LIKE OIL AND WATER: EQUITY CROWDFUNDING AND SECURITIES REGULATION

by
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The internet's ability to gather large numbers of people with similar interests has enabled an explosion of interest in crowdfunding. Examples of funding sites include Kickstarter, Indiegogo, and Peerbacker. In exchange for individual "donations," fundraisers offer rewards ranging from something as small as a thank-you note to a copy of the finished product or even more cachet items like the funder's name in movie credits. These sites demonstrate the great potential for crowdfunding as a source of funding. However, up until recently, federal securities law has prevented crowdfunding from offering debt or equity interests in return for funding. The Jumpstart Our Business Startups Act changed this by providing an exemption for crowdfunded securities.

This Comment examines crowdfunding in the context of federal securities law to demonstrate fundamental inconsistencies. Securities law primarily seeks to control the market by requiring disclosure of material information and imposing liability for misstatements and material omissions. Some exemptions permit reduced disclosures when there are alternative means of investor protection. Unfortunately, any crowdfunding exemption would require heavily reduced disclosure requirements and the peculiarities of crowdfunding preclude traditional alternative means of investor protection. This Comment explores this fundamental incompatibility, uses the JOBS Act to demonstrate the problems with a crowdfunded security exemption, and offers some observations on what might be more successful.

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I. INTRODUCTION

In a short period, crowdfunding has gone from a new concept to a major component of a President's jobs agenda. The term "crowdfunding" is as new as 2006.[1] In July of 2010, the Sustainable Economies Law Center petitioned the Securities and Exchange Commission ("SEC") to exempt securities offerings of up to $100,000, provided no single investor contributed more than $100.[2] The petition cited "crowdfunding" as support for the idea that "[t]he public has already demonstrated an interest in making the[se] types of small investments . . . exempt."[3] A year later, as a part of a slew of job-creating proposals, the White House endorsed a new crowdfunding exemption.[4] In April 2012, Congress enacted the Jumpstart Our Business Startups Act ("JOBS Act") to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[5] Title III of the JOBS Act is a crowdfunding exemption. The SEC has proposed rules implementing the exemption.[6]

Having risen to prominence so quickly, crowdfunding lacks precise boundaries and definitions. Crowdfunding is a descendent of "crowdsourcing": the practice of soliciting services or ideas from a large group of individuals often using the internet.[7] Crowdfunding shares

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[1] Various sources on the internet attribute the term to Michael Sullivan, founder of the now defunct FundaVlog. *See, e.g.*, *Crowdfunding*, Paul McFedries Word Spy (July 1, 2008), http://www.wordspy.com/words/crowdfunding.asp; *The History of Crowdfunding*, Fundable.com, (2014), http://www.fundable.com/crowdfunding101/history-of-crowdfunding.

[2] Sustainable Economies Law Ctr., Petition for Rulemaking: Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration (July 1, 2010), *available at* http://www.sec.gov/rules/petitions/2010/petn4-605.pdf. Other petitions followed. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Law,* 2012 Colum. Bus. L. Rev. 1, 81.

[3] Sustainable Economies Law Ctr., *supra* note 2, at 3.

[4] Press Release, White House Office of the Press Secretary, Fact Sheet and Overview (Sept. 8, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview. The endorsement indicated that the exemption should be limited to firms raising less than $1 million, and individual investments should be capped at $10,000 or 10% of an investor's annual income.

[5] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

[6] Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified in scattered parts of 17 C.F.R.).

[7] Andrew A. Schwartz, *Crowdfunding Securities,* 88 Notre Dame L. Rev. 1457, 1459 (2013).

crowdsourcing's "democratic impulse" but differs in that it taps the crowd's wallets rather than the crowd's expertise.[8] The internet's ability to gather large numbers of people with similar interests has enabled an explosion of interest in crowdfunding. Examples of funding sites include Kickstarter, Indiegogo, and Peerbacker. In exchange for individual "donations," fundraisers offer rewards ranging from something as small as a thank-you note to a copy of the finished product or even more cachet benefits like the funder's name in movie credits.[9] These sites demonstrate the great potential for crowdfunding as a source of funding.[10] However, up until recently, federal securities law has prevented crowdfunding from offering debt or equity interests in return for funding.[11]

Federal securities regulations forbid offering a security for sale unless the issuer files a registration statement with the SEC.[12] With registration comes a host of regulatory requirements, including requiring the disclosure of information about the security, the offering, and ongoing periodic financial reports.[13] Those selling securities are liable for misstatements and material omissions in these disclosures.[14] Registering a security is "an absolute bar to the very smallest offerings and a substantial impediment to slightly larger offerings."[15] Instead, companies usually raise equity capital using a statutory or regulatory exemption from registration.[16] An analysis of both registration and registration exemptions as a single model of regulation reveals several principles. Federal securities regulations primarily seek to control the market by requiring disclosure of material information and imposing fraud liability for misstatements

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[8] Jeff Howe, Crowdsourcing: Why the Power of the Crowd is Driving the Future of Business 246 (2008).

[9] *See* Bradford, *supra* note 2, at 16.

[10] Kickstarter alone has helped raise over $900 million since its launch on April 28, 2009. *Kickstarter Basics*, Kickstarter (2014), https://www.kickstarter.com/help/faq/kickstarter%20basics.

[11] Bradford, *supra* note 2, at 31 ("Crowdfunding offerings of the donation, reward, and pre-purchase type clearly do not involve securities for the purpose of federal law. . . . Crowdfunding sites organized on the equity model are usually offering securities.").

[12] Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2012).

[13] *See id.* § 10(a), 15 U.S.C § 77j; Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m.

[14] Section 11 of the Securities Act imposes strict liability for untrue or omissions of material statements in a registration statement. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k. Rule 10b-5 of the Exchange Act imposes liability for fraud in connection with the purchase or sale of a security. 17 C.F.R. § 240.10b-5 (2014).

[15] C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. Small & Emerging Bus. L. 1, 24 (2001).

[16] In 2012, private offerings raised $1.7 trillion while registered offerings raised $1.2 trillion. Vladimir Ivanov & Scott Baugess, SEC, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012, at 8 (July 2013), *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

and material omissions in those disclosures.[17] Recognizing that this is expensive, exemptions provide an alternative means of raising capital. These exemptions reduce disclosure, thus reducing cost, but only if justified by some other form of investor protection. The most prominent alternative source of protection is the sophistication of the investor or some proxy for it.

The JOBS Act added several new exemptions from the registration requirement, including one for crowdfunding. Critics of the new exemption argue that it imposes regulatory requirements beyond existing exemptions[18] while others argue that the exemption fails to protect investors.[19] This Comment takes one step back and argues that the problems with the crowdfunding exemption stem from a larger issue—the fundamental incompatibility between crowdfunding's principles and the primary mode of federal securities regulation in the United States.

Part II of this Comment identifies the primary method of investor protection in federal securities laws by looking at the registration requirement in the Securities Act as well as the exemptions to registration. Part III identifies key crowdfunding principles and demonstrates how these principles are incompatible with the traditional methodology of investor protection in federal securities regulations. Part IV examines the crowdfunding exemption in the JOBS Act to demonstrate this incompatibility and identify alternative methods of investor protection in the Act. Part V proposes modifications to the crowdfunding exemption.

II. THE DISCLOSURE SLIDING SCALE OF FEDERAL SECURITIES REGULATIONS

A. *Federal Securities Law in a Nutshell*

Prior to the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), the federal government

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[17] Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984).

[18] *See, e.g.*, Stuart R. Cohn, Essay, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1437 (2012); C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 200–02 (2012).

[19] *See, e.g.*, Letter from Mary L. Schapiro, Chairman, SEC to The Honorable Tim Johnson, Chairman, Comm. on Banking, Housing, and Urban Affairs, U.S. Senate, & Richard C. Shelby, Ranking Member, Comm. on Banking, Housing, and Urban Affairs, U.S. Senate (Mar. 13, 2012) *available at* http://www.aicpa.org/Advocacy/Issues/DownloadableDocuments/404b/3-13-12_SEC_Chm_Schapiro_Letter_to_Johnson.pdf; Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1767 (2012) ("Exposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals to the perceived need to lower the disclosure barriers for small businesses and crowdfunding techniques.").

largely left securities regulation to state "Blue Sky" laws.[20] The 1920s stock market crash and Great Depression led many to believe that federal regulation was required to protect the public. Interstate securities transactions were becoming the norm.[21] This made complying with multiple state laws burdensome for both those seeking investment and those litigating claims for fraud.[22]

The regulatory model of the Securities Act and the Exchange Act is mandatory disclosure of material information.[23] This model "protect[s] investors by promoting full disclosure of information thought necessary to informed investment decisions."[24] Section 5 of the Securities Act makes it unlawful to offer to sell securities without filing a registration statement with the SEC and requires disclosure of information to prospective purchasers in a prospectus.[25] A registered offering under the Securities Act triggers the Exchange Act's ongoing periodic reporting requirements.[26] Fraud provisions in the Securities and Exchange Acts gives force to the mandated disclosures. Section 11 of the Securities Act imposes liability for materially false or misleading statements in a registration statement or prospectus. Rule 10b-5 prohibits fraud in connection with the sale of securities. This regulatory model of disclosure continues today:

> The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.[27]

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[20] Manning Gilbert Warren III, *Reflection on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. Rev. 495, 496–97 (1984).

[21] Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 Harv. L. Rev. 1197, 1223 (1999).

[22] Easterbrook & Fischel, *supra* note 17, at 679.

[23] *See* H.R. Rep. No. 73-85, at 2 (1933) ("There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."); Williams, *supra* note 21, at 1209–10.

[24] SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

[25] Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2012).

[26] Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m.

[27] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, (May 11, 2013), http://www.sec.gov/about/whatwedo.shtml#.U0rZLvldWJs.

Disclosing information is expensive in an abstract economic sense.[28] The discloser must bear the costs of gathering the information, preparing it for publication, and checking it for accuracy. In the registration and periodic reporting process, these costs can be astronomical. Underwriter fees often equal five to seven percent of gross proceeds from sale and additional costs, including legal, accounting, and printing fees, often run in the millions.[29] After a registered offering, companies become "public" and must comply with costly ongoing reporting requirements.[30] Recognizing this cost, as well as the difficulty many companies would have complying with the requirements, federal securities laws exempt various offerings from the registration requirements.[31] Exempt securities offerings are still subject to fraud liability.[32] Section 17 of the Securities Act[33] and Rule 10b-5 under section 10(b) of the Exchange Act[34] impose liability for misstatements and omissions of material facts in connection with the sale of securities regardless of whether the sale was registered. These provisions create a de facto disclosure requirement of material information for all sales of securities.[35]

B. *The Disclosure Sliding Scale*

Regulation by exemption demonstrates a pattern: a reduction in required disclosure if some other restriction or requirement provides an alternative means of investor protection. This is what this Comment calls the "disclosure sliding scale" of securities regulations—less disclosure in exchange for other investor protections. These alternatives do not guarantee investor protection. Federal securities law, in both registration and its exemptions, rely on the principle of *caveat emptor*—let the buyer beware. Instead of guaranteeing a good investment, registration and exemption balance the competing goals of securities regulations: facilitating the raising of capital and protecting investors.

The disclosure sliding scale is identifiable in many of the more common exemptions to the disclosure requirements. Section 4(a)(2) of the Securities Act, the private placement exemption, exempts "transactions by an issuer not involving any public offering" from the registration

[28] *See* Easterbrook & Fischel, *supra* note 17, at 669–71.

[29] Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 Entrepreneurial Bus. L.J. 369, 372 (2006) ("The total charge after expenses and underpricing can average over seventeen percent of the value of the stock sold, as measured at the end of the first day of trading.").

[30] *See Small Business and the SEC: Should My Company Go Public?*, SEC (Feb. 27, 2014), http://www.sec.gov/info/smallbus/qasbsec.htm#gopublic.

[31] SEC v. Ralston Purina Co., 346 U.S. 119, 121 (1953).

[32] 15 U.S.C. § 77q(c) (2012).

[33] Securities Act of 1933 § 17, 15 U.S.C. § 77q.

[34] 17 C.F.R. § 240.10b-5 (2014).

[35] *See* Harry S. Gerla, *Issuers Raising Capital Directly from Investors: What Disclosure Does Rule 10B-5 Require?*, 28 J. Corp. L. 111, 124 (2002).

requirement of section 5 of the Securities Act.[36] The difference between public and private offerings "turn[s] on whether the particular class of persons affected needs the protection of the [Securities] Act."[37] An offering is exempt if the security is only offered to those that are "able to fend for themselves."[38] In determining an offeree's ability to fend for themselves, courts have focused on sophistication and access to information.[39] The offeree must have access to the type of information that a registration statement would provide.[40] The disclosures required in a private placement, through the anti-fraud provisions, are less substantial than a fully registered offering. The sliding scale reduces the cost of disclosure while limiting the sale to those who are "able to fend for themselves" with both access to information and sophistication to understand the information.[41]

The SEC provides a safe harbor provision to section 4(a)(2) in Rule 506 of Regulation D.[42] The rule limits sales to "accredited investors" and up to 35 sophisticated investors who "either alone or with his purchaser representative(s) [have] such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment."[43] Both categories serve as proxies for sophistication.[44] Accredited investors include sophisticated entities, such as banks and insurance companies; sophisticated insiders in the company selling the securities; and wealthy individuals with a net worth greater than $1,000,000 or annual income greater than $200,000.[45] Commentators have questioned the wisdom of using wealth as a proxy for sophistication, especially when the measure of wealth does not adjust to inflation.[46] However, the accredited investor standard is justified as limiting

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[36] Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2).

[37] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

[38] *Id.*

[39] *See* Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971) (denying a section 4(2) exemption when sophisticated investors in a franchise had no access to information).

[40] *See Ralston Purina Co.*, 346 U.S. at 125–26; Teague v. Bakker, 35 F.3d 978, 988 & n.12 (4th Cir. 1994); Ackerberg v. Johnson, 892 F.2d 1328, 1337 (8th Cir. 1989); SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980); Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 900 (5th Cir. 1977).

[41] *See Ralston Purina Co.*, 346 U.S. at 125.

[42] 17 C.F.R. § 230.506 (2014).

[43] *Id.* § 230.506(b)(2)(ii).

[44] C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1123. The first proxy, accreditation, is much more common—only 11% of Rule 506 offerings between 2009 and 2012 included non-accredited investors. IVANOV & BAUGESS, *supra* note 16, at 15.

[45] 17 C.F.R § 230.501(a)(5) & (6).

[46] *See, e.g.*, Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3427–28 (2013); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 733 (2009).

private placements to those that are more likely to be financially sophisticated, have enough financial resources pay for advice, and can bear the risk of a total loss. In addition to the de facto disclosure requirement required by the liability section, Rule 506 requires disclosure of financial information to non-accredited investors and recommends similar disclosures to all investors.[47] Rule 506 demonstrates the traditional sliding scale of federal securities regulations. Less extensive and expensive disclosures are required than in a section 5 registered offering. This reduction is justified by alternative means of investor protection—the rule limits offers to those who can fend for themselves, because of either sophistication or wealth.

Another example of the disclosure sliding scale can be found in the local offering exemption. Securities offered exclusively intrastate are statutorily exempted from section 5 registration.[48] Courts narrowly construe the statute[49] and the SEC offers a narrow safe harbor.[50] The justification for the statutory exemption is difficult to discern from the legislative history. The 1933 House Committee Report states registration should not be required "where there is no practical need for [the bill's] application or where the public benefits are too remote."[51] The SEC has taken the position that "the investors would be protected both by their proximity to the issuer and by state regulation."[52] The safe harbor of section 3(a)(11) only exempts intrastate offerings from the registration and prospectus requirements; the de facto disclosure requirement imposed by anti-fraud sections still apply. The intrastate offering demonstrates the disclosure sliding scale model. Reducing disclosure requirements is justified by the protections provided by the proximity of the purchaser to the offering.

[47] 17 C.F.R. § 230.506(b)(2)(ii). § 230.502(b) ("Note: . . . an issuer . . . should consider providing such information [as it provides to non-accredited investors] to accredited investors . . . in view of the anti-fraud provisions of the federal securities laws.").

[48] Section 3(a)(11) of the Securities Act exempts from registration "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012).

[49] *See*, *e.g.*, Busch v. Carpenter, 827 F.2d 653, 656 (10th Cir. 1987).

[50] Rule 147 provides that offers and sales by an issuer of securities shall be deemed to be a section 3(b)(11) intrastate offering if all the following conditions are satisfied: (1) the issuer is a resident and doing business within the state; (2) the offerees and purchasers are all residents within the state; (3) resales are limited to residents within the state for nine months; and (4) issuer takes certain precautions to prevent sales outside the state. 17 C.F.R. § 230.147.

[51] H.R. Rep. No. 73-85, at 5.

[52] Part 230—General Rules and Regulations, Securities Act of 1933: Definitions and Clarification of Certain Conditions Regarding Intrastate Offering Exemption, 39 Fed. Reg. 2353 (Jan. 21, 1974).

The disclosure sliding scale is perhaps clearest in the varying disclosures required in a section 5 registered offering, a Regulation A exemption offering,[53] and proposed regulation implementing section 401 of the JOBS Act.[54] Regulation A exempts offerings less than $5 million in a 12-month period from the registration process while requiring a less demanding disclosure process that mimics section 5 registration. Regulation A issuers must file a disclosure document, called an offering statement, with the SEC.[55] "The core of the offering statement is the offering circular, a disclosure document much like an abbreviated version of the prospectus in a registered offering."[56] Issuers must deliver the offering circular to prospective purchasers, and the circular must contain financial statements.[57] These disclosures are designed to be cheaper than full registration in part because they are not subject to section 11 liability.[58] Additionally, issuers do not have to provide audited financial statements and are not subject to the Exchange Act's periodic reporting requirements.[59] These reduced disclosure requirements are justified given the limited size of the offering, "bad actor" disqualifications,[60] and lack of state blue-sky law preemption.[61] Regulation A offerings are rare—between

[53] 17 C.F.R. § 230.251. Regulation A, often called a "mini-offering," is authorized by section 3(b) of the 1933 Act, which allows the SEC to exempt from the registration requirement offerings up to $5 million subject to the condition that the SEC find that registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b).

[54] Section 401 of the JOBS Act amended section 3(b) of the Securities Act by adding section 3(b)(2). JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 323–25 (2012) (codified in scattered sections of 15 U.S.C.). Section 3(b)(2) directs the SEC to adopt rules adding a new exemption from the registration requirements for offerings of up to $50 million in a 12-month period. 15 U.S.C. § 77c(b)(2).

[55] 17 C.F.R. § 230.252. For a more extensive review of the filing and disclosure requirements under Regulation A, see Rutherford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 32 DEL. J. CORP. L. 77, 104–06 (2006).

[56] Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3927 (proposed Jan. 23, 2014) (to be codified in scattered parts of 17 C.F.R.).

[57] Rule 251(d)(2) prohibits sales of securities until the issuer files an offering statement with the SEC, the offering statement becomes qualified, and the issuer has delivered an offering circular to the purchaser. 17 C.F.R. § 230.251(d)(2). Rule 253 lists the required contents of an offering circular including narrative and financial information. *Id.* § 230.253.

[58] Section 11 of the Securities Act imposes strict liability for untrue statements or omissions of material facts in a registration statement. Securities Act of 1933 § 11, 15 U.S.C. § 77k. Because a Regulation A issuer files an "offering statement" instead of a "registration statement," section 11 does not apply.

[59] 17 C.F.R. § 230.251(a)(2).

[60] *Id.* § 230.262.

[61] In 2005, Congress considered preempting state control for most security offerings including Regulation A but declined to do so. Capital Markets Deregulating and Liberalization Act of 1995, H.R. 2131, 104th Cong. § 18.

2009 and 2012 there were only 16 Regulation A offerings.[62] Issuers have found the costs similar to full registration and prohibitively expensive.[63] Expensive disclosure requirements discourage smaller offerings while coordination with state law discourages larger offerings.[64]

The JOBS Act amended section 3(b) of Securities Act to require the SEC to add a new exempted class of securities.[65] The SEC's proposed rule effectively splits Regulation A offerings into two tiers.[66] Tier 1 consists of the pre-JOBS Act Regulation A offering. Tier 2 (the so-called "Regulation A+" exemption) allows offerings of up to $50 million in a 12-month period.[67] Again, issuers are only exempt from section 5 registration requirements, so disclosure of material information is de facto required by anti-fraud provisions. Tier 2 offerings must comply with all tier 1 requirements but must also provide audited financial statements in their offering documents as well as file annual and semiannual reports with the SEC.[68] Additionally, investors cannot invest more than 10% of the greater of their annual income or net worth in a tier 2 offering.[69] The proposed regulation would preempt state securities law registration in both tiers.

The section 5 registration process, the Regulation A exemption, and the proposed Regulation A+ exemption create a three-tier system. The largest offerings are subject to the highest disclosure requirements. Smaller offerings require less disclosure. This reduction in disclosure is justified by their smaller size as well as other alternative means of investor protection including state regulation, "bad actor" preemption, and caps on individual investments.[70]

Other areas of securities regulations reflect the disclosure sliding scale. For example, smaller registered companies and newer registered companies have reduced ongoing disclosure requirements if they qualify as an "emerging growth company" or a "smaller reporting company."[71] Reduced disclosure is justified, as these companies do not pose the same systemic risk as large reporting companies. The types of securities that are categorically exempt from the Securities Act provide another example of the disclosure sliding scale. Government issued securities are ex-

[62] Crowdfunding, 78 Fed. Reg. 66,428, 66,510 (Proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232).

[63] Sustainable Economies Law Ctr., *supra* note 2, at 5.

[64] Campbell, *supra* note 55, at 111.

[65] JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 323–25 (2012) (codified in scattered sections of 15 U.S.C.).

[66] Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3925, 3927 (proposed Jan. 23, 2014) (to be codified in scattered parts of 17 C.F.R.).

[67] *Id.*

[68] *Id.*

[69] *Id.* at 3929.

[70] *Id.* at 3930, 3937.

[71] 17 C.F.R. § 229.10(f) (2014); Securities Act of 1933 § 7(a)(2), 15 U.S.C. § 77g(2) (2012).

empt[72] because the democratic process and lack of profit motive theoretically decrease the likelihood of fraud.[73] Short-term, unsecured promissory notes issued by large corporations to meet short-term debt, called commercial paper, are exempt[74] due to the sophistication of the market and market participants.[75]

The disclosure sliding scale model accurately describes much of federal regulation of the sale of securities. It describes the general preference for disclosure of information instead of merit-based regulation. This model is not completely accurate. Almost 100 years of legislation, SEC rulemaking, and judicial interpretation define federal securities regulation and no one model can accurately capture it in its entirety. However, the model provides a useful framework for understanding any modification to securities regulations.

III. THE SLIDING SCALE AND CROWDFUDING—FUNDAMENTALLY INCOMPATIBLE

While crowdfunding is difficult to define, at a minimum, it includes collecting small investments from a large number, the "crowd," of individuals.[76] "Equity crowdfunding" is crowdfunding where the crowd receives an equity interest in exchange for their funds. It is difficult to distinguish this from traditional financing.[77] After all, any initial public offering solicits contributions from a large number of investors to fund a single project. Differentiating equity crowdfunding from traditional equity financing requires looking at the characteristics of investors, the issuers who stand to gain, and the purported benefits of the "wisdom of the crowd."

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[72] Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2).

[73] Some disclosure is still required through the Exchange Act requiring securities firms that deal in municipal securities to provide "official statements" for offerings over $1 million. 17 C.F.R. § 240.15c2–12.

[74] Section 3(a)(3) of the Securities Act exempts any "note . . . arising out of [a] current transaction[]. . . ." Reves v. Ernst & Young, 494 U.S. 56, 80 (1990) (Rehnquist, J., dissenting) (citation and internal quotation marks omitted). The Court has interpreted this to include commercial paper. *Id.* at 76 (majority opinion).

[75] The financial crisis of 2007 to 2009 demonstrated how important these securities are to the economy as well as their potential for harm. A sudden drop in commercial paper value led the Federal Reserve to take the unprecedented step of purchasing commercial paper to buoy the market. Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper During the Crisis of 2007–2009*, 24 J. Econ. Perspectives 29, 30, 32 (2010). Just because an exemption or exclusion exists in the regulatory framework does not mean it is always a great idea.

[76] *See, e.g.*, Cohn, *supra* note 18, at 1434 (Crowdfunding "has become synonymous with efforts to raise funds from numerous donors, usually in small amounts through internet sources.").

[77] *See id.* (Crowdfunding as a "concept is not new. Politicians, charities, and local non-profit organizations all engage in raising funds from broad swaths of the population for specific purposes and generally in relatively low dollar amounts.").

A. *Who Funds and Who Gets Funded*

Distinguishing crowdfunding from traditional equity financing in part rests on who is doing the funding. "Unlike typical business financing, which comes primarily from wealthy individuals and institutional investors, crowdfunding raises money from the general public."[78] This democratization is particularly relevant in the U.S. where the accredited investor standard prevents non-accredited investors from participating in popular exempt offerings like private placements.[79] Some crowdfunding proponents go so far as to call this standard an intentional plot to favor the wealthy and keep non-accredited investors away from good investments.[80] Usha Rodrigues, in a more sedate criticism, argues that the standard harms non-accredited investors by preventing diversification into the high risk, high return market of private placements.[81] Regardless of its wisdom, maintaining a broad crowd, including non-accredited investors, is essential to distinguishing equity crowdfunding from traditional equity financing.

Another distinguishing aspect of crowdfunding is what types of issuers are likely to use a crowdfunding exemption. While nothing limits crowdfunding to outsiders,[82] proponents have touted crowdfunding's ability to provide capital to activities that traditional financing methods would leave underfunded.[83] In the realm of equities, many have heralded crowdfunding as the solution to the "funding gap" in the early stage of start-ups.[84] Some commentators attribute this gap to systematic inefficien-

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[78] Bradford, *supra* note 2, at 5.

[79] *See* So-Yeon Lee, Note, *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 987 (2012) ("Surprisingly, U.S. securities regulations award special investment privileges to the already affluent, resulting in a legal system that makes it even easier for them to amass wealth.").

[80] *See, e.g.*, Comment from Sten E. Hakanson on Proposed Rule: Crowdfunding (Feb. 28, 2014), *available at* http://www.sec.gov/comments/s7-09-13/s70913-292.htm ("The real motivation is to protect accredited investors from competition.").

[81] Rodrigues, *supra* note 46, at 3427–28.

[82] Kickstarter has been used to crowdfund a *Veronica Mars* movie, Zach Braff's directorial follow up to *Garden State*, and Spike Lee's most recent film to the tunes of $5.7 million, $3.1 million, and $1.4 million, respectively. Those running the campaigns are hardly outsiders. Juliet Lapidos, Editorial, *Celebrities with Their Hands Out*, N.Y. TIMES (Sept. 14, 2013), http://www.nytimes.com/2013/09/15/opinion/sunday/celebrities-with-their-hands-out.html?_r=0.

[83] *See, e.g.*, HOWE, *supra* note 8, at 254 ("Artists are . . . at the mercy of movie studios and music labels, who decide which projects to bankroll. . . . Crowdfunding, on the other hand, allows artists to appeal directly to consumers."); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 932 (2011) ("Because of their particularized interest[s] . . . investors in crowdfunded ventures may choose to fund businesses and projects different from those funded through more traditional capital-raising methods.").

[84] *See, e.g.*, Bradford, *supra* note 2, at 100; Heminway & Hoffman, *supra* note 83, at 931–32; Nikki D. Pope, *Crowdfunding Microstartups: It's Time For the Securities and*

cies in capital markets.[85] Others blame the federal securities laws and the SEC as being blind to the difficulty of small companies.[86] Many have offered a crowdfunding exemption as a solution to this problem.[87] This reason was one of the primary arguments for including a crowdfunding exemption in the JOBS Act.[88]

Equity crowdfunding promises to democratize equity markets while providing new capital sources to start-ups and small businesses. At the same time, combining high-risk investments, unsophisticated investors, and the internet could be a recipe for fraud. The real question is whether the benefits of a crowdfunding exemption outweigh these costs.[89] This determination requires considering crowdfunding principles in the context of federal securities regulations. This analysis reveals inherent incompatibilities. Crowdfunding precludes many of the traditional alternative investor protection mechanisms while the availability of other competing exemptions threatens the sustainability of any crowdfunding exemption.

Federal securities law primarily protects investors by requiring disclosures of material information.[90] These requirements are relaxed if an alternative principle protects investors. The primary alternative is sophistication or accreditation on the theory that the investors will be clever enough to invest wisely, or at a minimum can afford the loss of their investment.

Equity crowdfunding, if it is to be distinguished from regular equity financing, targets small businesses and start-ups. These will often have little capital or projected future earnings. These businesses are the least able to afford the high price of disclosure. Therefore, any crowdfunding

Exchange Commission to Approve a Small Offering Exemption, 13 U. PA. J. BUS. L. 973, 973–74 (2011).

[85] *See, e.g.*, William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 3 (2004) ("Many emerging companies fail to raise critical early-stage capital largely because of market inefficiencies.").

[86] 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, 6 (2007) ("The irony is that, for both practical and legal reasons, it is easier for a medium-sized company to raise $50 million than for a small company to raise $500,000.").

[87] *See* Sjostrom, *supra* note 85, at 4; Hemingway & Hoffman, *supra* note 83, at 931 ("Crowdfunding may solve a key problem that small businesses have in funding their operations: locating a sufficient number of potential and actual investors in a cost-effective manner.").

[88] *See* Barack Obama, Remarks by the President at JOBS Act Bill Signing at the White House, *available at* http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing ("Right now, [start-ups and small businesses] can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. . . . Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors—namely, the American people.").

[89] Bradford, *supra* note 2, at 115–16.

[90] *See supra* Part II.

exemption that attempts to target underfunded business must have low disclosure requirements—it must be cheaper than other methods of raising capital. However, the traditional alternatives of sophistication or accreditation are not available in the crowdfunding context because crowdfunding relies on the crowd—those that are neither sophisticated nor wealthy—to do the funding.

Alternative protections are also not possible due to the particularities of crowdfunding. Because crowdfunding relies on the internet, these offerings cannot have the guarantee of locality as seen in the intrastate exemption. Because of the high cost of complying with multiple state regulations in an internet offering, state preemption is required, preventing state regulators from providing protection. Because investors will only contribute small amounts, they lack the bargaining power of angel investors or venture capitalists. Furthermore, if individual investments are limited, professional investors will not have an adequate incentive to provide competitive pricing work.[91]

If neither disclosure nor other protections provide investor access to information, there will be large information asymmetries in the market. Equity crowdfunding will be a market with legitimate, though often highly speculative, investments as well as intentionally fraudulent offerings. Without mandated disclosure of information, investors will not be able to distinguish the good from the bad and the legitimate from the fraudulent. As a result, investor confidence will crash and many will flee the market. Those who stay will demand a lower price to account for uncertainty. Legitimate investments will raise funds elsewhere leaving an even riskier, more dangerous marketplace. "Lemons" will dominate the market.[92]

B. Crowd Wisdom

If traditional means of protecting investors are unavailable in the crowdfunding context, a crowdfunding exemption must provide an alternative protection justification. Proponents have argued that the concept of "wisdom of the crowd" can provide this alternative protection. However, again due to the particularity of federal securities regulations, "crowd wisdom" is unlikely to be an adequate source of investor protection.

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[91] *See generally* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006) (arguing that the essential role of securities regulation is to create a competitive market for sophisticated professional investors and analysts).

[92] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 488 (1970).

Crowdfunding inherited the concept of "wisdom of the crowd" from its predecessor, crowdsourcing.[93] This concept describes the "intelligence" that occurs when "imperfect judgments are aggregated in the right way," leading to better results.[94] For example, an aggregation of individual estimates of the number of jellybeans in a jar will be more accurate than the majority of individual estimates.[95] Researchers have used crowds to predict, with some accuracy, much more complicated answers such as the likelihood of chemical weapon inspections in Syria[96] and the location of a crashed submarine.[97] This concept of crowd wisdom is important in crowdfunding and proponents have proposed several benefits derived from this concept, including choosing the best investments and limiting fraud.[98]

Given that "a diverse group of less-expert decision-makers can often make better choices than an expert working individually[, i]t is at least possible that crowdfunding investors will do a better job compared to venture capitalists and angel investors than their relative lack of sophistication would predict."[99] However, this accuracy principle of the crowd wisdom is not far from the efficient market hypothesis.[100] The hypothesis predicts that the market incorporates all public information about a security resulting in a price that is an accurate representation of its actual value.[101] Individual investors do not need to know all public information about a security; rather they can rely on the market price as a close ap-

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93 Armin Schwienbacher & Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures*, *in* THE OXFORD HANDBOOK OF ENTREPRENEURIAL FINANCE 369, 371–72 (Douglas Cumming ed., 2012).

94 JAMES SUROWIECKI, THE WISDOM OF THE CROWDS, xiv (2004).

95 *See id.* at xi–xiii.

96 *See* Michael Horowitz, *Good Judgment in Forecasting International Affairs*, MONKEY CAGE (Nov. 26, 2013), http://www.washingtonpost.com/blogs/monkey-cage/wp/2013/11/26/good-judgment-in-forecasting-international-affairs-and-an-invitation-for-season-3/.

97 SUROWIECKI, *supra* note 94, at xx–xxi.

98 *See, e.g.*, Richard Waters, *Start-ups Seek the 'Wisdom of Crowds*,*'* FINANCIAL TIMES (Apr. 3, 2012), http://www.ft.com/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html#axzz2ymhhxaXv (Supporters believe "'open' investment forums will be able to limit fraud through a combination of community ratings and the use of algorithms to detect illicit activity."); 158 Cong. Rec. 1884, 1895 (daily ed. Mar. 21, 2012) (statement of Sen. Scott Brown) ("All the experts agree that we would need to require an intermediary, say, like an eBay, where the crowd can help identify the good and bad players, the way that eBay users identified bad sellers on their site.").

99 Bradford, *supra* note 2, at 114.

100 *See* Henry G. Manne, *Insider Trading Symposium-January 27, 2007: Keynote Address*, 4 J.L. ECON. & POL'Y 225, 230 (2007) ("*The Wisdom of Crowds* [is] built on an important Hayekian notion, that market price is some sort of an amalgamation of bits and pieces of preference and knowledge that people have even though the market participants involved are disparate, independent, and unknown to each other. Somehow it all gets aggregated into something called the market price.").

101 Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970).

proximation of value.[102] However, the efficient market hypothesis depends on market characteristics, which are absent in the crowdfunding context.[103] Again, a crowdfunding exemption will only be successful if costs and disclosure requirements are low. Less information enters the market when less disclosure is required,[104] and with little information the crowd will be less accurate in its ability to predict winners and losers. Furthermore, it is doubtful that the wisdom of crowd provides substantial benefits even in the context of highly efficient markets like major stock markets. James Suroweicki, the coiner of the "wisdom of crowds" term, points to a lack of short selling, systemic overconfidence, the availability of leverage, and speculators to explain why "financial markets are decidedly imperfect at tapping into the collective wisdom."[105] Crowds may be better on average at aggregating large amounts of information into an accurate prediction, but it is unlikely that the crowd will be accurate in equity crowdfunding if highly efficient markets cannot reach accurate results.

Communication between investors in the crowd may "help to prevent fraud by allowing investors with particular knowledge about an offering or an issuer to communicate it to other investors. Investors who are aware of a particular entrepreneur's shady business background can communicate that knowledge to others."[106] Non-equity crowdfunding has demonstrated these kind of activities. After observing several instances of fraud, Kiva—a crowdfunding site that uses crowdfunding to finance micro-lending projects—adopted a ranking system for lenders to help others evaluate the risk level.[107] A recent Kickstarter campaign failed, despite pledges totaling $363,000 (Canadian), after skeptical investors used the

[102] The Supreme Court has accepted the efficient market hypothesis for support of the "fraud-on-the-market presumption" in proving reliance in Rule 10b-5 cases. Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988) ("An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.").

[103] Courts do not presume an efficient market in all cases. For example, the Sixth Circuit considers five factors: "(1) a large weekly trading volume; (2) the existence of a significant number of reports by securities analysts; (3) the existence of market makers and arbitrageurs in the security; (4) the eligibility of the company to file a S-3 Registration Statement; and (5) a history or immediate movement of the stock price as the result of unexpected corporate events or financial releases." Freeman v. Laventhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (citation omitted). None of the listed factors are present in the crowdfunding context.

[104] Some have argued that information will still enter the market voluntarily as good investments try to differentiate themselves from the "lemons." *E.g.*, Easterbrook & Fischel, *supra* note 17, at 682–83.

[105] Surowiecki, *supra* note 94, at 223–36.

[106] Bradford, *supra* note 2, at 134.

[107] Howe, *supra* note 8, at 249.

comment section to question the project.[108] A recent study of Kickstarter projects found only 11 out of 381 projects failed to deliver products or refund investments, and those projects represented less than 1% of the total funds.[109] Investors who live near an investment can verify basic factual assertions while investors with specialty knowledge can provide the crowd with a more sophisticated understanding of the investment.[110]

Unfortunately, fraud detection in crowdfunding is unlikely to be superior to fraud detection elsewhere. Due diligence is expensive. For publicly traded equities, retail investors usually rely on professional analysts to provide due diligence.[111] The Financial Industry Regulatory Authority ("FINRA") imposes due diligence requirements on broker dealers in private placements.[112] Crowdfunding ventures are unlikely to attract the attention of professional analysts due to their size. Furthermore, no individual crowdfunding investor will have a large stake in any one company. Investors have little incentive to expend considerable amounts of money for due diligence over a small investment. The crowd may be able to identify simple frauds but frauds that are more complex will go undiscovered.[113]

Crowdfunding proponents have argued that the crowd will be a resource for the issuing company. Investors see angel investors and venture capitalists as beneficial due to their ability to contribute to the company through knowledge and contacts.[114] Some crowdfunding proponents believe the crowd can provide similar benefits.[115] However, it is unrealistic to assume that the crowd can perform similar functions to angel investors or

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[108] Evelyn M. Rusli, *Kickstarter Project Canceled amid Fraud Accusations*, DIGITS (Nov. 12, 2013), http://blogs.wsj.com/digits/2013/11/12/kickstarter-project-canceled-amid-fraud-accusations/.

[109] Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 11–12 (2014). Mollick does acknowledge that this low rate of fraud may not hold true in other forms of crowdfunding. *Id.* at 14.

[110] Bradford, *supra* note 2, at 134.

[111] Fin. Indus. Reg. Auth., Regulatory Notice 10-22, Regulation D Offerings 3–5 (Apr. 2010), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.

[112] *Id.* at 3.

[113] Crowd communication has not always been successful at preventing fraud in the non-equity crowdfunding context. For example, despite extensive allegations of fraud, one Indiegogo crowdfunding project continues to raise funds exceeding $1 million. James Robinson, *Healbe Hustle: The Full Story of How a Failed Russian Cake Shop Owner Humiliated Indiegogo and Took "the Crowd" for Over $1m*, PANDODAILY (Apr. 12, 2014), http://pando.com/2014/04/12/healbe-hustle-the-full-story-of-how-a-failed-russian-cake-shop-owner-humiliated-indiegogo-and-took-the-crowd-for-over-1m/.

[114] *See* Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 107–08, 116–17 (2010).

[115] Bradford gives the examples of investors with business or accounting expertise helping with the business plan and investors with legal expertise pointing out regulatory issues. Bradford, *supra* note 2, at 134.

venture capitalists.[116] Some members of the crowd may be able to provide useful advice, but the cost of monitoring, verifying, and differentiating the good advice from the bad advice make this impracticable. Furthermore, as the number of investors increases, the costs of complying with investor demands increases—more investors demanding the attention of key personnel, and an increased likelihood of shareholder derivative suits.

A more likely benefit will come when the crowd of investors is also a crowd of "potential customers [who] can explain why the proposed product or service will or will not succeed and can suggest modifications."[117] A crowd of investors who are consumers can also provide valuable marketing, as well as information about the potential demand, for the product.[118]

To be successful, a crowdfunding exemption requires lower costs, mostly through reduced disclosures, than competing exemptions. Such a reduction requires an alternative means of protecting investors. The peculiarities of crowdfunding preclude traditional alternative investor protection methods. The "wisdom of the crowd" alone is an insufficient alternative. Therefore, any new exemption requires new means of protecting investors.

IV. THE JOBS ACT CROWDFUNDING EXEMPTION

A. *What the Act Does*

Title III of the JOBS Act[119] creates an exemption from registration for crowdfunding. The Act allows private offerings of restricted shares[120] to unaccredited investors provided the offerings comply with four conditions designed to protect investors.[121] First, the Act caps total sales of

[116] *Id.* at 104 ("If startups turn to passive, unsophisticated public investors, they will not receive the collateral services provided by sophisticated venture capitalists and angel investors.").

[117] *Id.* at 134.

[118] Schwienbacher & Larralde, *supra* note 93, at 372–81.

[119] Named the CROWDFUND Act, a painfully clumsy backronym for "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012." JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315 (2012) (codified in scattered sections of 15 U.S.C).

[120] Investors must hold restricted shares for one year before reselling unless the sale is to the issuer, an accredited investor, a family member in connection with death or divorce of the purchaser, or as a part of a registered offering. JOBS Act § 302(b), *amending* the Securities Act of 1933 § 4A(e), 15 U.S.C. § 77d-1(e) (2012).

[121] For a more extensive review of the Act see generally, Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under The CROWDFUND Act*, 66 VAND L. REV. EN BANC 43 (2013).

crowdfunded securities by any issuer to $1,000,000 in a 12-month period.[122]

Second, the Act imposes a cap on individual investments in all crowdfunded securities. Investors cannot invest more than the greater of $2,000 or 5% of their annual income or net worth during a 12-month period.[123] If an investor has either annual income or net worth greater than $100,000, she can invest 10% of her annual income or net worth, but not to exceed $100,000.[124]

Third, the Act forbids direct sales—issuers must use a financial intermediary.[125] Intermediaries must be either a broker or a funding portal. Intermediaries must register with the SEC and any applicable self-regulatory organization. They must take measures to reduce the risk of fraud, protect privacy of information collected from investors, and ensure that each investor reviews educational materials. Intermediaries cannot compensate promoters, finders, or lead generators and must prohibit key staff from having any financial interest in an issuer using its services.[126]

Fourth, the Act imposes detailed requirements on issuers.[127] Issuers must file with the SEC and provide investors and intermediaries with specified disclosures. These disclosures include detailed information about the issuer, the securities, and the offering.[128] Financial disclosures are scaled so that the larger the offering, the more expensive the disclosure. Offerings less than $100,000 only require tax income returns for the most recent year and a financial statement certified by the principal executive officer to audited financial statements. Offerings between $100,000 and $500,000 require financial statements reviewed by an independent public accountant. Offerings over $500,000 require audited financial statements. Additionally, issuers must annually provide the SEC and investors an operation report and a financial statement.[129]

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[122] JOBS Act § 302(a), *amending* the Securities Act of 1933 § 4(a)(6)(A), 15 U.S.C. § 77d(a)(6)(A).

[123] *Id.*, *amending* the Securities Act of 1933 § 4(a)(6)(B), 15 U.S.C. § 77d(a)(6)(B).

[124] *Id.*

[125] *Id.*, *amending* the Securities Act of 1933 § 4(a)(6)(C), 15 U.S.C. § 77d(a)(6)(C). The requirements for intermediaries are found in JOBS Act § 302(b), *amending* the Securities Act § 4A(a), 15 U.S.C. § 77d-1(a).

[126] *Id.*, *amending* the Securities Act of 1933 § 4A(a), 15 U.S.C. § 77d-1(a).

[127] *Id.*, *amending* the Securities Act of 1933 § 4A(b), 15 U.S.C. § 77d-1(b).

[128] Information includes the name, legal status, physical address, and website of the issuer; the names of the directors, officers, and each person holding more than 20% share of the issuer; a description of the business of the issuer and the anticipated business plan; a description of the financial condition of the issuer; a description of the purpose and intended use of the proceeds of the offering; the target offering amount; the price to the public of the security or the method for determining the price; a description of the ownership and capital structure of the issue; and other information required by SEC rulemaking. *Id.*

[129] *Id.*

The Act contains a liability provision that imposes a private right of action for material misstatements and omissions.[130] Liability mimics section 12(a)(2) of the Securities Act, requires only negligence, and puts the burden of disproving negligence on the issuer.[131]

B. The JOBS Act Crowdfunding Exemption's Excessive Costs

Several commentators have criticized the law for being too burdensome to be useful. These problems result from applying the traditional disclosure sliding scale to crowdfunding.

Stuart Cohn argues that "[p]romoters seeking to raise small amounts from small investors are now subject to such a wide range of disclosure and regulatory requirements that it is hard to imagine typical crowdfunding promotions being carried out under such conditions."[132] Primarily, Cohn points to transaction costs imposed by the intermediary requirements and required disclosure of expensive financial information as reasons why crowdfunding will be too costly for smaller businesses.[133] The SEC estimates the cost as a percent of an offering amount will range from 22.92% for the smallest offerings to 14.69% for the largest offerings.[134] Additionally, crowdfunding imposes a fixed cost of ongoing annual disclosure and audit of financials that the SEC estimates will range from $4,000 to $32,700.[135] Faced with these costs, it is unlikely that for small offerings, "either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities."[136] Cohn believes that larger offerings "may be able to justify transaction costs and employ professionals to allay liability concerns."[137] However, as the offering amount increases, other exemptions become more attractive.[138]

Jason Parsont raises many of the same concerns that Cohn raises. Parsont goes one step further and argues that the issuers will be unlikely to use the crowdfunding exemption due to "accredited crowdfunding."[139] Section 201 of the JOBS Act exempts crowdfunding platforms from regis-

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[130] JOBS Act § 302(b), *amending* the Securities Act of 1933 § 4A(c), 15 U.S.C. § 77d-1(c).

[131] *Id.*; Securities Act of 1933 § 12(a)(2), 15 U.S.C § 77l(a)(2).

[132] Cohn, *supra* note 18, at 1438.

[133] *Id.* at 1438–43.

[134] Jeff Thomas, *Making Equity Crowdfunding Work for the Unaccredited Crowd*, 4 HARV. BUS. L. REV. ONLINE 62, 65 (2014), http://www.hblr.org/?p=3773; Crowdfunding, 78 Fed. Reg. 66,428, 66,521 & n.918 (proposed Nov. 5, 2013) (to be codified in scattered parts of 17 C.F.R.).

[135] Thomas, *supra* note 134, at 66.

[136] Cohn, *supra* note 18, at 1444.

[137] *Id.*

[138] *Id.*

[139] Jason W. Parsont, *Crowdfunding: The Real and Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 284 (2014).

tration as a broker dealer.[140] Rule 506(c) lifted the prohibition on general solicitation and general advertising in Rule 506 and Rule 144A offerings.[141] Together, the exemption from registration as broker dealer and the ability to advertise permits crowdfunding websites that only offer securities to accredited investors. These websites are currently operating and examples include AngelList, SeedInvest, Fundable, and MicroVentures.

Accredited crowdfunding may be more attractive to issuers for several reasons. Rule 506 offerings are already a popular fundraising method.[142] Moreover, the pool of capital is quite large—accredited individuals represent only 7.4% of all households[143] but they hold 70% of the available capital in the country.[144] Parsont states, "accredited crowdfunding will be less expensive, more flexible, and will have fewer marketing restrictions than retail crowdfunding."[145] Unlike accredited crowdfunding, retail crowdfunding requires more disclosures, including audited financial statements, and stricter requirements on intermediaries leading to "higher legal and accounting fees, higher directors and officers liability insurance . . ., and higher intermediation fees."[146] Furthermore, retail crowdfunding has a tougher liability standard,[147] and lacks a substantial

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[140] JOBS Act § 201, Pub. L. No.112-106, 126 Stat. 306, 314–15 (2012) (codified in scattered sections of 15 U.S.C.), *amending* the Securities Act § 4(b)(1) & (2), 15 U.S.C. § 77d(b) (1) & (2).

[141] Rule 506(c) was mandated by section 201 of the JOBS Act. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013) (codified 17 C.F.R. pts. 230, 239, & 242).

[142] IVANOV & BAUGES, *supra* note 16, at 7–8 (finding that 94% of Regulation D offerings are issued under Rule 506).

[143] Parsont, *supra* note 139, at 284 (citing Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *supra* note 141, at 44,793).

[144] *Id.* (citing Edward N. Wolff, The Asset Price Meltdown and the Wealth of the Middle Class 58 (Aug. 26, 2012) (unpublished manuscript), *available at* http://www.colorado.edu/AmStudies/lewis/1025/incomestudy2012.pdf).

[145] *Id.* at 317.

[146] *Id.* at 284–85.

[147] Section 302(b) of the JOBS Act creates a new cause of action for material misstatements and omissions in a crowdfunding offering. JOBS Act § 302(b), Pub. L. No. 112-106, 126 Stat. 306, 318–19 (2012) (codified in scattered sections of 15 U.S.C.), *amending* the Securities Act of 1933 § 4A(c)(1)(B), 15 U.S.C. § 77d-1(c)(1)(B) (2012). An issuer is liable unless the issuer can show that they were not negligent. Rule 506 liability comes from Rule 10b-5, which requires a showing of scienter—intentional, knowing, or recklessness. For a detailed criticism of the high cost of the liability in crowdfunding, see David Mashburn, Comment, *The Anti-Crowd Pleaser: Fixing the Crowdfunding Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 151–68 (2013).

compliance rule.[148] Meanwhile, accredited crowdfunding has several advantages. Accredited crowdfunding can raise unlimited funds[149] and it bars fewer companies than retail crowdfunding.[150] Finally, the JOBS Act lifted the general advertising and solicitation ban on Rule 506 offerings.[151] Meanwhile, issuers can solicit and advertise in retail crowdfunding but are limited to "notices which direct investors to the funding portal or broker" and strictly prohibits issuers from "advertise[ing] the terms of the offering . . . ."[152] These advantages make it likely that retail crowdfunding "may become largely superfluous" or worse, give rise to "a market for lemons."[153]

The problems highlighted by Cohn and Parsont stem from forcing the crowdfunding exemption to conform to the traditional disclosure sliding scale. Crowdfunding lacks the alternative protections of investor sophistication or accreditation and therefore disclosures that are more substantial are necessary to protect the public. The legislative history of the JOBS Act supports this assertion. The first crowdfunding bill, introduced by Congressman Patrick McHenry in 2011, contained neither mandatory disclosure nor heightened liability exposure.[154] By the time the bill passed the House, it contained many of the features of the final exemption in the JOBS Act, including: caps on individual investor limits, caps on offering size, imposing duties on crowdfunding sites to perform due diligence, and limited conflicts of interests.[155] At a Senate hearing on the bill, multiple witnesses expressed concern over the lack of disclosure.[156] In response to these concerns, Senator Jeff Merkley introduced an alternative bill, which required extensive mandatory disclosures, stricter

[148] *See* 17 C.F.R. § 230.508 (2010).

[149] *See id.* § 230.506.

[150] Retail crowdfunding prohibits public companies, foreign companies, private investment funds, and bad actors from issuer eligibility. JOBS Act, § 302(b), *amending* the Securities Act of 1933 § 4A(f), 15 U.S.C. § 77d-1(f). Rule 506 offerings, including accredited crowdfunding, only bar bad actors. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44,771 (Sept. 23, 2013) (codified in 17 C.F.R. 200, 230, 239).

[151] JOBS Act, § 201(b), *amending* § 4(b)(1) of the Securities Act of 1933, 15 U.S.C. § 77d(b)(1).

[152] *Id.* § 302(b).

[153] Parsont, *supra* note 139, at 318.

[154] Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (as introduced on Sept. 14, 2011).

[155] Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (as passed by House, Nov. 3, 2011).

[156] *See Spurring Job Growth Through Capital Formation While Protecting Investors: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs* 112th Cong. 61, 64 (2011) (Statement of John C. Coffee, Jr., Professor, Columbia Law School).

regulation of crowdfunding sites, and heightened liability exposure.[157] This alternative bill became section 304 of the JOBS Act.[158]

C. *Alternative Methods of Protecting Investors in the JOBS Act Crowdfunding Exemption*

Despite the flaws in the JOBS Act, the crowdfunding exemption does offer unique measures that serve to protect investors. The exemption limits the financial exposure of investors by capping investments and it imposes a due diligence duty on financial intermediaries. These two provisions should be the alternative protection mechanism that allows reduced disclosures in the crowdfunding exemption.

Capping individual investments is a new method of protecting investors. This method is used in the crowdfunding exemption and in the proposed Regulation A+ exemption, both children of the JOBS Act. The justification for capping individual investments is that it will prevent individuals from having "too much skin in the game." This justification is similar to the justification for using wealth as a proxy for sophistication in the accredited investor standard. In a world where we can bet it all in a casino, caps on individual investment seem overly paternalistic. However, investments in crowdfunded start-ups will be high-return, high-risk assets. The diversification model of investment would recommend limiting such investments to a small portion of a portfolio. As Rodrigues has pointed out, one of the justifications for relaxing the accreditation standard is to permit limited investment.[159] If the harm caused by the accredited standard is preventing full diversification, then capping these investments does not harm small investors.

The second innovative method of investor protection is requiring the use of intermediaries and imposing information gathering and fraud reduction requirements on intermediaries. Intermediaries must "take such measures to reduce the risk of fraud . . . ."[160] Proposed Rule 301 of Regulation Crowdfunding implements this section.[161] The proposed rules would require an intermediary to have a reasonable basis for believing the issuer complies with the Act and would require an intermediary to deny access to its platform if it had a reasonable basis for believing that an issuer is subject to a disqualification. The rules also require background and securities enforcement regulatory history checks on each is-

[157] CROWDFUND Act, S. 1970, 112th Cong. (2011).

[158] Parsont argues that accepting the more heavily regulated crowdfunding exemption was a part of a compromise in exchange for section 201(c), which enabled the creation of accredited crowdfunding. Parsont, *supra* note 139, at 297–300.

[159] Rodrigues, *supra* note 46, at 3427–28.

[160] JOBS Act § 302(b), Pub. L. No.112-106, 126 Stat 306, 316 (2012) (codified in scattered sections of 15 U.S.C. §§ 77a–aa, 78a–pp), *amending* the Securities Act of 1933 § 4A(a)(5), 15 U.S.C. § 77d-1(a)(5).

[161] Crowdfunding, 78 Fed. Reg. 66,428, 66,556 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.301).

suer, officer, and director, as well as shareholders with a 20% share of the company.

Requiring the use of financial intermediaries is an important method of investor protection. Intermediaries serve as a gatekeeper for offerings, verifying basic information. It also ensures that crowdfunding will happen in a space accessible to regulators. Finally, competition between intermediaries will cause some to seek the best investments to gain the benefit of reputation bonuses.

V. FIXING THE ACT—LESS DISCLOSURE, MORE ALTERNATIVES

The crowdfunding exemption in the JOBS Act is fundamentally flawed. The exemption has one foot in the traditional disclosure model and another foot in untested alternative methods of protection. The result is an exemption that will at best go unused and at worst create a market for lemons. Fixing the Act, either through legislative amendment or SEC rulemaking, requires reducing costs to issuers. Primarily, these cost reductions should come from reducing disclosure requirements. This will increase the likelihood of fraud. To provide some investor protection, the exemption should rely on individual investor caps to limit investor exposure and the due diligence of financial intermediaries to serve as a gatehouse.

The cost of raising small amounts of money through a crowdfunding exemption must be less than the cost of raising money through other exemptions. To reduce costs to issuers, mandatory disclosures, particularly audited financial statements, should be removed from the exemption. Ongoing reporting requirements should be limited to basic information preferably in a checklist form. The standard for liability for misstatements should be reduced from the current negligence standard to scienter. Crowdfunding's higher standard of liability than competing exemptions, like Rule 506, almost guarantees the exemption will be rarely used. Additionally, the SEC should create a generous safe harbor for minor deviations from the Act's requirements. The SEC has proposed such a rule[162] but it should go further and define "insignificant" to reduce the cost of potential litigation.

The justification for reducing disclosures would be alternative sources of investor protection. Currently in the Act are three: capping the aggregate amount raised at $1 million, capping individual investments, and imposing due diligence requirements on financial intermediaries. All three should continue to be in any future modified exemption. Because they would serve as the backbone of investor protections, these requirements should be strengthened.

The current caps on individual investment allow individuals to become overexposed to high-risk investments. The SEC proposed rule in-

[162] *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,562 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.502).

terpreting the investor cap increases this risk by interpreting ambiguities in favor of more lenient standards.[163] For example, an individual with $25,000 in Social Security income and a nest egg of $100,000 could invest up to $10,000 a year in crowdfunded securities because their net worth equals or exceeds $100,000. An alternative interpretation would limit the individual to a $2,000 investment because neither annual income nor net worth alone exceed $100,000. The SEC's interpretation may be more consistent with the Act's capital raising goals, but the more restrictive interpretation is more consistent with protecting investors. Legislative action would be required to reduce investor caps even further, but it should be considered.

A low cap on individual investments creates its own problem—no large investor will be incentivized to provide information gathering and analysis. Parsont has suggested that by interpreting aggregation to apply only to other section 4(a)(b) crowdfunding offerings, a company could perform back-to-back retail and accredited crowdfunding offerings.[164] If the securities are the same class, smaller retail investors could piggyback information gathering and analysis provided by more heavily invested investors.

Another issue with capping individual investments is determining who is in charge of guaranteeing that investors abide by the caps. The individual investment caps do create a costly problem of verification. Intermediaries must verify how much each investor has invested in all crowdfunded securities in the last 12 months.[165] At the same time, they must protect investor information.[166] Since an investor could use multiple crowdfunding sites, verification will be costly. Some have proposed fixes including a government run, centralized database. A simpler solution would be to allow intermediaries to rely on investor representations unless they had reason to believe otherwise.[167]

Due diligence requirements on financial intermediaries may be one of the primary cost drivers in crowdfunding. Broker dealers and funding portals will pass the cost of due diligence, as well as potential for future liability, onto issuers. However, imposing the due diligence on intermediaries is the right call. If crowdfunding brings together small, cash strapped start-ups, intermediaries are the only party capable of using economies of scale to reduce costs. Reducing required disclosures would reduce the cost of intermediary due diligence.

Another modification to the crowdfunding exemption would be to discourage frivolous investments by expanding the use of educational

[163] *Id.* at 66,434.

[164] Parsont, *supra* note 139, at 336.

[165] JOBS Act § 302(b), *amending* the Securities Act of 1933 § 4A(a)(8), 15 U.S.C. § 77d-1(a)(8).

[166] *Id.*

[167] For example, if an investor had already exceeded their limit on the platform's own site.

materials. Section 302(b) of the JOBS Act requires intermediaries to ensure that prospective investors understand the risks associated with crowdfunding investments by distributing educational materials and requiring investors to affirm that they have reviewed the materials and answer questions demonstrating they understand the risks associated with their investment.[168] The Act specifically requires investors to answer questions demonstrating an "understanding of the level of risk . . . in startups, emerging businesses, and small issuers . . . the risk of illiquidity" and other matters as determined by the SEC.[169] Proposed rules require the educational materials to include the basic information about the securities, limitations on resale, and the risks of having limited voting power and dilution.[170] To verify that investors actually read the educational materials, investors should be required to answer more specific questions including questions about the specific security, limitations on resale, and the risks of limited voting power and dilution. Such questions may help create a more educated investor. However, the greater benefit from a more detailed investment questionnaire is to deter frivolous investments. Questions that are more detailed would impress on prospective investors the seriousness of the investment and reduce the likelihood of investing on a whim. While this would reduce the potential available capital, creating simple barriers to investment increases the likelihood of a more knowledgeable investing pool. To create a more detailed questionnaire system, the SEC should require intermediaries to create multiple-choice quizzes and prohibit investors from investing unless they have successfully answered all questions.

By reducing the cost of using the crowdfunding exemption, we reduce the likelihood of creating a market for lemons. Maintaining a cap on individual investments helps limit any one person's exposure to loss. The right amount of regulation of financial intermediaries can provide many of the due diligence and information gathering services provided by professional investors in other contexts. As a final note, any new exemption will cause an increase in fraud. The important question is: What is the right amount of access to capital compared to risk to investors? Determining where to draw the line depends on our collective risk tolerance. To get it right, some experimentation is required. The crowdfunding exemption in the JOBS Act is a valiant first draft but revisions are required. Otherwise, equity crowdfunding and securities regulations are destined to mix poorly like oil and water.

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[168] JOBS Act § 302(b), *amending* the Securities Act of 1933 § 4A(a)(3) & (4), 15 U.S.C. § 77d-1(a)(3) & (4).

[169] *Id.*

[170] Crowdfunding, 78 Fed. Reg. 66,428, 66,556 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.302).