FROM: Raj Patel
DATE: 12/17/2013
RE: Comments on Crowdfunding Act

Crowdfunding: A Balancing Act Between Investor Protection and Capital Formation

Completing the prestigious Y-Combinator, a Silicon Valley program dedicated to educating and supporting entrepreneurs, Eric Migicovsky was seemingly well positioned to attract investors and grow his company -- Pebble Watch.[1] An innovative concept, Pebble Watch synchronized smart phone applications with wrist watches. With a solid proof of concept, viable plan to scale, and dedicated management, Pebble Watch outcompeted its Y-Combinator peers during initial rounds of fundraising.[2] However, as a hardware company focused on bringing a tangible product to market, Pebble Watch would inevitably face greater overhead costs and be subject to the uncertainties of outside manufacturers and distributors.[3] As a result of these risks, no traditional sources of venture financing (i.e. venture capital firms or angel investors) were willing to invest further in Pebble Watch.[4] At the beginning of 2012, Migicovsky's promising company had one foot in the Silicon Valley graveyard.[5]

The story of Pebble Watch's struggles to secure venture financing is not uncommon.[6] Without the benefit of hindsight, venture capital firms and angel investors are forced to make their investment decisions based squarely on the information in front of them. The majority of

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[1] Mark Milian, *Rejected by VCs Pebble Watch Raises $3.8M on Kickstarter*, Bloomberg (April 17, 2012), *available at* http://go.bloomberg.com/tech-deals/2012-04-17-rejected-by-vcs-pebble-watch-raises-3-8m-on-kickstarter. *See also* Ryan Mac, *Top Startup Incubators And Accelerators: Y Combinator Tops With $7.8 Billion In Value*, Forbes (April 30, 2012), *available at* http://www.forbes.com/sites/tomiogeron/2012/04/30/top-tech-incubators-as-ranked-by-forbes-y-combinator-tops-with-7-billion-in-value.
[2] Milian, *supra* note 1 ($375,000 from four angel investors, including Paul Buchheit, a partner at Y Combinator).
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] Dileep Rao, *Why 99.95% Of Entrepreneurs Should Stop Wasting Time Seeking Venture* Capital, Forbes (July 22, 2013), *available at* http://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time-seeking-venture-capital.

entrepreneurs seeking venture financing have been unable to receive debt financing from a bank, due to the high risk of their venture, or adequate financing from family and friends, due to the large amount of capital needed. These risky and capital intensive investments do sometimes produce massive returns; however, on the whole, 75% fail and 95% substantially underperform.[7] Recognizing that for every one Facebook there are ten Friendsters, even relatively risk prone venture capitalists close their doors and pocketbooks on most entrepreneurs.

Further debilitating entrepreneurs' ability to raise capital are the high costs imposed by securities regulation. Filing reports with the SEC, and corresponding self-regulatory organizations, which detail a company's financial health is seemingly undemanding. However, when taking into consideration the legal and accounting fees necessary to comply with these regulations, many startups do not have adequate resources. Even Schedule A and D exceptions, which aim to reduce the regulatory burden on startup companies have proven too expensive (e.g. Regulation A disclosure costs averaged $ 40,000-$ 60,000)[8]. Forcing a new company to redirect its cash flow from reinvestment to backroom fees, or in many cases simply look past investors because it does not have the needed budget for regulatory compliance, stifles if not suffocates its growth.

Now, focused primarily on their returns, the decisions of venture capitalists make sense. However, often discounted in their analysis, and rightfully so, is the potential for fully funded startup companies to produce an additional positive externality--jobs. On the other hand, there is no excuse for policymakers to discount potential job creation in their analysis and formation of securities regulations. While larger firms and established small businesses account for the

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[7] Deborah Gage, *The Venture Capital Secret: 3 out of 4 Start-Ups Fail*, Wall St. J., Sept. 19, 2012 (Presenting research by Shikhar Ghosh, a senior lecturer at Harvard Business School).
[8] Andrew C. Fink, *Protecting the Crowd and Raising Capital Through the CROWDFUND Act*, 90 U. Det. Mercy L. Rev. 1, 13 (2012).

majority of employment in the United States, startups contribute nearly 20 percent of gross job creation.[9] And while many of these jobs are quickly lost due to the high rate of start-up failures, a wealth of scholarship has indicated that the net job creation of startups outpaces both their large and small business counterparts.[10]

Recognizing these benefits, but also the asymmetric interests of private venture capital firms and high regulatory costs faced by entrepreneurs, economists and policymakers alike called for reform in the structure of start up financing. As a response, On April 12, 2012 the Jumpstart Our Businesses Act ("Jobs Act") was passed.[11] Most pertinent to the problems faced by budding entrepreneurs, was Title III of the Jobs Act, which incentivizes "crowdfunding," or in other words, investment from the general public.[12]

Title III of the Jobs Act helps startups in two key ways: (1) it allows access to a larger base of investors, and (2) makes the process of securing venture financing more affordable. [13] Firstly, the risk aversion demonstrated towards many entrepreneurs, such as Migicovsky, is attributable to the concentration of venture financing firms, and subsequent risks, among a few groups and individuals.[14] By allowing startups to solicit the general public for investments, startups are no longer prisoner to traditional venture financers, who are already burdened by existing portfolios.[15] In effect, the Jobs Act spreads risk among a sea of investors, who are

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[9] John Haltiwanger et al., *Who Creates Jobs? Small vs. Large vs. Young* 29 (Nat'l Bureau of Econ. Research, Working Paper No. 16300, 2010).
[10] *Id* at 2.
[11] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (hereinafter "JOBS Act" or "The Act").
[12] JOBS Act, §§301-05 (hereinafter "Crowdfund Act").
[13] S.E.C., Press Release, *SEC Issues Proposal on Crowdfunding* (Oct 23, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.UowRa1Pe6EY ("the JOBS Act was intended to help alleviate the funding gap and accompanying regulatory concerns faced by startups").
[14] Fink, *Protecting the Crowd, supra* note 8, at 15-16
[15] *Id.*

subject to a maximum investment amount, which limits individual loss.[16] Secondly, the Jobs Act removes certain expensive regulatory barriers, which not only disincentivized, but out right prevented many startups from growing and creating jobs.[17]

Irrespective of its advantages, the Jobs Act's crowdfunding provisions are not without opposition. Many accuse the new legislation of gutting existing investor protections and argue that "exposing unsophisticated investors to risky investments without adequate disclosure…offers fertile ground for scammers."[18] Critics further claim that even the protections contemplated by the SEC are counterintuitive and will in fact lead to decreased enforcement of securities fraud.[19] In no way a marginal position, even the SEC has acknowledged the high risk of fraud, and potential for self-dealing and overreaching by issuers of crowdfunded securities. [20]

The crowdfunding exception, like any securities law exception, requires a complicated balancing of two sometimes conflicting goals: investor protection and economic growth.[21] While investor protection is often the core of the SEC's mission, it also has the obligation to

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[16] Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND* Act, 66 Vand. L. Rev. En Banc 43, 45 (2013)(It is practically impossible to lose one's "life savings" in crowdfunding, no matter how unwise or unlucky one's choices may be). ; *see also* Karina Sigar, *Fret No More: Inapplicability Of Crowdfunding Concerns In The Internet Age And The Jobs Act's Safeguards*, 64 Admin. L. Rev. 473, 495 (2012).

[17] *SEC Issues Proposal on Crowdfunding*, *supra* note 12; Schwartz, *Keep it Light, supra* note 16.

[18] Thomas Lee Hazen, *Social Networks And The Law: 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).

[19] Benjamin P. Siegel, *Title III Of The Jobs Act: Using Unsophisticated Wealth To Crowdfund Small Business Capital Or Fraudsters' Bank Accounts?*, 41 Hofstra L. Rev. 777, 798 (2013) (Specifically, the possibility of more investor fraud is rooted in … distributing the reduced number of issuer disclosures to investors in a dense and difficult-to-understand way, thus decreasing issuer transparency; and setting the ceiling investment amounts for investors too low to allow for economically viable recovery in instances of fraud").

[20] Commissioner Louis A. Aguilar, S.E.C., Speech, *Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors* (October 23, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540003081#.Uo5fJVPe6EY ("small business investments may pose relatively high risks of fraud, and may afford the potential for self-dealing or overreaching by controlling shareholders').

[21] C. Steven Bradford, *Crowdfunding And The Federal Securities Laws*, 2012 Colum. Bus. L. Rev. , 1, 98 (2012)("The SEC has long seen its mission as investor protection in the sense of remedying information asymmetries and rooting out fraud, but all of the sec's foundational statutes require it to consider, in addition to the protection of investors, whether the … action will promote efficiency, competition, and capital formation).

"promote efficiency, competition and capital formation."[22] Examining the SEC's recent emphasis on specialization and enforcement, the Jobs Act's statutory safeguards, and the "crowd's" inherent access to information, it is clear that the push towards this new form of investing will prove an effective and fair compromise between investor protection and economic growth.

In April 2012, Pebble Watch turned to crowdfunding to sustain its operations.[23] Within twenty eight hours, the company had raised one million dollars; and within thirty seven days they had over ten million dollars.[24] And as of summer 2013 Migicovsky's company had fulfilled over 93,000 orders and created 29 new jobs.[25] The Jobs Act promises to replicate this success.

I. **What is Crowdfunding**?

In the most basic sense, crowdfunding is when the general public "pledges" money towards a project or business.[26] The Jobs Act aims to build on the current system and allow for the general public to "invest," through buying securities, in a business without triggering securities regulations. While the difference between "pledging" and "investing" might seem inconsequential, the present system of crowdfunding revolves around facilitating the former and avoiding the latter.

The Supreme Court has defined securities, which include investment contracts allowed by the Jobs Act, broadly as "(1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) arising solely from the efforts of the promoter or a third party."[27] If an entrepreneur were to sell securities in his venture, then he or she would be subject to securities

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[22] *Id.*
[23] Pebble Tech., *Next for Pebble*, Kickstarter (July 11, 2013), available at http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/posts/536005.
[24] *Id.*; See also David Mashburn, The Anti-Crowd Pleaser: Fixing The Crowdfund Act's Hidden Risks And Inadequate Remedies, 63 Emory L.J. 127, 132 (2013).
[25] *Id.*
[26] Bradford, *supra* note 21, at 10.
[27] Id at 30-31 (citing SEC v. W. J. Howey Co., 328 U.S. 293 (1946)).

regulations, namely costly reporting and filing requirements under Section 5 of the Securities Act of 1933.[28] For example, in 2009 two entrepreneurs attempted to buy blue-ribbon winning beer company, Pabst Brewery.[29] In return for pledges of financial support, individuals would receive free beer and a certificate of ownership in Pabst Brewing.[30] Despite receiving over 200 million dollars from 5 million individuals, the entrepreneurs' vision never came into fruition.[31] The SEC quickly stepped in and halted the entrepreneurs' efforts for failing to register.[32]

Learning from examples such as Pabst Brewery, current crowdfunding platforms and the businesses who use them, do not attempt to sell securities in a company or promise an ownership interest in exchange for financial support. Rather, the majority of current crowdfunding relies on two basic models: (1) the rewards model, or (2) the lending model.

A. REWARDS MODEL

Most commonly the rewards model offers individuals who contribute to a project or business "items produced by the project itself – a copy of the CD, a print from a show, or a limited edition of the comic."[33] The two crowdfunding platforms leading this space are Kickstarter and IndieGoGo. Pebble Watch, referenced earlier, attracted funding by promising individuals a free watch if they pledged more than 115 dollars.[34] And often, rewards offered by startups range further than simply pre-purchasing their products. For example, "The Canyons," a feature film which sought to take advantage of crowdfunding, offered personal meetings with the

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[28] Mashburn, supra note 24, at 138; see Securities Act of 1933 §5(a)(1), 15 U.S.C. §77e(a)(1)(2012).
[29] Bradford, *supra* note 21, at 6 (citing Chad Bray, *Huge Beer Run Halted by Those No Fun D.C. Regulators*, Wall St. J. L. Blog (June 8, 2011), *available at* http://blogs.wsj.com/law/2011/06/ 08/huge-beer-run-halted-by-those-no-fun-d-c-regulators/?mod=WSJBlog).
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id* at 17 (citing *Frequently Asked Questions: Kickstarter Basics*, Kickstarter, *available* at http://www.kick starter.com/help/faq/kickstarter%20basics).
[34] Mashburn, *supra* note 24; *see* Pebble Tech., *supra* note 23.

producer and even Robert De Niro's money clip in exchange for pledges.[35] At no point are individuals, who pledge money, promised returns in the form of equity or interest.

B. LENDING MODEL

Crowdfunding is also executed through a lending model. Again, as businesses or projects are not permitted to solicit financial contributions premised on the expectation of an ownership interest, the lending model primarily relies on individuals' good will and charity. The leader in this space is Kiva. Kiva operates through partnering with another growing industry, microfinance.[36] Microfinance institutions primarily focus on assisting underprivileged segments of the population by providing low interest loans and also offering non-monetary support. When there is a need for a microfinance loan, it will be posted on the Kiva website.[37] Interested individuals can pledge money towards that specific loan.[38] The funds are then distributed to the microfinance institution, who in turn will loan them to a qualified loan applicant.[39] Upon repayment of a loan, the intermediary microfinance institution will absorb the interest, and the Kiva contributor will simply receive back his original contribution.[40] If, by chance, the loan remains unpaid neither the microfinance institution or individual pledger will receive any return.[41]

[35] Braxton Pope, *The Canyons*, Kickstarter (March 12,2012), *available at* http://www.kickstarter.com/projects/1094772583/the-canyons.
[36] Bradford, *supra* note 21, at 20-21 ("Kiva does not lend directly to entrepreneurs, but instead partners with microfinance lenders around the world…. The local institutions make loans to entrepreneurs….Kiva collects and distributes this money back to the field partners and credits lenders with any repayments the entrepreneurs make).
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] Risk and Due Diligence, Kiva, *available at* http://www.kiva.org/about/risk (Average default rate is approximately 1%).

Even forced to skirt burdensome securities regulations, the crowdfunding model has helped raise over 4 billion dollars since 2011.[42] Extending the use of these viable platforms to businesses seeking investors will facilitate economic growth through allowing greater access to an untapped pool of capital beyond the reach of costly filing and registration requirements. Estimates suggest that when implemented, the Jobs Act could increase this number by 5.1 billion dollars in 2014 alone.[43]

II. Pre-Crowdfund Act Exemptions

While crowdfunding may be a relatively new mechanism to help startup ventures, policy makers have long realized the benefits of reducing regulation costs in order stimulate economic growth. While the previous exemptions to SEC filing and registration requirements acknowledged the problems faced by budding businesses, they did not effectively address them.

A. REGULATION D

Of the existing exemptions, the most widely used is Regulation D.[44] The ways in which Regulation D offers new business an escape from the requirements of the Securities Act of 1933 are threefold: (1) Rule 504, under Section 3(b), (2) Rule 505, also under Section 3(b) and finally (3) Rule 506, under section 4(2).[45]

Rule 504 provides an exemption for offerings that are less than 1 million dollars.[46] It is subject to a general solicitation restriction, which means business are limited as to who they can offer equity or interest in return for financial support. [47] Further, Rule 504 offerings are usually

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[42] Commissioner Aguilar, *supra* note 20.
[43] *Id* (citing Kent Bernhard Jr., *Crowdfunding's tally: $2.6 B in 2012 and growing*, Upstart Business Journal (April 8, 2013).
[44] Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You're Expecting*, 46 Cornell Int'l L.J. 427, 431 (2013).
[45] *Id.*; *see* Securities Act of 1933 §§3(b), 4(2); *see also* 17 C.F.R. §§230.500-08 through 230.504-06.
[46] *Id* at 431-32*; see* Bradford, *supra* note 21, at 47
[47] *Id.*

subject to stringent state filing and registration requirements.[48] "This independent state registration requirement could be equally as prohibitive as federal registration depending on the size and resources of the startup."[49]

Certain crowdfunding platforms have attempted to use this rule to their advantage, most notably "ProFounder" which restricted its offerings to only family and friends.[50] However, irrespective of its allowances, Rule 504 "eliminates much of the value of crowdfunding" by severely limiting an entrepreneurs access to capital and backhandedly imposing regulation costs.[51]

Rule 505 similarly curtails the growth of startups. While Rule 505 exempts offerings up to 5 million dollars and allows for investment from unaccredited investors, it is a far cry from the ease and viability of crowdfunding.[52] First, it caps the number of unaccredited investors at 35.[53] And second, unlike Rule 504, which allows general solicitation to the extent that it targets personal acquaintances or accredited investors, Rule 505 provides no such allowances.[54] Again by limiting access to capital, Rule 505 inadequately facilitates startup growth.

Lastly Rule 506, while well intended, faces the same shortcomings of its Section 3(b) brethren. While Rule 506 does not limit the amount asked for by a startup, it is still subject to the general solicitation prohibition.[55] And further, only accredited investors and up to 35 "sophisticated" parties may participate in an offering.[56] "The general test used to determine which investors qualify as sophisticated is whether the issuer reasonably believes immediately

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[48] *Id.*
[49] *Id.*
[50] Bradford, *supra* note 21, at 47
[51] *Id.*
[52] Weinstein, *supra* note 43, at 432-33; Securities Act of 1933 §§3(b), 4(2); *see also* 17 C.F.R. §§230.500-08 through 230.504-06.
[53] *Id.*
[54] *Id.*
[55] *Id.; see also* Bradford, *supra* note 21, at 45-46.
[56] *Id.*

prior to making any sale that the investor in question has enough knowledge and experience in financial and business matters to enable him to properly evaluate the merits and risks of the investment."[57] Each of Regulation D exemptions are inconsistent with the crowdfunding model, and thus, unable to achieve the same benefits.

B. REGULATION A

Less often used, but still available, is Regulation A under the Securities Act of 1933. Registration A is commonly understood as a "mini-registration" requirement.[58] It does not prohibit general solicitation of investors.[59] However, a startup looking to take advantage of this exemption is subject to a myriad of disclosure requirements, which although not as burdensome as in the absence of the exemption, are still prohibitive. "Regulation A is not cheap; the average cost of Regulation A offering in 1997 was $40,000-$60,000 dollars."[60] An emerging business is likely to not have the resources necessary to meet Regulation A requirements. As was the case with Regulation D exemptions, the costs of Regulation A make it an impossible substitute for crowdfunding.

III. Warning the Crowd

The inadequacy of current exemptions and the ability of crowdfunding to facilitate capital formation aside, many view crowdfunding legislation as nothing more than dangerous deregulation. The Jobs Act, they argue, tips the balance between investor protection and economic growth too far in favor of the latter. As stated by Professor of Law C. Steven Bradford:

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[57] *Id* (citing 17 C.F.R. §230.506(2012)).
[58] Bradford, *supra* note 21, at 48.
[59] *Id.*
[60] *Id* (citing William M. Prifti, 24 *Securities: Public and Private Offerings* § 1A:17 (2d ed. 2010)(listing costs of a Regulation A offering, including: filing fee $ 100; underwriting costs 10-18% of the offering amount; printing costs $ 7,500-15,000; engraving stock certificates $ 1,500; legal costs 3% of the offering amount; accounting costs $ 5,000-20,000; expert fees $ 300-5,000; state filing fees $ 150-4,000 per state; and NASD filing fees $ 500 plus 0.01% of the offering amount)).

> Crowdfunding is not an unmitigated positive. It involves a potentially dangerous combination of investment risk and relatively unsophisticated investors. Crowdfunding involves sales to the general public, not just sophisticated or accredited investors, and many members of the general public are remarkably unsophisticated financially. And investing in small business, particularly at the startup stage, is inherently risky. The potential for fraud and self-dealing is high and, even in the absence of wrongdoing, small businesses are much more likely to fail than more established companies.[61]

In addition to concerns about uninformed investors and the risky nature of startups, critics opposed to crowdfunding also attack the Act's statutory safeguards. "Specifically, the possibility of more investor fraud is rooted in… setting the ceiling investment amounts for investors too low to allow for economically viable recovery in instances of fraud."[62] These fears and warnings are not completely unmerited. And each deserves careful examination, especially while debating SEC and FINRA's current Jobs Act rule proposals.

A. *UNINFORMED INVESTORS*

The heart of crowdfunding is gathering investment from the general public. The general public, however, has proven time and again to be financially illiterate and in dire need of the protections offered by federal securities law.[63] Exemptions currently in place, namely Regulation A and D, take into account this concern and limit investment in startups to sophisticated investors or a small network of family and friends.[64]

Affirming this fear, an SEC study on financial literacy, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, found: "that investors do not understand the most elementary financial concepts…and that investors lack critical knowledge that would help

[61] C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 Sec. Reg. L.J. 195, 196 (2012).
[62] Siegel, *Title III of the Jobs Act*, *supra* note 19.
[63] *Id* at 794.
[64] *Id.; see* Weinstein, *supra* note 43.

them protect themselves from investment fraud."[65] Further, older investors and poorly educated investors were the classes most likely susceptible to financial fraud.[66] A similar study in 2009 also revealed that American adults averaged 2.72 correct answers out of 5 basic financial literacy questions.[67]

Crowdfunding's necessary partnership with the internet is also cause for concern. "investors in crowdfunding offerings are likely to be strangers to the company, and, as such, would have no information about the company except that provided by the company or the website where the securities are offered for sale." And as a medium, the internet has revealed itself to be just the next technology that fraudsters see as an opportunity to exploit. Already a breeding ground for pump and dump schemes, crowdfunding platforms would offer a similar impersonal vehicle to access millions of unsuspecting consumers.

The Crowdfund Act's ambitions to open up investment to this uninformed pool of individuals, and reduce disclosure requirements is seemingly imprudent. However, looking to the current crowdfunding platforms, instances of fraud seem to be non-existent.[68] While not selling securities, potential fraudsters still have plenty of opportunity to line their pockets with the pledges of individuals through both the "reward" and "lending" crowdfunding platforms.

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[65] *Id* at 795 (citing SEC, *Study Regarding Financial Literacy Among Investors* (2012), *available at* http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf (finding retail investors to have inadequate financial literacy and proposing implementation of several initiatives to promote greater investor education)).
[66] *Id.*
[67] *Id.*
[68] *Id.* (citing Jason Best and Sherwood Neiss, *Crowdfunding Delayed Again, Blasted as a Top Danger*, VentureBeat (Aug. 22, 2012), *available at* http://venturebeat.com/2012/08/22/crowdfunding-delayed-again-blasted-as-a-top-danger/ (In the seven years crowdfund investing has been legal in Australia and in the two years it has been legal in the UK, no cases of successful fraud have been discovered)).

Expanding unsophisticated investors' ability to benefit from equity or interest would, therefore, "be a net gain to investors, increasing the possibility of gains without any increase in the risk."[69]

B. *INHERENT RISK OF STARTUPS*

In addition to fraudulent behavior, the businesses seeking crowdfunding are inherently risky. Unlike larger blue-chip companies, such as PepsiCo or Chevron, the value of startups is more prone to fluctuation. With minimal infrastructure in place, relatively new management, and at times an untested product, startups boast a failure rate of over 75%. [70]

This extra risk is factored in the decision process of traditional venture capital firms. In their analysis of how to mitigate this risk and which companies to invest in, "the key consideration is the management ability of management team behind the idea, not the idea itself."[71] With only a computer screen between unsophisticated investors and offerors, the central component of risk evaluation - evaluating management - is lost. As put by Professor of Entrepreneurship David M. Cromwell at Yale University:

> Incompetent management causes more failures in new business ventures than all of the other reasons, combined. Read any good textbook on venture capital investment or talk to some real VC firms -- almost all of them will say exactly the same thing. As an venture investor, you cannot judge the abilities of the management team over the Internet. Real venture capitalists do not make their investments over the Internet -- they spend hours and hours interviewing the founders / management team, in person. Small investors cannot successfully invest over the Internet, either.[72]

Crowdfunding not only exposes unsophisticated investors to an inherently risky marketplace, but apparently places faith in an impersonal structure that robs investors of the information and tools used by professional venture capitalists.

[69] Bradford, *supra* note 21, at 104-05.
[70] Gage, *The Venture Capital Secret*, supra note 7.
[71] David M. Cromwell, Securities and Exchange Commission, *Comments on Proposed Rule: Crowdfunding*, File No. S7-09-13 (October 27, 2013), *available at* http://www.sec.gov/comments/s7-09-13/s70913-22.htm.
[72] *Id.*

Condemning startups' inherent risks, however, is inconsistent with (1) current securities laws and (2) success of current crowdfunding platforms. [73] Firstly no law prevents individuals from investing in companies with poor management or poor financial health. In the absence of fraud or a violation of a legal duty, individuals are not permitted recourse against a company that fails. Secondly, if crowdfunding platforms were notorious for losing their current contributors' pledges, they would immediately lose favor in the market. Looking to Kiva, however, of the $497,192,075 loans disbursed over 99.01% have been successfully repaid.[74] With statistics rivaling, if not eclipsing most major banks, maybe unsophisticated consumers are well equipped to judge who deserves crowdfunding.[75] Again, the Jobs Act will increase the upside for investors, who can now expect returns, while keeping risks constant.

C. *INVESTMENT CEILINGS AND RECOVERY*

The Jobs Act's provisions aimed at limiting individual investor loss have also received criticism. Under the current scheme, a company can only solicit up to 1 million dollars via crowdfunding.[76] Further, investors earning less than $100,000 dollars annually are only permitted to invest the greater of $2,000 or 5% of their net worth.[77] Investors earning more the $100,000 are permitted to invest up to 10% of their net worth.[78] And no investor is allowed to invest more than $100,000 in crowdfunding. [79] Again, these restrictions were intended to spread risk among a wide base of investors, and limit loss in cases of default or fraud.

Critics argue that in establishing these limits, however, the authors of the Crowdfund Act overestimated the general public's litigiousness. "Since the most an individual investor can have

[73] Risk and Due Diligence, *supra* note 41.
[74] Risk and Due Diligence, *supra* note 41.
[75] *Id.*
[76] Crowdfund Act, §302(a)(6)(A).
[77] *Id* at §302(a)(6)(B)(i).
[78] *Id* at §302(a)(6)(B)(ii).
[79] *Id.*

at stake in a crowdfunded venture is between $ 10,000 and $ 100,000, and probably no more than $ 2000, the costs associated with hiring an attorney to litigate a securities fraud claim would not be economically worthwhile."[80] Neither investors nor attorneys will apparently be incentivized to use the Jobs Act's built in private right of action or institute class action proceedings to recover losses.[81]

While fraud can come in small packages, those in support of removing the Crowdfund Act's investor cap limits ignore a core characteristic of fraudsters – greed. They also ignore a core characteristic of recovery efforts in instances of large scale fraud – the absence of any money left to collect.[82] "There are almost no cases in which all investors involved recovered 100 percent of their investments. The average recovery rate is less than 40 percent.[83]Implementing limits on investors and offerors may disincentivize litigation to an extent, but the alternative carries a much greater risk of unrecoverable loss.

IV. Protecting the Crowd

Evaluating the risks put forward by those who oppose crowdfunding, it is clear that both policy makers and enforcement agencies may face challenges in achieving the combined goal of investor protection and capital formation. "Balancing these competing interests is a fundamental challenge of securities regulation and [those in charge] usually tilt this balance in favor of investor protection."[84] The Jobs Act is not an exception to this rule. While crowdfunding will encourage the growth of emerging companies' growth, it will also be subject to stringent

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[80] Siegel, *Title III of the Jobs Act*, *supra* note 19, at 798-99.
[81] *Id.*
[82] Surendranath R. Jory, Ph.D., and Mark J. Perry, Ph.D., *Ponzi Schemes: A Critical Analysis*, Journal of Financial Planning (July 2011) (These observations were made from a random sample of 80 Ponzi schemes investigated by the SEC and the FBI. Case reporting was not standardized, and the observations do not represent the full set of Ponzi schemes).
[83] *Id.*
[84] Bradford, *supra* note 21, at 98-99.

oversight from three key sources: (1) the SEC and securities self-regulatory organizations (2) its own statutory safeguards, and (3) the investors who use it – a somewhat unique characteristic.

A. THE SEC AND SELF-REGULATORY AGENCIES

Following the financial crisis in 2008, lawmakers and the SEC were quick to realize the consequences of half-hearted regulatory and enforcement efforts. The rhetoric of increased oversight of the securities market was met with a sincere reorganization of the SEC to better discover and shut down potential fraud. Proudly asserted by SEC Chair Mary Jo White: "Since 2008, the enforcement division has brought crisis-related actions against more than 160 entities and individuals, including many CEOs and other senior executives, barred dozens of fraudsters and returned billions of dollars to harmed investors."[85] Through attracting more specialized talent and better defining the focus of its divisions, the SEC is well positioned to continue its enforcement success with respect to crowdfunding.

The first step in strengthening the SEC's investigatory and enforcement capabilities was to saturate the agency with individuals having specialized knowledge of the financial industry. In addition to senior officials, the agency has targeted new staff "with expertise in modern financial products and techniques — such as structured debt, derivatives, and private fund activities. Now, other staffers can tap into that expertise to help them identify emerging issues and understand the ways the industry is changing."[86] And to keep all members of the agency updated and aware of potential challenges the SEC has expanded its internal education

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[85] Commissioner Mary Jo White, S.E.C., Speech, *Deploying the Full Enforcement Arsenal* (September 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.Uo_QCFPe6EY.
[86] *Post Madoff Reforms*, The Securities and Exchange Commission, *available at* http://www.sec.gov/spotlight/secpostmadoffreforms.htm.

program.[87] These changes in hiring and training have been effective in rooting out more instances of fraud since 2008, and indicate comparable success against abuses of crowdfunding.

Secondly, under the leadership of Robert Khuzami, the SEC reorganized its enforcement division to concentrate their resources and better address the complex and evolving nature of financial fraud.[88] "Specialized teams of lawyers and market experts were created to focus in the areas of Asset Management, Market Abuse, Complex Financial Instruments, Foreign Corrupt Practices, and Municipal Securities and Public Pensions."[89] These teams aimed to "utilize enhanced training, hiring of and consultation with individuals with industry experience or other specialized skills, targeted investigative approaches, and in some cases new technology, to conduct more efficient and comprehensive investigations."[90] Further, the Office of Market Intelligence and Division of Economic Risk (DERA) were created to streamline the agency's access to fraud-finding information.[91]

The success of this reorganization is illustrated by SEC action taken against ZeekRewards.com, a $600 million online Ponzi and pyramid scheme that was on the verge of collapse and had raised money from more than one million customers.[92] Under the guise of "crowdfunding," ZeekRewards solicited investment from unsuspecting investors absent an approved crowdfunding platform.[93] Within 1 year the SEC halted the ZeekRewards scheme and

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[87] *Id.*

[88] Michael Bobelian, *Will the SEC Lose its Edge After Khuzami's Departure?,* Forbes (January 22, 2013)(Khuzami turned around the Enforcement Division by instituting its biggest reorganization in thirty years. The agency brought in experienced prosecutors and recruited from Wall Street's ranks to bolster its expertise in these various areas, allowing it to better understand and keep up with an ever-changing financial sector).

[89] Commissioner Louis A. Aguilar, S.E.C., Speech, *A Stronger Enforcement Program to Enhance Investor Protection*, (October 25, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540071677#.Uo_PClPe6EZ.

[90] Bobelian, *supra* note 88.

[91] Aguilar, *supra* note 89.

[92] Nathalie Tadena, *SEC Shuts Down ZeekRewards as Scam,* Wall St. J. (August 17, 2012), *available at* http://online.wsj.com/news/articles/SB10000872396390443324404577595773662395922.

[93] *Id.*

reached a settlement with the perpetrator.[94] The specialization inherent in the SEC's new structure, and its emphasis on efficiency, will prove helpful in addressing future challenges of crowdfunding.

Lastly, self-regulatory organizations (SROs) have also begun preparation to combat potential crowdfunding fraud. Aware of the rise in crowdfunding portals since the introduction of the Jobs Act, SROs have actively implemented new cyber monitoring mechanisms to make certain that the promises of crowdfunding are realized.[95] For example, the North American Securities Association (NASSA) is "currently coordinating multi-jurisdictional efforts to scan various online offering platforms for fraud, and, where authorized, will coordinate investigations into online or crowdfunded capital formation fraud."[96] Further NASSA's task force, like the SEC, "is working with NASAA's Investor Education Section to develop investor and industry awareness programs regarding crowdfunding." [97] Preemptive security measures and developing personnel well suited to identify crowdfunding fraud at the SRO level is yet another shield for investor protection.

B. STATUTORY SAFEGUARDS

The organizational protections of the crowd are supplemented by strict statutory safeguards against offerors and even stricter safeguards against crowdfunding platforms. Placing limits on potential investment, expanding civil liability provisions, and tasking funding portals with the obligations of a de facto SRO serve as a three pronged insurance policy against loss and fraud.

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[94] *Id.*
[95] Bob Webster, *NASSA Sees Sharp Spike in Crowdfunding Presence on the Internet*, North American Securities Administrators Association (December 5, 2012), *available at* http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/.
[96] *Id.*
[97] *Id.*

As mentioned earlier, the Crowdfund Act only permits startups to solicit up to 1 million dollars in investment.[98] Moreover, individuals earning less than $100,000 can only invest up to $2,000 or 5 percent of their net worth; likewise, individuals earning more than $100,000 can only invest up to 10 percent of their net worth, but not exceed $100,000.[99] With respect to investor protection, the benefits of investment cap limits are two-fold. Firstly, and most importantly, individual loss is limited.[100] For instance, if an individual earned $60,000 annually, then his maximum allowed investment would be $3,000. Even assuming that the individual in question was defrauded, or more realistically lost their investment due to the high risks of startups, the lion's share of his wealth would remain untouched. "It is practically impossible to lose one's life savings in a crowdfunding, no matter how unwise or unlucky one's choices may be. By contrast, an investor can lose her life saving –quickly, easily, and legally---by investing in the stock market, gambling at a casino, or playing the state lottery."[101]

Second, investment caps lower the incentive for fraudsters to use crowdfunding as the vehicle for their crime. A potential payout of less than 1 million dollars does not offset the cost of evading the SEC, SROs, funding portals, and a new class of informed investors; especially when fraud outside of the crowdfunding arena, which will yield higher rewards, is still available.

Not allowing smaller losses to offset other investor protections, the Crowdfund Act also incorporates a robust civil liability provision.[102] Crowdfund Act Section 4(A)(c) provides investors with a right of action against issuers for materially misleading statements or omissions contained in oral or written communication. In choosing this language Congress specifically countered the Supreme Court's "business friendly" interpretation of Section 4(A)(c)'s

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[98] Crowdfund Act, §302(a)(6)(A).
[99] *Id* at §302(a)(6)(B)(i)-(ii).
[100] Schwartz, *supra* note 16, at 45.
[101] *Id.*
[102] Crowdfund Act, §302(c).

predecessor, Section 12(a)(2) of the Securities Act of 1933.[103] In *Gustafson v. Alloyd Co.*, the Supreme Court held Section 12(a)(2)'s negligence standard to only apply in public offerings. Those wishing to bring action against private offerings, thus, were burdened with demonstrating a higher level of culpability.[104]

Through passing Section 4(A)(c), Congress' message was clear. The Crowdfund Act lessens disclosure requirements on emerging businesses.[105] In addition to less costly review of their financial statements, offerors are only responsible for detailing their ownership, valuation, and risks. [106]Lowering the cost and quantity of disclosures, however, was not to be taken as lowering disclosure quality. By allowing a private remedy against businesses which misrepresent information, either intentionally or negligently, those benefitting from the crowdfunding platform share in the responsibility of providing investors accurate information.

Lastly, investors are protected by the regulations imposed on crowdfunding portals (e.g. Kiva). [107] The Crowdfund Act, most notably, requires funding portals to monitor investors' compliance with existing regulations, educate investors as to risk, and remain disinterested in crowdfunding transactions. [108]

After being screened by the SEC, and registering with an SRO, portals are required to uphold SEC rules. [109]Currently being debated, the rules have not addressed exactly how the portals are to monitor whether or not potential investors have already met their statutory

[103] Mashburn, *supra* note 24, at 153-54 (discussing inconsistency between *Gustafson* and Crowdfund Act); *see Gustafson v. Alloyd Co.*, 513 U.S. 561, 567-68 (1995).
[104] *Id.*
[105] Crowdfund Act, §302(b) (Issuers asking for less than $100,000 must file tax return and financial statements certified by CEO; Issuers asking for $100,000-$500,000 must file financial statements reviewed by public accountant; Issuers asking for over $500,000 must file formally audited financial statements).
[106] *Id.*
[107] Crowdfund Act, §302(b)(A).
[108] *Id.*
[109] *Id* at §302(b)(A)(2).

investment limits.[110] The proposed rules simply state that the intermediary must have “a reasonable basis for believing that an investor has not exceeded the investment limits discussed above before accepting an investment commitment from that investor.”[111] While the SEC has discussed a possible central data system to verify investor incomes and investments, it is not yet in place. Funding portals, nevertheless, will be vigilant in screening investors in the prevention of fraud.[112] If investors were to consistently exceed the statutory investment limits and suffer large losses, confidence would be lost in the crowdfunding industry. It is in portals self-interest to prevent such losses and comply with the Crowdfund Act.

Funding portals are also charged with the duty to educate investors about the risks associated with investing.[113] Not only must they provide investors with adequate information, but ensure that investors affirm that they understand the information and demonstrate their understanding through a short test. [114]This regulation directly addresses the claims of Crowdfunding’s opposition, who are quick to credit all potential investment losses to blind decisions made by an uneducated class of people. [115] As an added benefit, providing information about crowdfunding’s risks and rules will also curtail the number of investors who inadvertently exceed their statutory investment caps.

To eliminate the incentives for crowdfund portals, and their personnel, to participate in possible fraud, the Crowdfund Act also contains stringent self-dealing provisions.[116] No funding portal is permitted to offer investment advice to investors or solicit investment for any offer

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[110] Crowdfund Act, Proposed Rules, Securities and Exchange Commission, 395-98 (October 23, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf.
[111] *Id.*
[112] *Id.*
[113] §302(b)(A)(4).
[114] *Id.*
[115] Siegel, *Title III of the Jobs Act*, *supra* note 19.
[116] Crowdfund Act, §302(b)(A)(9)-(12)

posted on its website. Through this measure portals will be relegated to their core function, which is to act as an independent virtual marketplace for businesses and investors.

C. A NEW TYPE OF INVESTOR

Investors seeking to take advantage of crowdfunding are distinguishable from investors in the 1990s, when the general solicitation ban gained support.[117] "Unlike the investors of the 1990s, people today are equipped with advanced tools to obtain enormous amounts of specific information at any time."[118] And in addition to an evolving breed of investors, the online platform embraced by crowdfunding facilitates the general public to share information and police fraud for themselves.[119]

Most noticeably, access to the internet has grown 100 fold over the past twenty years.[120] This access "reduces the problem of information asymmetry, and therefore prevents the incidence of fraud resulting from the monopoly over information by a small group of people."[121] Irrespective of the quantity of disclosure, offerors and company management will presumably always have more information pertaining to the financial health of their company. The internet, however, gives investors greater bargaining power to demand the information necessary for them to make informed choices.

The Supreme Court noted in *SEC v. Ralston Purina Co.,* "that if investors have the bargaining power to demand effective disclosure, there is no practical need to afford them protection of the registration requirements."[122] In the case of crowdfunding, if investors are dissatisfied with a company's disclosures they can signal the need for more information by not

[117] Sigar, *Fret No More, supra* note 16, at 489.
[118] *Id.*
[119] Fink, *Protecting the Crowd, supra* note 8, at 31.
[120] Sigar, *Fret No More,* supra note 16, at 489 (In 1990 2.2 million people in the United States had access to the internet. In 2010, the number of internet users had increased to nearly 240 million people in the United States).
[121] *Id.*
[122] *Id* at 494 (citing *SEC v. Ralston Purina Co.,* 346 U.S. 119 (1953)).

investing or potentially communicating their dissatisfaction on the funding portal itself. Investors' increased bargaining power, while not a substitute for registration, justifies the Crowdfund Act's lessened disclosure requirements.

Furthermore, the crowdfund platform allows for investors to warn one another of potential fraud in real time. "Current e-commerce companies such as eBay and Amazon permit users to rely, to some extent, on user reviews to police against fraud or misleading information."[123] The SEC has encourages crowdfunding portals to replicate this model, thereby, building another obstacle between fraudsters and potential victims.[124] Communicating in real time also allows investors to take an active role in improving the crowdfunding system. Through expressing their needs, products such as Gal-X Crowdfund Connect Software, which calculates the probability of survival of a project, were quickly developed by the private sector.[125] The Crowd, via the internet, has the ability to both invest in, police, and advance the current crowdfunding system.

V. Conclusion

The Jobs Act is well position to strike a balance between investor protection and facilitating capital growth. The Jobs Act promises to allow more businesses, such as Pebble Watch, to grow and create more employment opportunities.

While critics of the Act claim that it will proliferate fraud due to the access it grants unsophisticated investors to already risky business, they fail to realize that these risks are already present. By implementing crowdfunding legislation the SEC, SROs, funding portals, and the

[123] Fink, *Protecting the Crowd, supra* note 8, at 31.
[124] Crowdfund Act, Proposed Rules, *supra* note 110, at 397 ("we believe it is likely that investors and interested participants would provide relevant adverse information about an issuer or an offering through postings on chat sites, message boards, and other communication channels, including, but not limited to, the communication channels to be provided by the intermediary")
[125] Sigar, *Fret No More,* supra note 16, at 492.

general public will each add a layer of oversight to the practice. And moreover, investors will now have an opportunity to realize a greater personal financial upside by participating in crowdfunding.