfunding portals to pre-sell unique products or raise money from donors in exchange for small non-monetary rewards for several years, the registration and ongoing disclosure requirements of the Securities Act and Securities Exchange Act have effectively prevented companies from using those portals to sell equity or debt securities in

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<sup>8</sup> *Id.* at § 501 (amending the Securities Exchange Act) (“[W]ithin 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by either—(i) 2,000 persons, or (ii) 500 persons who are not accredited investors (as such term is defined by the Commission) . . .”).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at § 201 (“Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors.”).

<sup>11</sup> *Id.* at § 401 (amending the Securities Act).

<sup>12</sup> *Id.* at § 301 *et seq.*

<sup>13</sup> *Id.* at § 302 (“Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding at the end the following: ‘(6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that . . . (C) the transaction is conducted through a broker or funding portal that complies with the requirements of section 4A(a) . . . .’”).

a fledgling enterprise.<sup>14</sup> The CROWDFUND Act provides a new exemption from registration requirements for certain types of small offerings, subject to several conditions. The exemption allows the sale of securities to retail investors through traditional broker-dealers or through Internet “funding portals” registered with the government.<sup>15</sup> Though the Act does impose some limits on the total amount individual investors may invest and the dollar amount of securities that a company may issue, this provision of the Act still opens the door to an entirely new type of fundraising.<sup>16</sup> Most existing exemptions allow only accredited investors to participate or limit the number of non-accredited investors who may be included.<sup>17</sup> Rather than relying on a small number of deep-pocketed investors, small companies can now use the Internet to seek small equity investments from a broad base of potential investors.<sup>18</sup>

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<sup>14</sup> See generally Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (2012); Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (2012).

<sup>15</sup> 15 U.S.C.A. § 77d (West 2015); *Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, SEC. & EXCH. COMM’N (May 7, 2012), <https://www.sec.gov/divisions/marketreg/tmjjobsactcrowdfundingintermediariesfaq.htm> [http://perma.cc/M6V9-CTPY] (“Until the SEC has completed this rulemaking, you cannot act as a crowdfunding intermediary, even if you are already a registered broker.”).

<sup>16</sup> Jenny Che, *Indiegogo Sets Sights On ‘Holy Grail’ Of Crowdfunding*, HUFFINGTON POST (July 29, 2015, 3:56 PM), [http://www.huffingtonpost.com/entry/indiegogo-equity-crowdfunding\\_55b8e5dae4b0224d8834968b?kvcommref=mostpopular](http://www.huffingtonpost.com/entry/indiegogo-equity-crowdfunding_55b8e5dae4b0224d8834968b?kvcommref=mostpopular) [perma.cc/2C93-6REX] (“Startup investing was previously limited to a smaller segment of the population, including accredited investors.”).

<sup>17</sup> See generally *Small Business and the SEC*, SEC. & EXCH. COMM’N (Feb. 27, 2014), <http://www.sec.gov/info/smallbus/qasbsec.htm#4a5> [http://perma.cc/Z656-HYPM] (“Section 4(a)(5) of the Securities Act exempts from registration offers and sales of securities to accredited investors when the total offering price is less than \$5 million.”).

<sup>18</sup> See Che, *supra* note 16 (“Title IV, another provision of the JOBS Act, went live in June, allowing startups to raise up to \$50 million from non-accredited investors, or regular individuals who have a net worth of less than \$1 million and who have an annual income below \$200,000. Indiegogo plans to roll out funding options that support this provision shortly, Rubin said. Startup investing was previously limited to a smaller segment of the population, including accredited investors.”).

While the Act received praise in some circles,<sup>19</sup> it has not been without its detractors. The Act was harshly criticized by regulators and consumer advocates for undermining the investor protections provided by the federal securities laws—most notably for circumventing requirements that companies file registration statements with the SEC and deliver prospectuses to investors containing audited financial statements and other information.<sup>20</sup> Former SEC Chairman Arthur

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<sup>19</sup> The Act was largely lauded by the technology and startup communities. In a statement, the Consumer Electronics Association called the Act “Washington at its best—putting the interest of economic good and business before political agendas.” Consumer Elec. Ass’n, *CEA Celebrates Senate Passage of JOBS Act*, CTA.TECH (Mar. 3, 2012), <http://www.cta.tech/News/News-Releases/Press-Releases/2012-Press-Releases/CEA-Celebrates-Senate-Passage-of-JOBS-Act.aspx?feed=Policy-Press-Releases> [<http://perma.cc/RT2R-AHSA>] (“Today, we saw the blue moon of opposing political forces aligned for good, as the Senate enacted the House-approved JOBS Act . . . .” In its Public Policy Blog, Google called the crowdfunding provisions “particularly exciting.” Pablo Chavez, *Bipartisanship, new businesses and new jobs, with a little help from your friends*, GOOGLE: PUB. POL. BLOG (Mar. 15, 2012), <http://googlepublicpolicy.blogspot.com/2012/03/bipartisanship-new-businesses-and-new.html> [<http://perma.cc/A33R-D8QP>]. The National Venture Capital Association and U.S. Chamber of Commerce, among others, praised the bill for modernizing regulations and easing regulatory burdens on small businesses. Letter from Biotechnology Indus. Org., Info. Tech. Indus. Council, NASDAQ OMX, Nat’l Venture Capital Ass’n, NYSE Euronext, AOL, SVB Fin. Grp., Silicon Valley Leadership Grp., Tech Am., TechNet and the U.S. Chamber of Commerce to the U.S. Senate (Mar. 15, 2012) (on file with author) (“This measure, supported by the Administration, and passed by the House of Representatives by an overwhelmingly bipartisan margin of 390-23, seeks to modernize the nation’s capital formation rules and provide for a transition into public company regulatory compliance for emerging growth companies. Doing so will allow these companies to grow, create jobs, and to ultimately reach their full economic potential.”).

<sup>20</sup> Kathleen Pender, *Financial Regulations Guttled In New Bill*, SFGATE (Mar. 11, 2012), <http://www.sfgate.com/business/article/Financial-regulations-guttled-in-new-bill-3407178.php> [<http://perma.cc/4H7A-NCZ9>] (“Arthur Levitt, chairman of the Securities and Exchange Commission under President Bill Clinton, told me, ‘The bill is a disgrace.’”); Lynn E. Turner, Managing Dir., LitiNomics, Inc., Statement Before the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 6, 2012) (“The proposed legislation is a dangerous and risky experiment with the U.S. capital markets, and the savings of over 100 million Americans who depend on those markets. The evidence does not support the need for it. In fact, it contradicts it. I do



Levitt called the bill a “disgrace,” and several other prominent securities regulators voiced strong criticisms, including former SEC Chief Accountant Lynn Turner and the North American Securities Administrators Association.<sup>21</sup> Consumer and investor advocates, including the AARP, the Consumer Federation of America, and the Council of Institutional Investors also opposed the bill, as did the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), the American Federation of State, County, and Municipal Employees (AFSCME), the National Education Association, and other labor groups.<sup>22</sup> Other critics alleged that the House version of the bill “obliterate[d] many regulations designed to safeguard investors” and “reliev[ed] businesses that are preparing to go public from some of the most important auditing regulations that Congress passed after the Enron debacle.”<sup>23</sup> The Consumer Federation of America alleged that “[b]ecause they are likely to result in higher capital costs that negate any compliance cost savings, these bills don’t even offer any prospect of meaningful job creation to justify their attack on fundamental investor and market protections.”<sup>24</sup>

This note reviews the history and mechanics of crowdfunding, existing securities law, and the various crowdfunding provisions of the

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not believe it will add jobs but may certainly result in investor losses.”); Letter from N. American Sec. Admin. Ass’n to Senate Majority Leader Harry Reid and Senate Minority Leader Mitch McConnell (Mar. 12, 2012) (on file with author) (“While intending to promote an internet-based fundraising technique known as ‘crowdfunding’ as a tool for investment, this legislation will needlessly preempt state securities laws and weaken important investor protection.”).

<sup>21</sup> *Id.*

<sup>22</sup> *Organization and Individuals Critical of Anti-Investor Provisions in the House JOBS Act and Companion Senate Bills*, CONSUMER FED’N OF AM. (Mar. 12, 2012), [http://consumerfed.org/press\\_release/organization-and-individuals-critical-of-anti-investor-provisions-in-the-house-jobs-act-and-companion-senate-bills](http://consumerfed.org/press_release/organization-and-individuals-critical-of-anti-investor-provisions-in-the-house-jobs-act-and-companion-senate-bills) [<http://perma.cc/2KS9-5M79>].

<sup>23</sup> See Gail Collins, *The Senate Overachieves*, N.Y. TIMES (Mar. 14, 2012), [http://www.nytimes.com/2012/03/15/opinion/collins-the-senate-overachieves.html?\\_r=0](http://www.nytimes.com/2012/03/15/opinion/collins-the-senate-overachieves.html?_r=0) [<http://perma.cc/Q7BT-AAA2>]; Pender, *supra* note 21 (“It’s hard to believe that Democrats, who brought you the Dodd-Frank financial regulation act and the Consumer Financial Protection Bureau, are solidly backing a bill that would weaken or obliterate many regulations designed to safeguard investors.”).

<sup>24</sup> Letter from the Consumer Fed’n of Am. to Senators Timothy Johnson and Richard Shelby (Mar. 5, 2012) (on file with author).

JOBS Act in an attempt to determine whether the new exemption created by the Act is likely to assist emerging growth companies in raising new capital. Part II reviews the history and mechanics of crowdfunding. Part III details the specific features of the new crowdfunding exemption created by the JOBS Act and how the Act fits within the greater context of federal securities laws. Part IV examines the potential drawbacks to the crowdfunding exemption, compares the new exemption to a startup's current fundraising options, predicts which enterprises are likely to take advantage of this new source of potential funds, and offers proposed changes to make the crowdfunding exemption more useful. This note concludes that due to the high costs associated with a crowdfunded offering and the fact that issuers will be barred from raising more than a modest amount of capital, that only a narrow set of businesses will take advantage of the new exemption. The businesses that do undertake crowdfunding offerings will be those unable to raise capital from other more established sources. With this in mind, the Act would be more effective if it focused on providing issuers access to many small contributions at extremely low cost.

## II. *Background: Crowdfunding*

Generally speaking, crowdfunding consists of the practice of soliciting a large number of small financial contributions to support a common project, usually via the Internet.<sup>25</sup> Under this model, a project initiator can raise money to help fund a specific project by soliciting many small donations from a large number of donors. Contributions are typically solicited via a website, or platform set up for that purpose.<sup>26</sup> In order to gain attention and convince potential backers of their project's worthiness, project initiators produce a promotional package of information about their project and post that package to the

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<sup>25</sup> *Crowdfunding Definition*, MERRIAM-WEBSTER ONLINE DICTIONARY, <http://www.merriam-webster.com/dictionary/crowdfunding> [<http://perma.cc/2T2E-KGXQ>].

<sup>26</sup> Andrea Ordanini, Lucia Miceli, Marta Pizzetti & A. Parasuraman, *Crowdfunding: Transforming Customers into Investors Through Innovative Service Platforms*, 22 J. OF SERV. MGMT. 443, 445 (2011) ("Therefore, crowdfunding, although sharing some characteristics of traditional resource-pooling and social-networking phenomena, has some unique elements related to creating service platforms through which individual consumers can pool monetary resources to support and sustain new projects initiated by others.").

funding platform.<sup>27</sup> Potential supporters can then review the listed projects and decide whether and how much they are willing to contribute to each one.<sup>28</sup>

The philosophy behind crowdfunding is essentially the same as that behind idea crowdsourcing: to substitute the opinions of expert investors or traditional employees for the “wisdom of the crowd” in determining which projects are worthwhile.<sup>29</sup> Since projects rely on a large number of small donations, only ideas that appeal to a large number of people will be able to attract enough donations to reach their target funding levels.<sup>30</sup> Thus, while dubious ideas may receive some funding, only truly worthy ideas will receive enough contributions to become fully funded.<sup>31</sup>

The idea of funding a project through a large number of small contributions has existed for several hundred years. The practice of praenumeration, that is, the use of a discounted pre-sale of an unpublished book to cover the eventual printing costs, was common in 18th century Germany.<sup>32</sup> When New York City struggled to raise the \$250,000 required to build a pedestal for the Statue of Liberty,

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<sup>27</sup> *Id.* at 444-45 (“[T]here are the subjects who propose ideas and/or projects to be funded . . . . Then there is the crowd of people that decide to financially support these projects . . . . These supporters co-produce the output, selecting—and sometimes developing—the offers they deem most promising or interesting.”).

<sup>28</sup> *Id.* at 445 (“[W]hat the crowd generates is financial support for already proposed initiatives.”).

<sup>29</sup> Giancarlo Giudici, Riccardo Nava, Cristina Rossi Lamastra & Chiara Verecondo, *Crowdfunding: The New Frontier for Financing Entrepreneurship?* 11 (Dep’t of Mgmt., Prod. and Indus. Eng’g Politecnico di Milano, Oct. 5, 2012), available at [http://papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=2157429](http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2157429) [<http://perma.cc/KY8F-ME3W>] (“Crowdfunders believe in the ‘power and wisdom of the crowd.’ They assume that the efficiency of crowds in selecting promising entrepreneurial projects increases with the heterogeneity of the public. Such collective intelligence is captured by sharing and aggregating information.”).

<sup>30</sup> See Ordanini et al., *supra* note 26, at 445-46 (discussing examples of crowdfunding platforms where funding must meet a target amount in order for investors to receive any benefit).

<sup>31</sup> See *id.* at 445 (summarizing the structure of crowdfunding mechanisms where investors select “the offers they deem to be most promising or interesting.”).

<sup>32</sup> Andrew Couzens, *Crowdfunding is Democratising Capital*, HIJACKED (Aug. 13 2014, 8:23 PM), <http://hijacked.com.au/crowdfunding-is-democratising-capital> [<http://perma.cc/8NUX-4MX9>].

publisher Joseph Pulitzer devised a successful fundraising campaign that solicited contributions through newspaper advertisements and eventually received contributions from more than 160,000 donors.<sup>33</sup>

Internet-based crowdfunding, however, began much more recently. In 1997, fans of the British rock band Marillion utilized an independent Internet campaign to fund a North American tour for the band.<sup>34</sup> Four years later, in a classic case of praenumeration, the band itself solicited pre-orders to fund the production costs of a studio album.<sup>35</sup> Meanwhile other artists, like filmmaker Mark Tapio Kines, were using similar campaigns to finance projects in other artistic media.<sup>36</sup>

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<sup>33</sup> *The Statute of Liberty and America's Crowdfunding Pioneer*, BBC NEWS MAGAZINE (Apr. 25 2013), <http://www.bbc.com/news/magazine-21932675> [<http://perma.cc/2N8V-R7YE>] (“It seemed as though New York had run out of options when renowned publisher Joseph Pulitzer decided to launch a fundraising campaign in his newspaper The New York World. The campaign eventually raised money from more than 160,000 donors, including young children, businessmen, street cleaners and politicians, with more than three-quarters of the donations amounting to less than a dollar.”).

<sup>34</sup> Dean Golemis, *British Band's U.S. Tour Is Computer-Generated*, CHICAGO TRIBUNE (Sept. 23, 1997), [http://articles.chicagotribune.com/1997-09-23/features/9709230071\\_1\\_music-fans-newsgroup-marillion](http://articles.chicagotribune.com/1997-09-23/features/9709230071_1_music-fans-newsgroup-marillion) [<https://perma.cc/U8E2-TZJM>] (“Immediately, the Marillionites took to their computer keyboards. Messages were posted on the Internet announcing a fundraising effort, bulk [sic] e-mail soliciting donations was sent, and by summer the British quintet had finally found its ticket to the U.S.—paid for in full by donors worldwide using the Internet as the sole means of raising cash. Thanks to these dedicated fans and the \$47,000 they have garnered so far—ahead of the original \$30,000 goal--the band put together a 21-date tour of the U.S. in support of its ninth studio album, ‘This Strange Engine.’”).

<sup>35</sup> Tim Masters, *Marillion 'Understood Where the Internet Was Going Early On'*, BBC NEWS (Sept. 1, 2013), <http://www.bbc.com/news/entertainment-arts-23881382> [<http://perma.cc/D9BR-D3FF>] (“Best known for their top ten hits *Kayleigh* and *Lavender* in 1985, Marillion are notable for pioneering a crowdfunding internet business model that is mirrored today in websites like Kickstarter. In 1997, fans clubbed together via the Internet and raised \$60,000 (£39,000) to help finance a North American tour. Inspired by that, the band turned the tables in 2001 and asked fans to pre-order an album 12 months before release. Some 12,000 signed up to finance the recording, resulting in the album *Anoraknophobia*.”).

<sup>36</sup> Andrew Rodgers, *Filmmaker Uses Web to Help Finance, Cast Movie*, CHICAGO TRIBUNE (June 11, 1999), [http://articles.chicagotribune.com/1999-06-11/features/9906110076\\_1\\_kines-investing-film](http://articles.chicagotribune.com/1999-06-11/features/9906110076_1_kines-investing-film) [<http://perma.cc/BP7W->

The phenomena of Internet portals dedicated to crowdfunding first gained traction in the United States in 2003 with the launch of the website ArtistShare.<sup>37</sup> Created as a way for musicians to solicit donations in exchange for small rewards, the site has become a common way for artists to fund projects and has expanded into film finance.<sup>38</sup> Its success paved the way for the launches of crowdfunding platforms supporting a broader array of projects, including the launches of Indiegogo in 2008 and Kickstarter in 2009.<sup>39</sup> Since then, filmmaker Zach Braff,<sup>40</sup> musician Amanda Palmer,<sup>41</sup> and TV producer Rob Thomas<sup>42</sup> have all used crowdfunding campaigns to finance

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M7B3] (“So Kines created a Web site for his film: [www.forcor.com](http://www.forcor.com). Eventually Kines and his producer were able to raise \$500,000 for the movie. Although most of the money came from friends and family and investors familiar with the film industry, nearly 25 percent came from people who first learned about the movie on the Web. All told, more than 25 Web fans sent Kines money to help finance his project.”).

<sup>37</sup> David M. Freedman and Matthew R. Nutting, *A Brief History of Crowdfunding 1* (Jan. 3, 2015) (unpublished manuscript) (on file with author) (“Crowdfunding gained traction in the United States when Brian Camelio, a Boston musician and computer programmer, launched ArtistShare in 2003.”).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 2 (“Thanks to ArtistShare’s success, more rewards-based crowdfunding platforms were launched, the most prominent of which were Indiegogo in 2008 and Kickstarter in 2009.”).

<sup>40</sup> Ben Child, *Zach Braff Kickstarter controversy deepens after financier bolsters budget*, THE GUARDIAN (May. 16, 2015), <http://www.theguardian.com/film/2013/may/16/zach-braff-kickstarter-controversy-deepens> [<http://perma.cc/C3DE-2WL8>] (“[A] month on from launching a high-profile campaign to raise funding for independent film *Wish I Was Here*, Braff has not only hit his \$2m Kickstarter target but secured millions of dollars in extra support from a traditional film financier.”).

<sup>41</sup> Marc Schneider, *Amanda Palmer Fans Pledge More than \$14,000 Per ‘Thing’ She Creates*, BILLBOARD (Mar. 4, 2013), <http://www.billboard.com/articles/business/6487764/amanda-palmer-patreon-crowdfunding-campaign> [[perma.cc/PMG6-4AKM](http://perma.cc/PMG6-4AKM)] (“The former Dresden Dolls vocalist, who raised \$1.2 million in 2012 using Kickstarter, has discovered a way to get paid handsomely each time she hits ‘publish’ no matter what the content is.”).

<sup>42</sup> Sarah Rappaport, *Kickstarter Funding Brings ‘Veronica Mars’ Movie to Life*, CNBC (Mar. 12, 2014), <http://www.cnbc.com/2014/03/12/kickstarter-funding-brings-veronica-mars-movie-to-life.html> [<https://perma.cc/Q73L-4DQ3>] (“Over 90,000 fans of the ‘Veronica Mars’ TV show, which aired from 2004-2007, opened up their check books to the tune of \$5.7 million to make the film a reality. The original Kickstarter campaign was for \$2 million, but the contributions nearly tripled the original ask.”).

large-scale artistic endeavors, and numerous small enterprises have used such campaigns to fund new products.

Under most modern crowdfunding arrangements, the wisdom of the crowd philosophy is compounded by an additional factor: “All-Or-Nothing” (AON) funding. Under the AON system, the project developers receive funds only if their funding target is reached.<sup>43</sup> That is, the aggregated contributions of the supporters are processed and transferred to the recipient only if the total amount of pledged contributions reaches a certain level.<sup>44</sup> Under this scenario, projects that do not reach their funding target retain none of the funds raised, and funds are returned to the contributors.<sup>45</sup> Contributors, thus, will not lose their contributions, but neither will they receive any of the promised rewards.<sup>46</sup> This system feeds into crowdfunding’s final broad characteristic: successful projects are utterly reliant on successful promotional campaigns to achieve their targets. Because a successful project generally requires mobilization of a large number of discrete and independent backers, gaining widespread notoriety is a crucial step.<sup>47</sup> Due to the small size and funding limitations of most crowdfunded projects (which make formal, large-scale advertising campaigns impossible), this sort of promotion typically happens through word of mouth or across social media.<sup>48</sup> Since early contributors will receive no rewards if the project is not fully funded, they are strongly incentivized to promote the project to others.<sup>49</sup> In successful projects, this often generates a pyramid effect, with each

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<sup>43</sup> Douglas J. Cumming, Gaël Leboeuf & Armin Schwienbacher, *Crowdfunding Models: Keep-it-All vs. All-or-Nothing 2* (May 31, 2015) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2447567](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2447567) [<https://perma.cc/27SU-SR2P>] (“The ‘All-Or-Nothing’ (AON) model involves the entrepreneurial firm setting a fundraising goal and keeping nothing unless the goal is achieved . . .”).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Kendall Almerico, *Your Crowdfunding Campaign is Doomed Without This*, *ENTREPRENEUR* (Mar. 3, 2013), <http://www.entrepreneur.com/article/231882> [<http://perma.cc/LB3J-458Z>] (“To be successful in rewards-based crowdfunding, effective use of social media is critical.”).

<sup>48</sup> *Id.*

<sup>49</sup> See Ordanini et al., *supra* note 24, at 455 (“[P]eople who participate in crowdfunding are instead motivated by the idea of realizing a monetary return from their investment, and contribute a non-trivial amount of money to a new way of funding an early-stage new venture.”).

wave of contributors promoting the project to successively larger numbers of people.<sup>50</sup> While project initiators may initiate this process and may supplement it with aggressive promotion of their own, the powerful army of committed backers does most of the work.<sup>51</sup>

Crowdfunding campaigns have fallen into two different categories thus far: reward-based crowdfunding and credit-based crowdfunding.<sup>52</sup> Reward-based crowdfunding is by far the most prevalent type, typified by websites like Kickstarter.<sup>53</sup> Under this system, backers receive small rewards (such as t-shirts, mugs, or advance product samples) for various levels of contribution.<sup>54</sup> Depending on the arrangement involved, backers may have their contributions returned if the project fails to hit its funding target or fails to deliver the promised rewards.<sup>55</sup> Credit-based crowdfunding is

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<sup>50</sup> See Sally Outlaw, *How to Spread the Word About Your Crowdfunding Campaign*, ENTREPRENEUR (Nov. 6, 2013), <http://www.entrepreneur.com/article/228544> [<http://perma.cc/ML7N-899X>] (“Reach out to high-profile Twitter users or leaders in your field. See if you can get them to mention your product or campaign to their followers and fans.”).

<sup>51</sup> See *id.* (“Don’t get discouraged when your campaign hits a lull. It’s common for a lot of backer support to show up in the later phase of the campaign. Those who may not have stepped up in the beginning may now be inspired to help you cross the finish line when discovering you are closer to your goal.”).

<sup>52</sup> Catherine Clifford, *Crowdfunding Generates More Than \$60,000 an Hour (Infographic)*, ENTREPRENEUR (May 19, 2014), <http://www.entrepreneur.com/article/234051> [<https://perma.cc/NPP9-SYQE>] (“‘Rewards’ Crowdfunding: Sometimes called the ‘Kickstarter model’ if the Entrepreneur can pre-sell a product (or service) to enough people then a business can start (or a product launch) without debt or sacrificing equity (shares).”); (“Equity Crowdfunding: Purchasing unlisted shares, usually in an early stage company that with some initial sales revenues that can demonstrate a capable team and a product for which there is market demand.”).

<sup>53</sup> *Id.* (containing an infographic showing the breakdown of crowdfunding platform types).

<sup>54</sup> See, e.g., *Rewards Based Crowdfunding*, FUNDABLE, <https://www.fundable.com/learn/resources/guides/crowdfunding-guide/rewards-based-crowdfunding> [<http://perma.cc/J2EJ-HAX8>].

<sup>55</sup> Casey Johnston, *Kickstarter Lays Down New Rules for When a Project Fails*, ARS TECHNICA, <http://arstechnica.com/business/2014/09/kickstarter-tries-to-help-creators-who-dont-deliver-with-new-terms> [<http://perma.cc/P7ZZ-SGN4>] (“If the creators can’t deliver, Kickstarter explains how to try and make good when the creators do not fulfill their goals or backer rewards. In that event, creators are expected to explain what is happening and how the money was used, giving refunds to any backers who

an extremely new phenomenon, having come about with the launch of the Lending Club in 2007.<sup>56</sup> However, the Lending Club and other platforms that attempt to match borrowers with pools of investors who are willing to meet their credit terms have grown rapidly.<sup>57</sup> Borrowers can often obtain credit for a lower interest rate than they might get on a typical consumer loan, and lenders can often achieve a higher return than a treasury security or junk bond might offer.<sup>58</sup>

However, neither reward-based nor credit-based crowdfunding allow donors a continuing ownership stake in the cause they have chosen to support.<sup>59</sup> Equity-based crowdfunding, however, would allow consumers to function essentially as small-scale venture capitalists, and would provide potentially larger rewards for the early identification of a promising investment.<sup>60</sup> It would further allow many more people, even those without access to large pools of ready capital, to invest in growing businesses at a very early stage.<sup>61</sup> Moreover, it would provide such businesses with a way to communicate directly with many potential investors, without a fund manager intermediary.<sup>62</sup> It is this form of crowdfunding that the JOBS Act seeks to legalize and regulate.<sup>63</sup>

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request them. Kickstarter also writes that, in lieu of giving refunds, backers can "explain how those funds will be used to complete the project in some alternate form.").

<sup>56</sup> William D. Cohan, *Bypassing the Bankers: How Peer-To-Peer Lending is Changing the Way Consumers Get Loans*, THE ATLANTIC (Jan. 28, 2014), <http://www.theatlantic.com/magazine/archive/2014/09/bypassing-the-bankers/375068> [<http://perma.cc/9EZ2-PEDZ>].

<sup>57</sup> *Id.* ("But the company is growing quickly. In 2013, its revenue—the fees it charges for the loans it helps arrange—tripled, to \$98 million. There is talk of an IPO later this year. In April, the company was valued at \$3.75 billion—38 times its 2013 revenue and more than 520,000 times its net income—when it raised \$65 million in additional equity from a new group of high-powered institutional investors, including BlackRock and T. Rowe Price.").

<sup>58</sup> *Id.*

<sup>59</sup> Crowdfunding, 78 Fed. Reg. 66427, 66429 (proposed Nov. 5, 2013).

<sup>60</sup> *See id.* at 66430.

<sup>61</sup> *See id.* ("We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts.").

<sup>62</sup> *See id.*

<sup>63</sup> *Id.* ("The proposed rules are intended to align crowdfunding transactions under Section 4(a)(6) with the central tenets of the original concept of crowdfunding, in which the public—or the crowd—is presented with an



### ***III. The JOBS Act and its Place in the Federal Securities Laws***

Generally speaking, U.S. securities laws governing who may buy and sell securities function on two basic principles. First, issuers must disclose certain information.<sup>64</sup> Securities laws do not seek to pass judgment about the nature of securities offered for sale, the worthiness of the offering company, or the likelihood that the securities' value will appreciate.<sup>65</sup> Rather, U.S. securities laws require a high level of issuer disclosure to ensure that potential purchasers are afforded the opportunity to make informed decisions.<sup>66</sup> Second, securities laws generally permit more qualified investors to assume a higher degree of risk.<sup>67</sup> If investors can demonstrate that they are experienced and knowledgeable enough to assess investment risk accurately or possess sufficient wealth to absorb any economic loss they may suffer, such investors may be able to participate in investment opportunities not available to the general public.<sup>68</sup>

As a result of the first principle (that issuers must disclose certain information), any business that seeks to sell its own securities must comply with two major statutes: the Securities Act and the Securities Exchange Act.<sup>69</sup> The Securities Act regulates public “offers and sales of securities in the United States, or offers and sales that use any means of interstate commerce, such as the Internet, U.S. telephone lines or the U.S mail.”<sup>70</sup> Any business offering and selling its own securities, even to a limited number of buyers, must register the offer

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opportunity to invest in an idea or business and individuals decide whether or not to invest after sharing information about the idea or the business with, and learning from, other members of the crowd.”).

<sup>64</sup> See *Small Business and the SEC*, *supra* note 17.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* (explaining that the prospectus, which “must be delivered to everyone who buys the securities, as well as anyone who is made an offer to purchase the securities,” must explain “important facts about [the issuer’s] business operations, financial condition, results of operations, risk factors and management.”).

<sup>67</sup> SEC. OFFICE OF INV. EDUC. AND ADVOCACY, SEC PUB. NO. 158, INVESTOR BULLETIN: ACCREDITED INVESTORS (2013), available at [https://www.sec.gov/investor/alerts/ib\\_accreditedinvestors.pdf](https://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf) [<https://perma.cc/6P89-MZ5R>].

<sup>68</sup> *Id.*

<sup>69</sup> See *Small Business and the SEC*, *supra* note 16.

<sup>70</sup> *Id.*

and securities with the SEC unless one of the Securities Act exemptions applies.<sup>71</sup>

Registering an offering with the SEC makes a company public, and can involve an enormous amount of disclosure and expense.<sup>72</sup> In order to register, the Securities Act generally requires a company to file a two-part registration statement containing information about the company, the nature of the offering, and the securities being offered for sale.<sup>73</sup> The first part of the registration statement consists of a prospectus, in which the offeror must disclose significant facts about its business operations, financial condition, results of operations, risk factors, management, and must include audited financial statements.<sup>74</sup> The offeror must deliver this prospectus to anyone who either buys or offers to buy the securities being issued.<sup>75</sup>

The second part of the registration statement “contains additional information that the company does not have to deliver to investors but must file with the SEC, such as copies of material contracts.”<sup>76</sup> These disclosure requirements continue after the company is publicly registered, though the requirements are reduced for “smaller reporting companies” and temporarily reduced for emerging growth companies.<sup>77</sup>

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<sup>71</sup> 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. 1736, 1740 (2012) (“Classification of a fundraising scheme as a security means that absent an applicable exemption, promotion of those investments will be subject to the 1933 Act.”).

<sup>72</sup> *Id.* at 1740 (“Once a company has engaged in a securities offering registered under the 1933 Act, it becomes subject to the periodic reporting requirements of the Securities Exchange Act of 1934 . . . .”); *id.* at 1738 (“[C]rowdfunding would not be a viable capital-raising method in light of the costs of complying with securities registration or even the more limited disclosure requirements available under the exemption set forth in SEC Regulation A.”).

<sup>73</sup> See *Small Business and the SEC*, *supra* note 16.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* (“The disclosure requirements scaled for smaller reporting companies permit your company, among other things to: include less extensive narrative disclosure than required of other reporting companies, particularly in the description of executive compensation; provide audited financial statements

As a result of the second principle (allowing sophisticated investors to take on more risk), the SEC has developed the “accredited investor” designation.<sup>78</sup> Accredited investors include large institutional investors like banks, insurance companies, and various types of business development companies.<sup>79</sup> Employee benefit plans, tax-exempt charitable organizations, corporations, and partnerships can also qualify if they have assets in excess of \$5 million, or (in some cases) if a bank, registered investment adviser, or insurance company is making the underlying investment decisions.<sup>80</sup> Wealthy individuals (those with incomes exceeding \$200,000 a year or with a net worth of at least \$1 million, excluding the value of their primary residence) can also qualify, as can certain trusts.<sup>81</sup> Any entity that qualifies may be eligible to participate in certain securities offerings not available to the general public.<sup>82</sup>

Companies can sell their securities without submitting to the above registration process if they qualify for one or more exemptions.<sup>83</sup> These companies are still subject to the anti-fraud

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for two fiscal years, in contrast to other reporting companies, which must provide audited financial statements for three fiscal years; and not have to provide an auditor attestation of internal control over financial reporting, which is generally required for SEC reporting companies under Sarbanes-Oxley Act Section 404(b).”); (“Emerging growth companies, among other things, are permitted to: follow the smaller reporting company requirements for disclosure and audited financial statements; not have to provide an auditor attestation of internal control over financial reporting under Sarbanes-Oxley Act Section 404(b); and choose not to become subject to certain changes in accounting standards.”).

<sup>78</sup> See generally *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953) (“The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which ‘there is no practical need for (the bill’s) application,’ the applicability of [Section 4(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”).

<sup>79</sup> 17 C.F.R. § 230.215 (2014).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> See *Small Business and the SEC*, *supra* note 17.

<sup>83</sup> See *Ralston Purina Co.*, 346 U.S. at 126-27 (“[T]he exemption question turns on the knowledge of the offerees . . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration.”); *Small Business and the SEC*, *supra* note 16.

provisions of the federal securities laws and may be subject to further state regulation, but do not need to register their offering with the SEC.<sup>84</sup>

Unfortunately, none of the exemptions available prior to 2012 were truly conducive to equity crowdfunding.<sup>85</sup> Those exemptions tended to ban general solicitation of investors, include onerous disclosure requirements, or were available only to accredited investors or investors within a single state.<sup>86</sup> To be effective, crowdfunding necessarily involves solicitation of a large number of small investors, most of whom are not sufficiently experienced or wealthy to achieve accredited investor or qualified purchaser status.<sup>87</sup> Crowdfunding further involves general solicitation of investors via the Internet, and selling of securities to purchasers in a huge variety of geographical locations.<sup>88</sup> Since most projects seeking financing through crowdfunding are extremely small, even the reduced disclosure requirements of existing exemptions might be too much for them to bear.<sup>89</sup> Further, without an exemption, a crowdfunding platform could also be subject to the broker-dealer requirements of the Exchange Act.<sup>90</sup>

The JOBS Act includes a new registration exemption, which allows equity crowdfunding to proceed under the regulatory auspices of the SEC.<sup>91</sup> This exception strives to strike a balance between minimizing the risk of potential fraud while avoiding the laborious disclosures required for more traditional securities offerings.<sup>92</sup> Under

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<sup>84</sup> *Small Business and the SEC*, *supra* note 17.

<sup>85</sup> *See generally id.*

<sup>86</sup> *See generally id.*

<sup>87</sup> *See* Crowdfunding, *supra* note 59, at 66429.

<sup>88</sup> *See id.* (“Moreover, a third party that operates a Web site to effect the purchase and sale of securities for the account of others generally would, under existing regulations, be required to register with the Commission as a broker-dealer and comply with the laws and regulations applicable to broker-dealers.”).

<sup>89</sup> *See id.*

<sup>90</sup> *See* Hazen, *supra* note 64, at 1756 (“The intermediary for a crowdfunding offering must be registered with the SEC either as a broker-dealer or under the new registration category for a crowdfunding portal.”).

<sup>91</sup> 15 U.S.C.A. § 77d (West 2015).

<sup>92</sup> Press Release, Sec. & Exch. Comm’n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013) *available at* <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677> [<http://perma.cc/E7YH-ESCR>] (“Together these measures were intended to

this new exemption, issuers are able to sell securities to an unlimited number of unaccredited investors through designated Internet portals or through traditional broker-dealers.<sup>93</sup> The portals would function much like currently available crowdfunding websites, but they would allow investors to purchase securities.<sup>94</sup>

However, the issuers, purchasers, and portals all face certain restrictions regarding eligible transactions.<sup>95</sup> Securities purchased and sold under the new registration exemption would be limited, both in terms of the amount that may be issued and liquidity after their initial issuance.<sup>96</sup> Issuers would be able to sell up to \$1,000,000 worth of securities during a 12-month period.<sup>97</sup> The securities issued would be “covered securities” exempt from state securities laws.<sup>98</sup>

The actions of issuers, too, would be restricted in certain ways under the new exemption. Issuers would be prohibited from advertising the securities offering outside of a simple notice directing investors to the funding intermediary.<sup>99</sup> Issuers would be barred from compensating anyone for promoting the securities without disclosure of that fact.<sup>100</sup> Additionally, the issuer would need to make certain disclosures in its initial filing with the SEC, and make the initial filing information available to both investors and the funding portal or

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facilitate capital raising by small businesses while providing significant investor protections.”).

<sup>93</sup> 15 U.S.C.A. § 77d (West 2015).

<sup>94</sup> See Crowdfunding, *supra* note 59, at 66430 (“To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer (including all entities controlled by or under common control with the issuer) must meet specified requirements, including the following: . . . transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a “funding portal.”).

<sup>95</sup> See *id.*; Michael T. Dunn, *Management Alert: Overview of Proposed SEC Crowdfunding Regulations*, SEYFARTH SHAW LLP (Oct. 30, 2013), <http://www.seyfarth.com/publications/MA103013CORP> [perma.cc/VN28-KR28] (“The new rules mirror the provisions of Title III, expand the scope and requirements of the exemption in several key respects and establish the guidelines for issuers, intermediaries and investors in the Crowdfunding space.”).

<sup>96</sup> *Id.*

<sup>97</sup> 15 U.S.C.A. § 77d(a)(6)(A) (West 2015).

<sup>98</sup> 15 U.S.C.A. § 78o(h)(5)(B)(i)(2) (West 2015).

<sup>99</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 101, 126 Stat. 306, 317-18 (2012) (codified in scattered sections of 15 U.S.C.A.).

<sup>100</sup> *Id.*

intermediary.<sup>101</sup> These disclosures would include the name, legal status, and address of the business; the names of officers, directors, and significant shareholders; a business plan and description of the business; financial information of the business, which could include tax returns, officer-certified financial statements, or audited financial statements depending on the amount raised; a description of the intended use of the funds; the price and target offering amount of the securities; and the ownership and capital structure of the business.<sup>102</sup> Finally, issuers would also need to make annual reports to the SEC and investors on the status of the offering and provide financial statements for the prior year.<sup>103</sup>

While investors would not need to be accredited, their opportunity to invest would be limited along similar lines. Investors would be barred from transferring or re-selling securities purchased in a crowdfunding offering under most circumstances.<sup>104</sup> The amount of crowdfunded securities that each investor would be able to purchase each year would be determined by their income.<sup>105</sup> Investors with an annual income or net worth below \$100,000 would be limited to purchasing an amount of securities equal to the greater of \$2,000 or 5% of the investor's annual income or net worth.<sup>106</sup> For investors with an annual income or net worth above \$100,000, investments would be capped at 10% of their annual income or net worth.<sup>107</sup>

The portals through which the securities would be sold would also see their allowable activities limited. These intermediaries would need to register with the SEC either as brokers or as portals.<sup>108</sup> For

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<sup>101</sup> *Id.* at 317.

<sup>102</sup> *Id.* at 317-18.

<sup>103</sup> *Id.* at 318.

<sup>104</sup> *Id.* at 319.

<sup>105</sup> *Id.* at 315 (“(B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—(i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000 . . .”).

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 316 (“(a) REQUIREMENTS ON INTERMEDIARIES. A person acting as an intermediary in a transaction involving the offer or sale of

those registering as brokers, existing brokerage restrictions would apply.<sup>109</sup> Portals would not be able to compensate promoters or finders and would be prohibited from allowing their officers or directors to take a financial interest in any issuer using their services.<sup>110</sup> Portals would further be barred from offering investment advice, soliciting transactions for securities offered on the portal, and holding investor funds or securities.<sup>111</sup>

#### **IV. Analysis**

##### **A. Available Alternatives**

When considering the circumstances under which a startup enterprise might consider a crowdfunding offering, it is important to illustrate what fundraising alternatives that enterprise might have before them. These alternatives essentially fall into three categories: the kind of rewards-based crowdfunding discussed above, debt offerings, and equity offerings.<sup>112</sup>

##### **i. Donation-Based Crowdfunding**

Startups have used donation-based (sometimes referred to as rewards-based) crowdfunding with a high degree of success since the founding of Kickstarter and Indiegogo in the late 2000s.<sup>113</sup> Indeed,

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securities for the account of others pursuant to section 4(6) shall—(1) register with the Commission as (A) a broker; or (B) a funding portal (as defined in section 3(a)(80) of the Securities Exchange Act of 1934) . . . .”).

<sup>109</sup> *Id.* at 316 (describing duties owed by brokers registered under the act).

<sup>110</sup> *Id.* at 316-17.

<sup>111</sup> See Dunn, *supra* note 95 (“A Crowdfunding Portal may not 1) provide investment advice, 2) solicit purchases or sales of securities offered on its website, 3) compensate employees, agents or other persons for solicitation of the purchases or sales of securities on its website, or 4) hold, manage, possess or otherwise handle investment funds or issuer securities and must engage a third party to conduct such tasks.”).

<sup>112</sup> Adam Heitzman, *5 Best Ways for Funding a Startup*, INC. (Nov. 25, 2014), <http://www.inc.com/adam-heitzman/5-best-ways-for-funding-a-startup.html> [<http://perma.cc/2Y66-24FM>].

<sup>113</sup> See Che, *supra* note 16; *The History of Crowdfunding*, FUNDABLE, <https://www.fundable.com/crowdfunding101/history-of-crowdfunding> [<https://perma.cc/W5YH-U8Q7>] (outlining the timeline of crowdfunding development).

crowdfunding websites have seen a steady increase in activity, with the total amount raised in rewards-based crowdfunding campaigns rising from \$89 million in 2010 to an estimated \$10 billion in 2014.<sup>114</sup> This increase was mostly driven by the sheer volume of small projects pursued, as the average campaign raises only about \$7,000.<sup>115</sup>

Less than 25% of Kickstarter campaigns have raised more than \$20,000, and only about 3% have raised more than \$100,000.<sup>116</sup> However, rewards-based crowdfunding remains a popular option because the costs required to undertake a campaign are so low.<sup>117</sup> Kickstarter, for example, charges its fees as a percentage of the amount raised, and charges nothing if the campaign is not successful.<sup>118</sup> While there is some indication that the prevalence of more sophisticated campaigns is driving up the costs of crowdfunding campaigns overall,<sup>119</sup> rewards-based crowdfunding remains a popular way for startups to raise the initial amount needed to produce a prototype or initial product.<sup>120</sup> Additionally, a successful rewards-based

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<sup>114</sup> See Catherine Clifford, *Crowdfunding Seen Providing \$65 Billion Boost to the Global Economy in 2014*, ENTREPRENEUR (Jan. 16, 2014), <http://www.entrepreneur.com/article/230912> [<http://perma.cc/8HSH-5CDX>] (providing an infographic showing the explosive growth of crowdfunding); Kylie Maclellan, *Global Crowdfunding Volumes Rise 81% In 2012*, HUFFINGTON POST (Apr. 8, 2013, 8:00 AM), [http://www.huffingtonpost.com/2013/04/08/global-crowdfunding-rises-81-percent\\_n\\_3036368.html](http://www.huffingtonpost.com/2013/04/08/global-crowdfunding-rises-81-percent_n_3036368.html) [<https://perma.cc/32EW-U44A>] (“Worldwide crowdfunding volumes reached \$2.66 billion in 2012, up from \$1.47 billion the previous year, according to a survey by Massolution, a research and advisory firm specializing in the sector. That followed growth of 64 percent in 2011.”).

<sup>115</sup> See *Crowdfunding Statistics*, FUNDABLE, <https://www.fundable.com/crowdfunding101/crowdfunding-statistics> [<http://perma.cc/7AQS-EFTM>].

<sup>116</sup> *Stats*, KICKSTARTER (Aug. 8, 2015, 1:18 PM), <https://www.kickstarter.com/help/stats> [<http://perma.cc/KC4Y-9GFB>].

<sup>117</sup> See, e.g., Brown, *supra* note 2.

<sup>118</sup> *Fees for the United States*, KICKSTARTER, <https://www.kickstarter.com/help/fees> [<http://perma.cc/2QMW-QT6Y>].

<sup>119</sup> Sally Outlaw, *Crowdfunding Campaigns Come With A Growing Price Tag*, ENTREPRENEUR (Dec. 8, 2014), <http://www.entrepreneur.com/article/240504> [<http://perma.cc/XX28-TU36>] (“Previously an entrepreneur could sketch out an idea on the proverbial napkin and post the concept on a portal to gather feedback and contributors. Now many project creators spend thousands of dollars on their campaigns before heading to the crowd.”).

<sup>120</sup> See, e.g., *id.*



crowdfunding campaign leaves the founders with little debt and in full possession of all of their company's equity.

However, the expense of a crowdfunded securities offering suggests that enterprises considering such an offering will often have greater capital needs than a rewards-based crowdfunding campaign can supply. Because of this, rewards-based crowdfunding is unlikely to be a viable alternative to equity crowdfunding. Rewards-based crowdfunding can be an effective way to raise a few thousand dollars, but is less helpful for businesses with greater capital needs.

## ii. Debt Financing

Debt financing, however, may indeed prove to be a viable alternative to equity crowdfunding. Though startups are notoriously risky enterprises,<sup>121</sup> many are still able to obtain some form of debt financing.<sup>122</sup> This is often accomplished through use of loans from friends and family, credit cards, or through small business loans.

Family and friends may be willing to lend to an entrepreneur based solely on a personal relationship, despite lack of clear creditworthiness.<sup>123</sup> However, the amount that an entrepreneur can raise from such sources may be limited.<sup>124</sup> Alternatively, credit cards allow companies immediate access to services they need, such as cash advances, and a way to track spending.<sup>125</sup> Additionally, credit card lines typically are not subject to the same sort of periodic review that banks often conduct with more traditional loans, and credit card

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<sup>121</sup> Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*, WALL ST. J. Sept. 20, 2012, at B1 (“About three-quarters of venture-backed firms in the U.S. don't return investors' capital, according to recent research by Shikhar Ghosh, a senior lecturer at Harvard Business School.”).

<sup>122</sup> See, e.g., Marco Carbajo, *Business Credit Cards: What Every Business Owner Should Consider*, SMALL BUS. ADMIN. (Nov. 12, 2013), <https://www.sba.gov/blogs/business-credit-cards-what-every-business-owner-should-consider> [<http://perma.cc/5BRK-DAJE>] (“Statistics even show that over 65% of small businesses use credit cards on a frequent basis.”); Julian Hills, *How to Finance a Startup Today*, ENTREPRENEUR (Oct. 21, 2013), <http://www.entrepreneur.com/article/229459> [<http://perma.cc/T5Y8-QYQN>] (“In the U.S. alone, there are an estimated 27.5 million small businesses. And nearly 80 percent of them get their money through bank loans, credit cards and lines of credit.”).

<sup>123</sup> See Crowdfunding, *supra* note 59, at 66511.

<sup>124</sup> *Id.*

<sup>125</sup> Hills, *supra* note 122.

companies can even increase credit limits.<sup>126</sup> Credit card debt, however, is some of the most expensive debt available, with interest rates totaling 14% or more, and often debt must be personally guaranteed by the business owners,<sup>127</sup> even if the business is fully incorporated.<sup>128</sup>

Small business loans are typically available on more favorable terms,<sup>129</sup> but are vastly more difficult for startups to obtain.<sup>130</sup> This is because most banks look for possible collateral when determining whether to make a loan, and most early-stage enterprises lack any assets against which a bank could secure their debt.<sup>131</sup> These requirements “[eliminate] bank loans as a realistic option for many start-ups.”<sup>132</sup> However, small business loans do remain an attractive option for those that qualify.

In the end, debt financing remains attractive for early-stage companies because of its relatively low cost. Debt capital is typically much cheaper than equity capital,<sup>133</sup> and does not require a founder to

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<sup>126</sup> See Carbajo, *supra* note 122.

<sup>127</sup> ROCKETHUB, REGULATION OF CROWDFUNDING BUILDING ON THE JUMPSTART OUR BUSINESS STARTUPS ACT 3 (2012).

<sup>128</sup> Katie Murray, *Three Popular Startup Financing Options*, SMALL BUS. ADMIN. (May 21, 2014), <https://www.sba.gov/blogs/three-popular-start-financing-options> [<http://perma.cc/MZ59-N4A7>] (“It varies by state, but your credit-card issuer might still require that shareholders with significant ownership guarantee the line of credit—even if your business is incorporated.”).

<sup>129</sup> Jennifer F. Bender, *The Average Interest Rate for Small Business Loans*, CHRON, <http://smallbusiness.chron.com/average-interest-rate-small-business-loans-15342.htm> [[perma.cc/9WQP-DJZY](http://perma.cc/9WQP-DJZY)].

<sup>130</sup> Karen E. Klein, *Funding a Small Business? Don't Bother With Banks*, BLOOMBERG (Feb. 13, 2014), <http://www.bloomberg.com/bw/articles/2014-02-13/funding-a-new-small-business-dont-bother-with-banks> [<http://perma.cc/B7FK-GAQX>] (“Getting a small business bank loan is never easy, and it’s been especially difficult since the financial crash of 2008 and the lingering credit crunch. Even though small business lending is rebounding somewhat, it is still virtually impossible to get a loan to open a new business.”).

<sup>131</sup> See ROCKETHUB, *supra* note 127 at 3 (“[C]rediworthiness is determined by a more holistic approach (via an analysis of factors including and entrepreneurs and/or business’ current financial standing, equity investment, earnings, working capital, collateral, and business plan) . . .”).

<sup>132</sup> *Id.*

<sup>133</sup> Ryan Caldbeck, *Small Business Loans: A Great Option...Unless You Actually Need Money*, FORBES (Nov. 14, 2012), <http://www.forbes>.

surrender control of their enterprise.<sup>134</sup> While it may be difficult for early-stage companies to obtain debt financing in amounts comparable to what they might be able to raise in a large equity crowdfunding offering, such companies are able to raise significantly more than what would be available through rewards-based crowdfunding. Even relatively expensive debt could prove to be cheaper than equity crowdfunding, and might be a more attractive option for companies considering a smaller equity crowdfunding offering.

### iii. Equity Offerings

Other existing forms of equity offerings might also offer more attractive financing options than a crowdfunded offering. While a traditional public offering might provide access to more capital than any other option explored in this note,<sup>135</sup> the cost of a public offering puts it well beyond the reach, or even needs, of most startup businesses.<sup>136</sup> However, a private offering, performed under one of the existing exemptions listed below, can fulfill the capital needs of most startups at comparatively minor cost.

Perhaps the most commonly utilized exemption is the non-public offering, or private placement exemption. Under this exemption, contained in Section 4(a)(2) of the Securities Act, “transactions by an issuer not involving any public offering” do not

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com/sites/ryancaldbeck/2012/11/14/small-business-loans-a-great-option-unless-you-actually-need-money [http://perma.cc/4Q4H-VKTH] (“[I]t is unusual for debt capital for a non-distressed company to be priced in excess of 15-18% interest rate per year. However, the cost of equity capital is often upwards of 25% per year in a small, rapidly growing company . . .”).

<sup>134</sup> *Id.* (“[E]ven a small equity investor could have a say in things like the sale of the company or subsequent capital raises. Debt investors just care about being repaid.”).

<sup>135</sup> See WILMERHALE, 2015 IPO REPORT 2 (2015).

<sup>136</sup> SEC. & EXCH. COMM’N, IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 9 (OCT. 21, 2011) (“Two recent surveys of pre- and post-IPO companies—one initiated by the IPO Task Force and one conducted by a company currently in registration by reviewing public filings of its peers place the average cost of achieving initial regulatory compliance for an IPO at \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year.”); see also Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 10 (2007) (suggesting that an IPO only makes economic sense when raising \$20 million or more).

need to be registered.<sup>137</sup> However, this exemption does impose certain limits on who may purchase the offered securities. All purchasers must be “sophisticated investors;” that is, they must possess sufficient business and finance knowledge to be able to evaluate the “risks and merits” of the securities at hand.<sup>138</sup> Alternatively, each investor must be able to show that he or she can “bear the investment’s economic risk.”<sup>139</sup> Though the issuer is not required to distribute a prospectus to each potential investor, each investor must have access to the kind of information a prospectus would normally contain.<sup>140</sup> Additionally, purchasers must “agree not to resell or distribute the securities to the public,” subject to the conditions described below.<sup>141</sup>

Since the determination of what constitutes a public offering can involve a great deal of uncertainty for issuers, the SEC promulgated several private offering safe harbors under Regulation D. Securities offerings meeting the Regulation D requirements will be automatically deemed private, and thus exempt from registration requirements, though the issuer must file a notice with the SEC within 15 days of the offering, informing the agency of the offering’s size and nature.<sup>142</sup> To be certified private under Regulation D, an offering must fulfill at least one of three sets of requirements. Those requirements are provided in Securities Act Rules 504, 505, and 506.

The “seed capital” exemption promulgated under Rule 504 allows for only a small offering size, but it contains the least onerous restrictions of the three options. In these offerings, an issuer may offer

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<sup>137</sup> 15 U.S.C. § 77d(a)(2) (2012).

<sup>138</sup> See *Small Business and the SEC*, *supra* note 17; Bruce E. Methven, “Sophisticated Investors”—How to Determine, THE CALIF. SEC. ATT’YS (Jul. 3, 2012), <http://documents.jdsupra.com/17e2b71a-208e-4344-a706-ad200b854276.pdf> [perma.cc/K34J-4YH9] (“Offering companies virtually always use an investor questionnaire to determine whether a potential investor is sophisticated. The questionnaire covers such things as prior investment experience, current investments, risk tolerance and the potential investor’s education and career. Top management of the offering company must review the responses and determine whether the investor is sophisticated. Management is entitled to rely on the responses unless it has reason to doubt them, in which case additional investigation must be made.”).

<sup>139</sup> *Id.* (“To qualify for this exemption, which is sometimes referred to as the ‘private placement’ exemption, the purchasers of the securities must . . . be able to bear the investment’s economic risk . . .”).

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

and sell up to \$1 million of securities within a 12-month period.<sup>143</sup> Generally, companies relying on this exemption may not use general solicitation or advertising to promote the securities, and the securities themselves are “restricted” (they cannot be re-sold without SEC registration or the use of another exemption).<sup>144</sup> However, neither of these two limitations applies if at least some of the securities are sold in accordance with state laws that require the public filing and distribution to investors of a substantive disclosure document.<sup>145</sup> These limitations are also avoided if the securities are sold in accordance with state laws that permit general advertising and solicitation, as long as sales are made only to accredited investors.<sup>146</sup> Most importantly, however, issuers relying on Rule 504 do not need to provide purchasers or offerees with any specific information about the company.<sup>147</sup> Companies relying on Rule 504 thus avoid altogether the costly informational disclosures required in other offering types.

Regulation D’s Rule 505 provides a second type of exemption. Under this exemption, issuers may sell up to \$5 million of securities in any 12-month period to an unlimited number of accredited investors and up to thirty-five non-accredited investors.<sup>148</sup> The non-accredited investors must receive a disclosure document that provides generally the same information as a registration statement, as well as any information provided to the accredited investors.<sup>149</sup> The issuer is also subject to certain financial statement requirements if the offering includes non-accredited investors, including auditing by a certified public accountant.<sup>150</sup> The securities sold are restricted and cannot be re-sold for at least a year,<sup>151</sup> and issuers cannot use general solicitation or advertising to attract potential purchasers.<sup>152</sup> Issuers are permitted

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<sup>143</sup> 17 C.F.R. § 230.504 (2014).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *See Rule 504 of Regulation D, SEC. & EXCH. COMM’N* (Oct. 27, 2014), <http://www.sec.gov/answers/rule504.htm> [<http://perma.cc/H6BJ-YB9C>] (“Even if a company makes a private sale where there are no specific disclosure delivery requirements, a company should take care to provide sufficient information to investors to avoid violating the antifraud provisions of the securities laws.”).

<sup>148</sup> 17 C.F.R. § 230.505 (2014).

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

to sell more securities under a 505 offering than a 504 offering, in exchange for complying with more burdensome disclosure requirements.

Rule 506 provides two further types of Regulation D exemptions, under sections 506(b) and 506(c). Though investors in both types of Rule 506 offerings receive restricted securities, the offerings are exempt from state registration and review.<sup>153</sup> Most importantly, Rule 506 sets no limit on the amount of securities that may be issued.<sup>154</sup>

Rule 506(b) provides another safe harbor “for the non-public offering exemption in Section 4(a)(2) . . . .”<sup>155</sup> To qualify, the issuer must not use general solicitation or advertising to market the securities; must not sell to more than thirty-five non-accredited investors (each of whom must have sufficient knowledge and experience to evaluate the risks of the investment); must give non-accredited investors a disclosure document that provides generally the same information as a registration statement, as well as any information provided to the accredited investors; must be available to answer questions from non-accredited prospective purchasers; and must provide the same financial statement information required under Rule 505.<sup>156</sup>

Introduced in 2013 to help implement parts of the JOBS Act, Rule 506(c) is a very recent addition to the securities laws.<sup>157</sup> This provision allows issuers to use general solicitation and advertising to market their securities, provided that all purchasers in the offering are accredited investors and the issuer takes reasonable steps to verify the accredited status of each investor.<sup>158</sup>

Another registration exemption is provided by Regulation A. Though Regulation A is promulgated under a different section of the

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<sup>153</sup> 15 U.S.C. § 77f (2012).

<sup>154</sup> See *Small Business and the SEC*, *supra* note 17.

<sup>155</sup> *Id.*

<sup>156</sup> See 17 C.F.R. § 230.506 (2014).

<sup>157</sup> *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC. & EXCH. COMM’N (Sept. 20, 2013), <https://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm> [<https://perma.cc/X2VY-NJTQ>] (“On July 10, 2013, the SEC adopted amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act to implement the requirements of Section 201(a) of the JOBS Act. The amendments are effective on September 23, 2013.”).

<sup>158</sup> 17 C.F.R. § 230.506 (2014).

Securities Act than Regulation D (Section 3(b)(1), not Section 4(a)(2)), it achieves a similar result by allowing companies to sell a limited amount of securities with reduced disclosure requirements.<sup>159</sup> Companies relying on the Regulation A exemption may sell up to \$5 million of securities to the public in any 12-month period, though they must file an offering statement consisting of a notification, offering circular, and exhibits for SEC review.<sup>160</sup> As with certain Regulation D offerings, “bad actors” are prohibited from participation, as are companies already subject to SEC reporting requirements, development-stage companies without a specified business, and investment companies registered under the Investment Company Act of 1940.<sup>161</sup>

In many ways, Regulation A offerings are quite similar to an offering of registered securities; indeed, Regulation A offerings have been dubbed “mini IPOs,” due to the fact that securities sold under Regulation A can be purchased by anyone, and not merely by accredited investors.<sup>162</sup> Issuers must provide purchasers with an offering circular that contains much of the same information as a prospectus, though issuers can use general advertising and solicitation to promote securities, and the securities sold are not restricted.<sup>163</sup> Often, purchasers can even re-sell securities up to a certain amount.<sup>164</sup>

However, Regulation A offerings differ from registered offerings in important respects. The Regulation A offering circular is generally much shorter and simpler than a full registration statement,<sup>165</sup> and the financial statements required in a Regulation A offering are much simpler and do not usually need to be audited.<sup>166</sup>

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<sup>159</sup> See *Small Business and the SEC*, *supra* note 17 (“Regulation A issuers do not incur either Exchange Act reporting obligations after the offering or Sarbanes-Oxley Act obligations applicable only to SEC reporting companies . . .”).

<sup>160</sup> *Id.*; 17 C.F.R. §230.251 *et seq.*

<sup>161</sup> See *Small Business and the SEC*, *supra* note 17.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* (“In most cases, shareholders may use Regulation A to resell up to \$1.5 million of securities.”).

<sup>165</sup> See 17 C.F.R. § 230.252 (2014) (“Documents to be included. The offering statement consists of the contents required by Form 1–A (§ 239.90 of this chapter), and any other material information necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”).

<sup>166</sup> See *Small Business and the SEC* *supra* note 17.

Companies relying on Regulation A usually do not incur reporting obligations under the Exchange Act or Sarbanes-Oxley Act unless they independently meet the thresholds that require Exchange Act registration.<sup>167</sup> Finally, Regulation A allows companies to “test the waters” by distributing a written document to prospective purchasers or making broadcast advertisements.<sup>168</sup> This allows the company to determine if there is sufficient interest in their offering before incurring the costs involved with preparing the offering circular.<sup>169</sup>

Regulation A offerings have fallen out of favor in recent years, due to the popularity of Regulation D. This is largely due to the fact that since 1996, Regulation D offerings are exempt from individual state registration; by contrast, issuers relying on Regulation A must still register their securities in every state where they are sold. Rules 505 and 506 thus allow issuers to offer a similar or larger amount of securities with a lower regulatory burden.<sup>170</sup>

The JOBS Act amended and expanded the Regulation A exemption, introducing a new category of offering dubbed “Regulation A+.”<sup>171</sup> Under such an offering, a company is able to issue up to \$50 million of securities in a 12-month period in two separate tiers, with registration requirements very similar to Regulation A.<sup>172</sup> Unlike previous Regulation A offerings, however, securities issued under a Tier 2 offering are exempt from state registration requirements.<sup>173</sup> While Regulation A+ opens the possibility of a much larger capital raise, the costs of such an issuance are likely to be quite significant; Forbes estimated them to be between \$50,000 and

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<sup>167</sup> *Id.*

<sup>168</sup> 17 C.F.R. § 230.254 (2014).

<sup>169</sup> See *Small Business and the SEC*, *supra* note 17.

<sup>170</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS (Jul. 2012).

<sup>171</sup> Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), <http://www.sec.gov/news/pressrelease/2015-49.html> [perma.cc/D5QP-8ZJU] (“The final rules, often referred to as Regulation A+, provide for two tiers of offerings . . .”).

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* (“In light of the total package of investor protections included in amended Regulation A, the rules provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to ‘qualified purchasers,’ defined to be any person to whom securities are offered or sold under a Tier 2 offering.”).



\$100,000.<sup>174</sup> Such costs and the burdensome disclosures required means that Regulation A+ will be a more cost-effective fundraising option for later stage companies that have already received some form of outside financing,<sup>175</sup> and will not function as a direct substitute for equity crowdfunding.

The securities laws provide for several additional registration exemptions, though none are as relevant to our discussion as those above. Section 3(a)(11) of the Securities Act provides a registration exemption for offers conducted entirely within a single state.<sup>176</sup> Since the federal securities laws apply only to interstate offerings, intrastate offerings need only comply with the laws of the relevant state. Thus, any offering where the issuer is organized and carries out a significant portion of its business in the state where the offering is made, and where the issuer offers and sells securities only to that states' residents will fall outside the jurisdiction of the federal securities laws.<sup>177</sup> Recently, states have begun to issue crowdfunding regulations that fit within this exemption (or within rule 504).<sup>178</sup> These exemptions vary from state to state, but generally allow sales of securities through a website portal or registered broker-dealer.<sup>179</sup> They generally share many features with the federal exemption promulgated under Section 4(a)(6), such as requiring basic disclosures to investors, offering limits between \$100,000 and \$5 million, and caps on the amounts individual investors can invest.<sup>180</sup> While these exemptions are very new and are limited to offerings where the issuer and all investors are domiciled within the same state, they may prove to be more attractive options for issuers seeking to raise several hundred thousand dollars in funds.

## B. Sources of Private Offering Capital

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<sup>174</sup> Tanya Prive, *Regulation A+: Now Everyone Can Invest In Your Startup*, FORBES (Jun. 19, 2015, 3:49 PM), <http://www.forbes.com/sites/tanyaprive/2015/06/19/regulation-a-now-everyone-can-invest-in-your-startup/2>.

<sup>175</sup> *Id.*

<sup>176</sup> 15 U.S.C.A. § 77c (West 2015).

<sup>177</sup> *Id.*

<sup>178</sup> Anya Coverman, Deputy Dir. of Policy, N. Am. Sec. Adm'rs Assoc., Address at the National Conference of State Legislatures 2015 Legislative Summit: State Crowdfunding Update (2015).

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

Perhaps because of the unlimited offering amounts and lack of restrictions on solicitation, Rule 506 has proven to be the most popular exemption for private securities issuers.<sup>181</sup> It is under Rule 506 and the other Regulation D exemptions that the two largest sources of funding for successful startups, angel investors and venture capitalists, tend to operate.<sup>182</sup> Angel investors tend to be wealthy individuals, investing alone or in groups, who invest in early-stage companies with the intent of fostering and profiting from the company's growth.<sup>183</sup> Such investors often bring significant business expertise to the companies they invest in, and provide advice or guidance to help a

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<sup>181</sup> See Crowdfunding, *supra* note 59, at 66509 (“Based on Regulation D filings by non-fund issuers from 2009 to 2012, there are a substantial number of issuers who choose to raise capital by relying on Rule 506 even though their offering size would qualify for an exemption under Rule 504 or Rule 505. With the recent amendment to Rule 506 of Regulation D that permits an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, subject to certain conditions, we expect to see an even higher percentage of issuers relying on that rule.”).

<sup>182</sup> *Id.* at 66511 (“At present, startups and small businesses can raise capital through several sources that could be close substitutes or complements to crowdfunding transactions that rely on Section 4(a)(6). These sources are either based on unregistered securities offerings or involve lending by financial institutions.”); See generally Conner Forrest, *Funding your startup: Crowdfunding vs. Angel Investment vs. VC*, TECHCRUNCH (Jul. 22, 2014, 5:07 AM), <http://www.techrepublic.com/article/funding-your-startup-crowdfunding-vs-angel-investment-vs-vc> [<http://perma.cc/EN97-VTVX>] (“New enterprises were once only birthed by born-wealthy proprietors, or business leaders who could roll capital over from another successful venture. As the venture capital industry began to grow, capital became available to innovators who wouldn't have had access to it before. Then, as angel investors grew in popularity, founders had a new way to get capital at an early stage where some VCs wouldn't tread. Now, consumer crowdfunding has added another layer to the investment equation for entrepreneurs.”).

<sup>183</sup> John Rampton, *7 Funding Options for Accelerating Startup Growth*, INC (May 25, 2015), <http://www.inc.com/john-rampton/7-funding-options-for-accelerating-startup-growth.html> [<http://perma.cc/KL56-F7ZF>].

business grow.<sup>184</sup> Though amounts vary widely, the average angel investment totaled about \$450,000 in 2006.<sup>185</sup>

Venture capitalists can invest in companies of all sizes, though are more likely to invest in more established enterprises than angel investors, and average individual investments tend to be in the range of several million dollars.<sup>186</sup> Like angel investors, venture capitalists often assist the companies in which they invest with business expertise,<sup>187</sup> though they also are likely to acquire significant control rights over such companies.<sup>188</sup>

While both angel investors and venture capitalists can provide startups with significant inflows of capital at a relatively low cost, such investors are investing with the intention of earning a profit and are usually quite selective about companies in which they invest.<sup>189</sup> Angel investors typically aim for a return of 20-25% on their investment, and so may decline to invest in companies whose initial growth prospects are slim.<sup>190</sup> Venture capitalists tend to concentrate their investments in companies with “high-growth potential and a high likelihood of going public after only a few years of financing” and tend to prefer companies that have already received some form of financing.<sup>191</sup> As a result, companies with the best growth prospects are likely to receive angel or venture capital funding, but those with less potential will find such funding difficult to come by.

### C. Potential Downsides of the Crowdfunding Exemption

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<sup>184</sup> Nicole Fallon, *14 Creative Financing Methods for Startups*, BUSINESS NEWS DAILY (Jul. 29, 2015, 7:31 AM), <http://www.businessnewsdaily.com/1733-small-business-financing-options-.html> [<http://perma.cc/HW46-6DUV>].

<sup>185</sup> See Crowdfunding, *supra* note 59, at 66514.

<sup>186</sup> See *id.* (“[I]n 2012, VCs invested approximately \$27 billion in approximately 3,800 deals that included seed, early-stage, expansion, and late-stage companies.”).

<sup>187</sup> See Forrest, *supra* note 182.

<sup>188</sup> See Crowdfunding *supra* note 59, at 66514 (“In addition, when investing in companies, VCs tend to acquire significant control rights (*e.g.*, board seats, rights of first refusal, etc.), which they gradually relinquish as the company approaches an initial public offering.”).

<sup>189</sup> *Id.*

<sup>190</sup> See Fallon, *supra* note 184.

<sup>191</sup> See Crowdfunding, *supra* note 59 at 66514.

While the JOBS Act exemption does open the door to equity crowdfunding in a way that was not previously possible, it imposes a number of costs on those seeking to take advantage of the crowdfunding exception and strictly limits the benefits that issuers may receive. Due to the high costs of a crowdfunding issuance, the relatively low caps imposed on the amount of securities able to be issued, and the heavy restrictions on solicitation, the crowdfunding exemption will most likely be useful only to a narrow set of issuers and investors.

The intent of the JOBS Act was “to make it easier for startups and small businesses to raise capital from a wide range of potential investors and provide additional investment opportunities for investors.”<sup>192</sup> However, these businesses are generally seeking liquid capital precisely because they do not have it in sufficient supply. As such, any costs required to raise that capital are likely to be a huge deterrent, and the cost of assembling and submitting all of the disclosures required for a crowdfunding issuance could be very high relative to the amounts raised.<sup>193</sup> By SEC estimates, issuers will need to pay an average of \$17,900 (and up to \$39,810) to raise roughly \$100,000.<sup>194</sup> By the same estimates, the average cost to raise amounts up to \$500,000 could reach \$70,000.<sup>195</sup> Estimates on costs per dollar raised decrease for larger offerings, but issuers seeking to raise larger amounts are likely to be more established and less likely to resort to crowdfunded offerings to begin with.<sup>196</sup> As a percentage of the amount

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<sup>192</sup> See Sec. & Exch. Comm’n, *supra* note 92.

<sup>193</sup> Robb Mandelbaum, *What the Proposed Crowdfunding Rules Could Cost Businesses*, N.Y. TIMES (Nov. 14, 2013, 7:00 AM), [http://boss.blogs.nytimes.com/2013/11/14/what-the-proposed-crowdfunding-rules-could-cost-businesses/?\\_php=true&\\_type=blogs&\\_r=0](http://boss.blogs.nytimes.com/2013/11/14/what-the-proposed-crowdfunding-rules-could-cost-businesses/?_php=true&_type=blogs&_r=0) [perma.cc/MT7V-UV3L] (“Add to that the fee a company will pay to a funding intermediary to facilitate the transaction, which the commission expects to range from 5 to 15 percent, and a company hoping to raise \$100,000 could end up paying more for the capital than it would by borrowing the money with a credit card.”).

<sup>194</sup> Sherwood Neiss, *It Might Cost You \$39K to Crowdfund \$100K Under the SEC’s New Rules*, VENTUREBEAT (Jan. 2, 2014, 2:14 PM), <http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules> [perma.cc/2QVY-JY7T]; See generally Crowdfunding, *supra* note 59, at 66785-86.

<sup>195</sup> See Neiss, *supra* note 194.

<sup>196</sup> See *id.*

raised, these numbers are quite high. By contrast, a full IPO typically costs issuers less than 7% of the amount raised.<sup>197</sup>

Compounding this problem is the relatively low cap on issuance amounts.<sup>198</sup> As noted above, issuers relying on the crowdfunding exemption would be limited to selling \$1,000,000 worth of securities in a year. However, as discussed below, startups able to do so can typically raise much more from an angel investor or other accredited investor under one of the existing exemptions.<sup>199</sup> This suggests that the only startups engaging in crowdfunding will be less promising ones who are unable to raise capital from more established sources, such as angel investors and venture capital funds.<sup>200</sup> This, in turn, undermines the investor-protection aspect of crowdfunding regulation. If less viable startups are the only ones engaging in equity crowdfunding, less sophisticated retail investors will be left to choose from only those startups rejected by more qualified experts. Though ideally, retail investors would be provided with enough information to determine which (if any) of these enterprises are worth their support, it still provides the least sophisticated investors with the worst menu of choices.

Apart from the high potential cost, a second problem facing issuers is the heavy restrictions on solicitation.<sup>201</sup> Unlike several of the

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<sup>197</sup> *Considering an IPO?*, PWC DEALS PRACTICE PUBLICATION (PricewaterhouseCoopers, Del.), Sept. 2012, at 7, [http://www.pwc.com/en\\_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf](http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf) [perma.cc/M9KM-BAS9].

<sup>198</sup> Brian Korn, *The Trouble With Crowdfunding*, FORBES (Sept. 24, 2014, 1:18 PM), <http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding>.

<sup>199</sup> Tanya Prive, *Angel Investors: How the Rich Invest*, FORBES (Mar. 12, 2013, 9:27 AM), <http://www.forbes.com/sites/tanyaprive/2013/03/12/angels-investors-how-the-rich-invest>.

<sup>200</sup> Jim Saksa, *Kickstarter, but With Stock*, SLATE (June 23, 2014, 10:54 AM), [http://www.slate.com/articles/business/moneybox/2014/06/sec\\_and\\_equity\\_crowdfunding\\_it\\_s\\_a\\_disaster\\_waiting\\_to\\_happen.html](http://www.slate.com/articles/business/moneybox/2014/06/sec_and_equity_crowdfunding_it_s_a_disaster_waiting_to_happen.html) [https://perma.cc/PY4C-26HC].

<sup>201</sup> Michael L. Zuppone, *Demystifying the Recently Enacted Crowdfunding and Private Offering Reforms: Opportunities for Issuers and Investors*, PAUL HASTINGS LLP 1, 2-3 (Apr. 2012), <http://www.paulhastings.com/assets/publications/2164.pdf> [perma.cc/X6RX-R333] (“While issuers and their intermediaries are free to provide the general public with unrestricted access to the online platform through which the securities are offered, they may not advertise the offering except with notices that direct investors to

other available exemptions, the crowdfunding exemption would not permit general solicitation and advertising, and issuers would instead be limited to distributing very general notice directing potential investors to the appropriate funding portal. While such a heavy restriction on advertising would present a problem in nearly any industry, it is uniquely troublesome for those attempting a successful crowdfunding campaign. Crowdfunding typically relies heavily on word-of-mouth advertising and issuer promotion to be successful. “[A] crowdfunding campaign, by its very nature, requires social momentum. And if there isn't the requisite amount of social momentum, the ball just won't get rolling,” noted Catherine Clifford in an article for *Entrepreneur*.<sup>202</sup> “[S]ocial buzz tends to correlate with money raised. The more you hustle to get your story out, the more money you raise.”<sup>203</sup> Issuers who are unable to maximize their advertising potential may find it very difficult to launch the ever-expanding wave of donors that is typically required to hit a funding goal.

Even beyond potential problems arising from too-aggressive advertising, it would be unsurprising to see issuers refrain from perfectly permissible activities due to the high degree of legal liability that the exemption would impose.<sup>204</sup> Under the proposed rules, an issuer, including its officers, directors, or partners, can be liable for any material misstatements or omissions contained in its disclosure materials.<sup>205</sup> This could force startups to retain outside legal or accounting assistance in preparing their disclosure materials or force them to purchase insurance to cover the cost of an enforcement action. Any of these options could be cost-prohibitive for a newly formed

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relevant broker or funding portal. This will preclude the use of detailed offering specific blast emails and faxes, mass mailed tout sheets and similar communications that promote the investment.”).

<sup>202</sup> Catherine Clifford, *Why Fraudsters Won't Sink Equity Crowdfunding*, *ENTREPRENEUR* (Apr. 22, 2014), <http://www.entrepreneur.com/article/233292> [<https://perma.cc/Y6LB-H6AD>].

<sup>203</sup> *Id.*

<sup>204</sup> *SEC Proposes Rules to Implement Crowdfunding Exemption: What Factors Will Affect Its Success?*, GIBSON, DUNN & CRUTCHER LLP (Nov. 11, 2013), <http://www.gibsondunn.com/publications/pages/SEC-Proposes-Rules-to-Implement-Crowdfunding-Exemption-What-Factors-Will-Affect-Its-Success.aspx> [<https://perma.cc/3MJC-EDP3>] (“Issuers and intermediaries in crowdfunding transactions are subject to liability under federal securities laws similar to registered offerings.”).

<sup>205</sup> See Crowdfunding, *supra* note 59, at 66498-99.

company. Though such costs would be less onerous for more established businesses, such businesses are more likely to have access to other funding sources, and are less likely to rely on a crowdfunded offering to raise capital.<sup>206</sup>

Additionally, the restrictions on secondary transfer could prevent issuers from engaging in a crowdfunded offering. Crowdfunded securities are subject to a 1-year holding period, preventing the initial purchaser from re-selling them for that amount of time.<sup>207</sup> Since early-stage companies in need of additional capital are unlikely to pay dividends frequently, investors will only be able to extract value from their securities through sale. Prohibiting such a sale thus decreases the securities' liquidity and necessarily decreases their value to investors, who are only likely to buy them for a discounted price. Even more concerning is the possibility that investors could face the predicament sometimes encountered by shareholders in closely-held companies, where the lack of a liquid secondary market means that investors are only able to sell back to company founders, who are able to exact unfair terms in the sale.<sup>208</sup> This, combined with the general uncertainty about how sales beyond the 1-year holding period would work, lowers the amount an investor would be willing to pay for a share offered through an equity crowdfunding offering, and thus limits the amount of capital that a company is able to raise through such an issuance.<sup>209</sup>

With these concerns in mind, there are several changes the SEC should make when promulgating its final rules in order to maximize the utility of the crowdfunding exemption. As noted by many commenters, the costs of compliance are perhaps the greatest

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<sup>206</sup> Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the Crowdfund Act*, 66 VAND. L. REV. 43, 46 (2013) ("First, experience in the IPO market has shown that mandatory disclosures can easily push the cost of a securities offering out of reach for offerings of modest size. For the type of small offerings authorized by the Act (under \$1 million), extensive disclosure is simply not an economically viable option. The only way that crowdfunding can work is if the process is exceedingly inexpensive.").

<sup>207</sup> See JOBS Act §302(e).

<sup>208</sup> See Schwartz, *supra* note 206, at 54.

<sup>209</sup> See GIBSON, DUNN & CRUTCHER, *supra* note 204 ("This concern may be heightened if the Commission adopts additional limitations on resale after the first year, or if resale or trading is restricted when the issuer is no longer in compliance with on-going reporting requirements or is out of business, as suggested by the Staff's questions in the proposing release.").

obstacle facing potential issuers.<sup>210</sup> However, eliminating many of the expensive informational disclosures required of issuers could significantly reduce these costs.<sup>211</sup> In order to balance the need to reduce disclosure costs with the SEC's mandate of consumer protection, it would be useful to create a "small donations" tier within the existing crowdfunding exemption.<sup>212</sup> Under such a scheme, an

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<sup>210</sup> See Schwartz, *supra* 206, at 46.

<sup>211</sup> See, e.g., Letter from Catherine T. Dixon, Chair of the Fed. Regulation of Sec. Comm., Am. Bar Ass'n, to Kevin M. O'Neill, Deputy Sec'y, Sec. & Exch. Comm'n 2 (May 28, 2014) (on file with author) ("In this regard, management of such issuers should be able themselves to read and understand the regulatory requirements, and become familiar with the liability consequences of noncompliance, without having to devote a significant portion of the proceeds of a crowdfunding offering to the payment of legal, accounting and financial advisory fees. The intended benefits of crowdfunding could be undermined, in our view, if the costs and burdens of compliance are inconsistent with the fundamental purpose of the legislation—to promote small business capital formation as a means of generating jobs.").

<sup>212</sup> Something along these lines was proposed by the Sustainable Economies Law Center in a Petition for Rulemaking to the SEC in 2010. Letter from Jenny Kassan, Sustainable Economies Law Ctr., to Elizabeth M. Murphy, Sec. & Exch. Comm'n, (July 1, 2010), <https://www.sec.gov/rules/petitions/2010/petn4-605.pdf> [<https://perma.cc/A4GV-VUV5>] ("[W]e propose a new exemption for securities offerings up to \$100,000 with a limit of \$100 per investor. These small investments can be a powerful source of grassroots and local funding for developing small businesses. The small amount at stake and maximum aggregate cap ensure the protection of investors while furthering the public interest in this type of investment."). This petition was cited in testimony by several witnesses at Congressional hearings preceding the passage of the JOBS Act in 2012. See *Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the Comm. on Oversight and Gov't Reform*, 112th Cong. 9 (2011) (statement of Meredith B. Cross, Director, Division of Corporation Finance, Sec. & Exch. Comm'n) ("For example, the Commission received a rulemaking petition requesting that the Commission create an exemption from the Securities Act registration requirements for offerings with a \$100,000 maximum offering amount that would permit individuals to invest up to a maximum of \$100."); *Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the Comm. on Oversight and Gov't Reform*, 112th Cong. 52 (2011) (statement of Sherwood Neiss) (Neiss mentions Murphy's Petition in a list of reports "written about the SEC



issuer would be freed from nearly all of the informational disclosure requirements under the proposed rules. However, while the issuer would still be able to raise an aggregate of \$1 million and the aggregate amount an investor would be able to invest in crowdfunding offerings would remain the same, the cap for individual investments would be very small. That is, investors would be limited to making very small investments, perhaps no more than \$250, in any particular project.<sup>213</sup>

This limitation would help to preserve the consumer-protection mandate of the JOBS Act. Typical donations to rewards-based crowdfunding sites are of a similar magnitude; the average pledge on Kickstarter is about \$70.<sup>214</sup> Such sites have a remarkable track record of self-policing without requiring much in the way of formal informational disclosures.<sup>215</sup> It is certainly possible that fraudsters might find spurious equity offerings to be more attractive vehicles than fraudulent rewards-based crowdfunding campaigns, but there is at least a strong history of crowdfunding communities policing themselves. The wisdom of the crowd, as many commenters noted, is often imperfect,<sup>216</sup> but it seems to be an adequate guard against fraud in these types of modest transactions. In such cases, those contemplating fraudulent schemes may decide that the amounts at stake are too low to make a scam worthwhile. Even if a fraudster did

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rules and how they prohibit access to capital for small businesses and entrepreneurs.”).

<sup>213</sup> Letter from Am. Sustainable Bus. Council to Sec. & Exch. Comm’n 1 (Jul. 24, 2012) (on file with author).

<sup>214</sup> Maxim Wheatley, *Kickstarter Statistics Dissected*, ALLEY WATCH (July 31, 2013), <http://www.alleywatch.com/2013/07/kickstarter-statistics-dissected> [perma.cc/A87J-8NSF].

<sup>215</sup> Letter from Ethan Mollick, Edward B. and Shirley R. Shils, Assistant Professor of Mgmt., Univ. of Penn., to Sec. & Exch. Comm’n 1 (on file with author) (“I found that fraud is very low in reward-based crowdfunding with the amount of money pledged to projects that ultimately seem to have no intention of delivering promised products accounts for less than 0.1% of all pledged funds in the study. This is despite the fact that reward-based crowdfunding sites have few if any formal controls against fraud beyond an initial screen by the reward-based portal.”).

<sup>216</sup> Daniel Isenberg, *The Road to Crowdfunding Hell*, HARV. BUS. REV. (Apr. 23, 2012), <https://hbr.org/2012/04/the-road-to-crowdfunding-hell> [http://perma.cc/EK9H-55HR] (“Crowds are stupid as often as not, or worse.”).

manage to perpetrate a scheme, \$250 is an amount most Americans can afford to lose without facing financial ruin.<sup>217</sup>

Moreover, if the \$250 limit would mitigate concerns about unsophisticated investors being hoodwinked by unscrupulous issuers, it would allow the SEC to lighten many of the regulatory burdens that issuers currently face. Most importantly, the SEC might be able to permit issuers to solicit more broadly under this regime. This would alleviate one of the major concerns for issuers regarding the crowdfunding regime embodied in the proposed rules; that any equity crowdfunding campaign would be dead on arrival due to the stringent limitations posed on solicitation. If issuers were permitted to solicit investors more broadly, they could actually initiate the kind of word-of-mouth advertising that drives most successful rewards-based crowdfunding campaigns. Indeed, the issuer would actually be practicing something much more like traditional crowdfunding than that contemplated by the current rules. After all, allowing a broad audience to decide on a potential investment's merits is the premise on which crowdfunding is based. The broader the audience that an issuer is allowed to reach, the better that audience should be at separating a potentially worthwhile investment from one that does not merit funding.

Additionally, because the \$250 amount is easily verifiable, it would remove a great deal of the enforcement burden currently placed on issuers and intermediaries. These kinds of administrability concerns are important for small issuers, whose ability to track their investors and contributions is extremely limited. Further, it would greatly simplify compliance with the applicable laws, and decrease the likelihood of an unsophisticated issuer accidentally running afoul of a complex regulatory regime. This simplified system might be attractive to issuers who would have been nervous of a more demanding regulatory slate and the high degree of legal liability that attaches to legal missteps. Under such a regulatory regime, issuers would be able to raise capital at a much-reduced cost and investors would be able to make equity investments in exciting new enterprises while limiting their risk of being defrauded.

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<sup>217</sup> See Am. Sustainable Bus. Council, *supra* note 213, at 1 (“Few would suggest that \$250 imposes a significant risk on any investor. In our view—and, we believe, in the view of the vast majority of Americans—the risk of investing \$250 in a local company is no greater than the risk most Americans regularly tolerate when they spend \$250 in a fancy restaurant or gamble in one of 1,000 casinos in the country.”).

## V. *Conclusion*

Excitement surrounding the potential of equity crowdfunding is widespread, and the JOBS Act exemption allows such a securities issuance to proceed in a way that was not previously possible. The ability to buy stock in small, private companies has thus far been mostly limited to deep-pocketed institutional investors, so some of this excitement is certainly understandable. When the SEC issues its final rules, investors will finally be able to support their chosen businesses with something more intimate than their patronage or even a donation; investors might actually be able to own a piece of the business themselves. Even beyond the ability to earn an investment profit in new ways, investors may now be able to have some say as to how their favorite coffee shop, gadget inventor, or app developer does business, or can secure a legal claim on that business's assets.

Meanwhile, small businesses with hopes of growth will be granted another tool with which they can battle the ever-present gauntlet of capital access. Businesses that need more cash than a rewards-based crowdfunding campaign can raise or who are unable to secure debt financing at a reasonable price will now have another option through which to seek funds. Combined with the apparent willingness of investors to support businesses they believe in with significant amounts of cash, this system should aid the flow of capital from investors to businesses, and help the American economy to develop.

However, the JOBS Act's focus on lowering barriers to capital formation runs directly counter to the regulatory apparatus that has sought to protect against systematic fraud since the Great Depression. In an effort to protect investors from those peddling worthless securities in nonexistent companies, the SEC requires any company selling securities to the public to disclose massive amounts of information about its operations and prospects, an expensive process that is beyond the means of most small businesses.

By necessity, then, the JOBS Act's attempt to please two masters ends up pleasing neither. In seeking to ensure that small securities issuances remain free of fraud, the JOBS Act places restrictions on such activity in a way that robs it of most of its attractiveness. The required disclosure burdens are detailed and costly, and the potential rewards are relatively low. Due to these limits, the simple uncertainty surrounding the new regime, and the availability of potentially more attractive fundraising methods, it is likely that most

issuers will eschew equity crowdfunding in favor of more established fundraising methods. As currently constructed, the equity crowdfunding exemption will remain useful only under an extremely narrow set of circumstances. Only issuers who are unable to obtain debt or venture capital financing are likely to resort to the small contributions provided by crowdfunding investors. Likewise, the only investors likely to actually purchase equity offerings through a crowdfunding platform will either be those undeterred by the risky nature of the issuers, or those who are supporting a company for motives other than making a profitable investment.

With this in mind, the exemption would be most useful if it embraced its limited nature and catered to the needs of that specific investor set, rather than trying to be all things to all people. If the exemption focused specifically on allowing only small investments at extremely low cost, the Act could actually help to fill a hole in the current startup-financing environment. Under such an arrangement, profit minded investors could still invest in a wide range of small enterprises; the low limits on individual investments might actually force investors to diversify their portfolios. Meanwhile, investors with an emotional attachment to a certain business could purchase an ownership stake, and companies in need of capital could solicit contributions while offering a more compelling reward than a few hats or t-shirts. The SEC, for its part, could rest easy knowing any single investor would be unlikely to lose their life's savings in an online fraud.

While not quite the grand, game-changing vision that the proponents of the Crowdfunding Act might have envisioned, this version of crowdfunding accomplishes nearly the same goals in a far humbler manner. In the world of securities investing, where grand pronouncements and superlatives should always be received with a grain of salt, humility may yet prove to be the most effective approach.