

Power to the People—How the SEC Can Empower the Crowd

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In 1886, the renowned journalist and press baron Joseph Pulitzer ran an advertisement in his newspaper soliciting donations to help build a pedestal for the newly constructed Statue of Liberty.¹ Pulitzer promised donors a six-inch replica statuette in exchange for \$1 or a twelve-inch version for \$5.² Over six months, individuals donated nearly \$100,000,³ with the majority of donations under \$1.⁴ Some one-hundred twenty years later, a revolutionary high-volume, low-amount, donation-based capital market emerged—crowdfunding.⁵

Crowdfunding is an online marketplace (portal) that connects aspiring entrepreneurs, who possess a great idea but no money, with a large audience of Internet users (the crowd), whom these companies hope will each contribute a small amount.⁶ Crowdfunding has the potential to infuse previously inaccessible capital into our sputtering economy because it connects companies that otherwise could not arrange funding with individuals who otherwise would not invest.⁷

Title III of the Jumpstart Our Business Startups [JOBS] Act carved out an exemption from securities registration for crowdfunded offerings, thereby creating an equity-based crowdfunding

¹ See *The Jobs Act: Economic Boon or Peril?*, MASSOLUTION, (Aug. 14, 2013), <http://events.massolution.com/the-jobs-act-economic-boon-or-peril/> (quoting Clay Shirky).

² *Id.*

³ The equivalent of \$2.4 million today. *Id.*

⁴ See *id.*; see also *Pulitzer Crowdfunded the Statue of Liberty?*, DAILYCROWDSOURCE, <http://dailycrowdsourcing.com/20-resources/projects/169-pulitzer-crowdfunded-the-statue-of-liberty> (last visited Dec. 28, 2013) (“The most incredible aspect of this campaign is that the over 120,000 donations were in most cases less than a dollar.”).

⁵ See *The Jobs Act: Economic Boon or Peril*, *supra* note 1.

⁶ Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. R. 879, 881 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1875584.

⁷ This Note will focus solely on the crowdfunding market in the United States, though advanced crowdfunding markets exist in many countries (e.g., the United Kingdom, Ireland, Australia, and Germany). See Ahlers et. al., *Equity Crowdfunding* 1, 10-11 (Dec. 2, 2013) (Working Paper), available at <http://ssrn.com/abstract=2362340>.

market.⁸ This revolutionary market would, if viable, reduce businesses' dependence on large institutions to arrange financing, while simultaneously offering promising investments to the public that were previously available only to the wealthy.⁹

Despite crowdfunding's promise, the Securities & Exchange Commission's [SEC or Commission] proposed regulations seek to create a market that offers perhaps the worst value proposition of any capital formation mechanism available to small businesses.¹⁰ The final regulations can further the primary goals of securities regulation by increasing access to capital for small businesses while protecting the interests of investors.¹¹ Crowdfunding's radical nature poses yet unanswered questions, which will require innovative regulation.¹² Using its broad statutory authorization, the Commission should adopt a trial-and-error approach to striking the appropriate balance, using a light regulatory touch initially and imposing harsher regulation only where necessary.¹³ I propose that the final regulations should reduce the amount of disclosure to a level commensurate with the nature of crowdfunded companies, empower portals to police offerings, and facilitate full communication between members of the crowd.¹⁴

This Note analyzes how the SEC's crowdfunding rules could satisfy the aims of securities regulation.¹⁵ Part I explores the economic environment that gave rise to the JOBS Act, provides a brief overview of crowdfunding's role within the overall securities market, and

⁸ Jumpstart Out Business Startups Act, Pub. L. 112-106, 126 Stat. 306 §306 (2012) [hereinafter, "JOBS Act"].

⁹ Andrew A. Schwartz, *Keep it Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 431 (2012).

¹⁰ See *infra* note 97.

¹¹ See Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 at 13: ("whether exemption is promoting new capital formation while at the same time providing key protections for investors.").

¹² Steven Davidoff, *Trepidation and Restrictions Leave Crowdfunding Rules Weak*, DEALBOOK (Oct. 29, 2013, 5:10 PM), http://dealbook.nytimes.com/2013/10/29/trepidation-and-restrictions-leave-crowdfunding-rules-weak/?_r=0

¹³ See *id.*; see also Schwartz, *supra* note 9.

¹⁴ See *infra* Part III. 'A Compromise'.

¹⁵ See *supra* note 11.

discusses the salient features of the SEC’s proposed regulations, noting where they deviate from the JOBS Act.¹⁶ Part II analyzes these proposed regulations to assess whether the disclosure requirements, the crowdfunding community (the crowd), and the unique function of portals are sufficient fraud safeguards, thereby allowing crowdfunding to fulfill its potential as a viable securities market.¹⁷ Part III outlines the original purpose of the crowdfunding exemption and suggests an alternative crowdfunding framework more consistent with these goals.¹⁸ This Note ultimately recommends a statutory framework that reduces issuers’ disclosure burden, yet still provides investors with adequate protection via portals’ screening efforts and the active participation of the crowdfunding community in selecting quality investments.¹⁹

I. Setting the Stage

Crowdfunding’s success in a non-equity setting flourished largely in the absence of regulation, but the paucity of capital available to entrepreneurs necessitated an equity-based market.²⁰ The factors that motivated this radical market and the evolution of the resultant legislation, are discussed below.

A. For the People, By the People

Crowdfunding is broadly defined as “efforts by entrepreneurial individuals and groups—cultural, social, and for-profit—to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the Internet, without standard financial intermediaries.”²¹ In its original format, known as donation- or rewards-based

¹⁶ See *infra* Part I.

¹⁷ See *infra* Part II.

¹⁸ See *infra* Part III.

¹⁹ See *infra* Part II.C. ‘Wisdom of the Crowd’

²⁰ See C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L. J.195, 196 (2012).

²¹ Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. OF BUS. VENTURING 1, 2 (Forthcoming 2014), available at <http://ssrn.com/abstract=2088298> or <http://dx.doi.org/10.2139/ssrn.2088298>.

crowdfunding, individuals donate a set amount of money in exchange for a pre-specified reward, such as a copy of the finished product (i.e., a compact disc, movie, widget, etc.) or a chance to attend a live-recording session.²² Kickstarter, the preeminent crowdfunding portal, demonstrates the power of this business model, having successfully raised \$927 million for over 50,000 projects since its inception in 2009.²³

Over the past few years, crowdfunding has generated significant organic momentum through the rise of websites like Kickstarter and Indiegogo.²⁴ The crowdfunding market doubled in size in the last year alone and has become an attractive financing option for a myriad of small businesses and start-ups seeking capital.²⁵ Start-ups ranging from a Bluetooth-enabled wristwatch manufacturer²⁶ to a New Jersey crab shack²⁷ have found great success funding their ventures mimicking Pulitzer's model.²⁸ Music and film productions, in particular, are well suited for donation-based crowdfunding because investors will accept non-monetary returns on

Crowdfunding borrows heavily from the concept of crowdsourcing, which involves companies drawing small labor contributions from a large number of individuals on the Internet to alter their production structure. *See generally*, Erin Frankone, *Free Agents: Should Crowdsourcing Lead to Agency Liability for Firms?*, 15 VAND. J. ENT. & TECH. L. 883 (2013).

²² Agrawal et al., *Some Simple Economics of Crowdfunding* 12 (Nat'l Bureau of Econ. Research Working Paper No. 19133, 2013), available at <http://www.nber.org/papers/w19133>.

²³ Among 54,151 successfully-funded projects. *Kickstarter Stats*, KICKSTARTER (last visited 12/25/2013, 11:00 A.M.) <http://www.kickstarter.com/help/stats>.

²⁴ www.kickstarter.com; [Indiegogo.com](http://www.indiegogo.com).

²⁵ Crowdfunding volumes in North America grew 108% to \$1.6B in 2012. *Crowdfunding Market Grows 81% in 2012: Crowdfunding Platforms Raise \$2.7 Billion and Fund More Than One Million Campaigns, Finds Research Firm Massolution*, PRNEWswire (Apr. 8, 2013), <http://www.prnewswire.com/news-releases/crowdfunding-market-grows-81-in-2012-crowdfunding-platforms-raise-27-billion-and-fund-more-than-one-million-campaigns-finds-research-firm-massolution-201911701.html>.

²⁶ Mark Nowotarski, *Getting Your Invention Off of the Ground With Crowdfunding*, IPWATCHDOG (Jun. 29, 2013, 9:05 AM) <http://www.ipwatchdog.com/2013/06/29/getting-your-invention-off-of-the-ground-with-crowdfunding/id%3D42567/> (documenting the story of the Pebble smartwatch, the most successful Kickstarter project to date, which raised over \$10 million).

²⁷ Jean Murray, *Crowdfunding – Legal Issues for Small Businesses*, ABOUT.COM, <http://biztaxlaw.about.com/od/financingsources/a/Crowdfunding-Legal-Issues-For-Small-Businesses.htm> (last visited Dec. 28, 2013, 12:29 PM).

²⁸ *See Economic Boon or Peril*, *supra* note 1.

their donation, such as satisfaction from contributing to an entrepreneurial initiative, early access to the product, or an opportunity to meet the creator.²⁹

As crowdfunding gains prominence, entrepreneurs grow increasingly creative in utilizing this investment model.³⁰ For example, one start-up recently attempted to raise \$300 million to purchase the Pabst Brewing Company by promising an amount of beer proportionate to the investment and a “crowdsourced certificate of ownership.”³¹ Similarly, the human-rights organization AHUMANRIGHT is currently accepting donations to launch a communications satellite into orbit that would provide Internet access to third-world countries.³² Other portals arrange peer-to-peer lending markets, matching borrowers and lenders with similar risk profiles.³³

²⁹ See e.g., Agrawal, *supra* note 11; Thaya Brook Knight, Huiwen Leo, & Adrian A. Ohmer, *A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act*, Mich. J. of Private Eq. & Venture Cap. L. (2012) (discussing the disproportionate success of projects exhibiting a sufficient ‘cool factor’); Film & Crowdfunding Market Grows 81% in 2012, *supra* note 14 (documenting how Performing Arts (11.9%) and Music & Recording Arts (7.5%) projects account for a large percentage of total crowdfunded ventures.); Chen et. Al., *The Truth About Spike Lee and Kickstarter*, KICKSTARTER (Aug. 19, 2013), <http://www.kickstarter.com/blog/the-truth-about-spike-lee-and-kickstarter-0> (citing the success of Veronica Mars, Zach Braff, and Spike Lee as crowdfunding creators).

³⁰ Even President Obama utilized crowdfunding to raise over \$100 million in small contributions during the 2008 presidential election. See Ahlers et. al., *Equity Crowdfunding* 1, 5-6 (Dec. 2, 2013) (Working Paper), available at <http://ssrn.com/abstract=2362340>. Mature companies are similarly pursuing this capital, as evidenced by DodgeDartRegistry.com, where an entrepreneurial youth can virtually assemble a replica of his/her dream Dodge Dart and then solicit donations from friends and family to pay for parts or features of the car. DodgeDartRegistry.com.

³¹ Alas, after a promising start saw the venture raise over \$200 million from five million discrete investors, the SEC shut down the campaign for failure to register as an offering of securities. At the time, no securities exemption permitted crowdfunded ventures to offer an ownership stake without registering with the SEC, which the certificate of ownership violated. See Matthew Hutchens, *Hitting the Target: How New Disclosure Rules Could Improve the Jumpstart Our Business Startups Act* (Sept. 27, 2013) (Working Draft) available at <http://ssrn.com/abstract=2332248>; see also Bill Singer, *SEC Skunks Pabst BuyBeerCompany Deal*, FORBES (Jun. 6, 2011, 3:21 PM) <http://www.forbes.com/sites/billsinger/2011/06/08/sec-skunks-pabst-buybeercompany-deal/>.

³² <http://www.buythissatellite.com> (last visited 10/30/2013).

³³ These loans can assume an altruistic structure (i.e., requiring the borrower to repay only the principal amount without interest) or an investment structure (i.e., requiring repayment of principal plus interest). Compare Kiva.com and CircleUp.com, with Prosper.com and LendingClub.com.

Despite this burgeoning market, small businesses' demand for capital far outweighs supply in the United States.³⁴ The demand for new investment is estimated to be around \$13 trillion over the course of the next decade.³⁵ In 2011, approximately 600,000 small businesses reported being entirely shut-off from credit, with an additional 800,000 obtaining less than they desired.³⁶ Yet, fifty-eight percent of all American adults maintain that they are willing to help fund a start-up or expanding small business in pursuit of the American Dream.³⁷ Crowdfunding has the potential to remedy this market inefficiency because it connects entrepreneurs who could not otherwise arrange financing with public investors who would not otherwise invest in startups.³⁸ One estimate projects a \$300 billion infusion of capital into the economy if Americans move just 1% of their investable assets into crowdfunding.³⁹ But funders require financial returns on their investment to invest in large enough quantities to satiate the demand for capital, which would bring the transactions under the purview of securities regulation.⁴⁰

B. Crowdfunding Investments as Securities

Prior to the JOBS Act, crowdfunding operated in the absence of government regulation. Though the crowdfunding market was not regulated, it was initially unclear if some of these companies were actually offerings securities, which would require compliance with extensive registration requirements before selling these financial interests.⁴¹ Then, the Commission issued

³⁴ Paul White, Comment to the JOBS Act, SEC (Jul, 22, 2013), <http://www.sec.gov/comments/jobs-title-iii/jobtitleiii-248.pdf> (citing statistics from Entrepreneur Magazine).

³⁵ *Id.*

³⁶ SMALL BUSINESS, CREDIT ACCESS, AND A LINGERING RECESSION, NAT'L FED'N OF INDEP. BUS. (January 2012), <http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/small-business-credit-study-nfib-2012.pdf>.

³⁷ See White Comment, *supra* note 26 (noting that the average crowdfunding investment is \$1300 and 69 percent of investors earning greater than \$75,000 per year would be willing to invest an average of \$1,900 per year).

³⁸ See *Promise Unfulfilled*, *supra* note 9, at 196.

³⁹ *The New Thundering Herd*, THE ECONOMIST, Jun. 16, 2012, available at <http://www.economist.com/node/21556973>.

⁴⁰ See *Promise Unfulfilled*, *supra* note 9, at 197.

⁴¹ An investment contract is an "investment of money in a common enterprise with an expectation of profits arising solely from the efforts of the promoter or a third party." Securities Act of 1933, 48 Stat. 74, 15 U.S.C. 77a §2(a)(1).

cease-and-desist orders to a number of issuers, thereby establishing limits on non-equity crowdfunding.⁴² This left entrepreneurs searching for a method to access the vast amount of untapped capital while avoiding the extensive disclosure requirements for reporting companies, which would render the cost of an offering prohibitive.⁴³

But equity-based crowdfunding clearly fits within the classic definition of an investment contract.⁴⁴ Consequently, these offerings are subject to the registration requirements of the Securities Act of 1933 (Securities Act) absent an applicable exemption.⁴⁵ No existing exemption applied to crowdfunded companies until the JOBS Act created one.⁴⁶

C. The JOBS Act and Proposed SEC Regulations

In response to the pent-up demand for start-up capital in a post-recession economy and the lack of a market mechanism to facilitate it, Congress introduced the JOBS Act, which President Obama signed into law on April 5, 2012.⁴⁷ The JOBS Act is intended “to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”⁴⁸ The legislation is an agglomeration of bills that collectively

⁴² See Zachary J. Griffin, *Crowdfunding: Fleecing the American Masses*, CASE W. RESERVE J. OF LAW, TECH. & THE INTERNET (Mar. 14, 2012), available at <http://ssrn.com/abstract=2030001> (detailing the trials and tribulations of ProFounder.com); see also Mikal E. Belicove, *Ohio Investigating Crowdfunding Platform SoMoLend*, FORBES (Aug. 13, 2013, 7:55 PM) available at <http://www.forbes.com/sites/mikalbelicove/2013/08/13/ohio-investigating-crowdfunding-platform-somolend/> (citing how Ohio security regulators shut down SoMoLend, a portal connecting borrowers with lenders, for securities fraud); BuyABeerCompany.com, *supra* note 23.

⁴³ See *Promise Unfulfilled*, *supra* note 9, at 196-97.

⁴⁴ 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, 1740 (2012), available at <http://ssrn.com/abstract=1954040> (noting that the statutory term “investment contract” is broadly construed to encompass any fundraising effort that expressly or impliedly offers investors a potential return on their investment, including notes and indebtedness).

⁴⁵ See *Promise Unfulfilled*, *supra* note 9, at 196.

⁴⁶ *Id.*

⁴⁷ Jumpstart Our Business Startups [JOBS] Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

⁴⁸ JOBS Act at 1.

seek to improve small businesses' access to capital.⁴⁹ Specifically, Title III adds Section 4(a)(6) to the Securities Act, creating an exemption from the registration requirements of Securities Act Section 5 for equity-based crowdfunded offerings.⁵⁰ The legislation, when it takes effect,⁵¹ will permit issuers to offer a financial interest in their business, either debt or equity, in exchange for a set investment of money.⁵²

While the JOBS Act outlines crowdfunding's general regulatory framework, the SEC must promulgate final regulations.⁵³ Consequently, the Commission assumed the daunting task of implementing rules for the crowdfunding market that strike the proper balance between the two primary tenets of securities regulation: 1) improving access to capital and 2) protecting the interests of investors.⁵⁴ On October 23, 2013, the SEC issued their proposed rules, starting the clock on a ninety-day comment period, after which they will promulgate final regulations.⁵⁵

i. Concerning Issuers

Consistent with the text of the JOBS Act, the Commission proposes to cap the maximum amount of crowdfunded securities any issuer may offer at \$1 million in any twelve-month period.⁵⁶ Further, it establishes three tiers of offerings, each carrying varying levels of disclosure, identical to those proposed by the JOBS Act.⁵⁷ Prior to offering crowdfunded securities, an issuer with a target objective of \$100,000 or less must submit tax returns from the

⁴⁹ Title I of the JOBS Act broadens the scope of an 'emerging growth company' while Title II relaxes the ban on general solicitation of accredited investors. *See* JOBS Act, Title I & II.

⁵⁰ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §I(B).

⁵¹ After the period for accepting comments on the proposed regulations ends (on Feb. 3, 2014), the SEC must then promulgate final regulations while also providing FINRA sufficient time to structure a market framework.

⁵² *See Promise Unfulfilled*, *supra* note 9, at 197

⁵³ Blunderbuss Clause requires issuers to comply with "such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest." JOBS Act at 11.

⁵⁴ *See supra* note 7.

⁵⁵ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 (proposed Oct. 23, 2013) (to be codified at 17 CFR pts. 200, 227, 232, 239, 240 and 249).

⁵⁶ The SEC took great care to explain that capital raised via other means (e.g., Regulation D exemption) should not be counted in determining aggregate amount sold in any given twelve-month period. *See id.* at 14-15.

⁵⁷ JOBS Act §4A.

previous fiscal year (if any) and unaudited financial statements.⁵⁸ For target offerings greater than \$100,000 but less than \$500,000, an issuer is required to submit financial statements certified by an independent public accountant.⁵⁹ For any offering above \$500,000 to the \$1 million ceiling, issuers must submit audited financial statements.⁶⁰ In addition, all issuers must provide a narrative discussion of their financial condition, similar to a Management Discussion & Analysis (MD&A) for reporting companies, which addresses the historical results of the issuer's operations and, to the extent material, its liquidity and capital resources.⁶¹ For issuers without a prior operating history, the narrative can be prospective, focusing on financial milestones and the various risks associated with the venture.⁶²

The proposed rules would not prohibit issuers from accepting investments in excess of the target-offering amount, capped at the \$1 million maximum, provided they have exceeded the target before a pre-specified deadline.⁶³ If an offeror elects to accept investments in excess of the target-offering amount, however, then they must disclose how much they are willing to accept, how the excess funds will be allocated, and the intended purpose for the additional funds.⁶⁴ To determine the requisite degree of financial disclosure, an issuer must aggregate all

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ For issuers with prior operating history, discussion should focus on “whether historical earnings and cash flows are representative of what investors should expect in the future.” Further the Commission recognizes that companies utilizing the Crowdfunding exemption are unlikely to be as large and complex as traditional reporting companies, thus the discussion of their financial condition will generally not be as detailed and lengthy as a MD&A. Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(B)(1).

⁶² If an issuer does not have a prior operating history, discussion should focus on “financial milestones and operational, liquidity and other challenges.” *Id.*

⁶³ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(B)(6).

⁶⁴ *Id.*

crowdfunding proceeds raised in the preceding twelve-month period with the target-offering amount, including the maximum oversubscription they are willing to accept.⁶⁵

In addition to these basic financial disclosures, issuers are subject to more extensive disclosure requirements intended to provide investors with sufficient information to form an educated opinion regarding the quality of investment.⁶⁶ These include, *inter alia*: the public price of the securities or a method for determining the price, a description of the issuer's ownership and capital structure, a description of the material terms of any indebtedness of the issuer, a description of exempt offerings conducted within the past three years, and material transactions.⁶⁷ Finally, issuers are required to provide regular updates on their progress towards the target-offering amount.⁶⁸ The JOBS Act listed the requisite general information that issuers must submit prior to issuance of securities, though it did not mandate the format for conveying this information to investors.⁶⁹ The proposed rules specify that the mandated disclosures must be submitted on the SEC's Electronic Data-Gathering, Analysis, and Retrieval [EDGAR] database using Form C.⁷⁰

⁶⁵ For example, if an issuer sets their target at \$450,000 but elects to accept investment up to a maximum of \$750,000, then they must submit audited financial statements. Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(B)(1).

⁶⁶ *Id.*

⁶⁷ The following information is also among the required disclosures: name, legal status, physical and website address of the business; pertinent information regarding directors and officers, as well as beneficial owners (i.e. persons owning 20% or more outstanding voting equity); a description of the business and anticipated business plan; stated purpose and intended use of the proceeds; a discussion of the material factors that make the investment speculative or risky; a description of the process to complete the transaction or cancel an investment commitment; the amount of compensation paid to the intermediary. *See id.*

⁶⁸ *Id.*

⁶⁹ "We recognize that there are numerous ways to achieve that goal and, as such, we are not proposing to mandate a specific disclosure format." *Id.*

⁷⁰ Form C is flexible, requiring the submission of certain disclosures in a specified format, while allowing issuers to format the remaining disclosures according to their preferences. Regulation Crowdfunding § 239.900; EDGAR is the online filings database of the SEC, available at <http://www.sec.gov/edgar.shtml>.

But the disclosure requirements for issuers do not end there.⁷¹ Under the proposed rules, an issuer would be subject to ongoing reporting requirements similar to the information required in the offering statement, including information about its financial condition.⁷² Companies must file these reports annually until one of three events occurs: (1) the issuer becomes a reporting company required to file reports under the Exchange Act of 1934; (2) the issuer or another party purchases or repurchases all of the securities, including any payment in full of debt securities or any complete redemption of redeemable securities; or (3) the issuer liquidates or dissolves its business in accordance with state law.⁷³ Any issuer who does not comply with these ongoing reporting requirements is excluded from offering crowdfunded securities until it files the two most recent annual reports.⁷⁴

The proposed rules prohibit the following categories of issuers from using Section 4(a)(6) to issue securities:⁷⁵ (1) non-U.S. issuers; (2) reporting companies; (3) investment companies; (4) issuers that are disqualified pursuant to the disqualification provisions of Section 302(d) of the JOBS Act; (5) issuers who have not complied with annual ongoing reporting requirements; and (6) issuers lacking a specific business plan or whose business plan is to engage in a merger or acquisition with unidentified company.⁷⁶

The JOBS Act text held issuers liable for material misstatements and omissions, without including a scienter element.⁷⁷ The proposed regulations then added a ‘substantial compliance’ provision, similar to Rule 508 of Regulation D, to protect unsophisticated investors from liability

⁷¹ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(B)(2).

⁷² *Id.*

⁷³ These reports must be filed on EDGAR no later than one hundred and twenty days after the close of the most recent fiscal year covered by the report. *Id.*

⁷⁴ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(A)(4).

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ JOBS Act §4A(c).

for merely negligent omissions.⁷⁸ This provision shields issuers from liability if a material omission or misrepresentation is “not misleading, provided that the purchaser did not know of the untruth or omission, and the issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.”⁷⁹

ii. Concerning Investors

The proposed rules contain the same bifurcated investor classes the JOBS ACT suggested,⁸⁰ but clarify potential ambiguity regarding the annual investment limitation.⁸¹ Any investor whose annual income and net worth are each less than \$100,000 is limited to an aggregate crowdfunding investment of \$2,000 or 5% of annual income or net worth, whichever is greater, in any given twelve-month period.⁸² If *either* annual income *or* net worth exceeds \$100,000, then the aggregate investment is limited to 10% of the greater of annual income or net worth, not to exceed \$100,000 in any given twelve-month period.⁸³ Issuers are permitted to rely

⁷⁸ C. Steven Bradford, *Crowdfunding and the SEC*, Bus. L. Prof. Blog (Apr. 18, 2011), http://lawprofessors.typepad.com/business_law/2011/04/crowdfunding-and-the-sec.html.

⁷⁹ Proposed Rules at 280 (The anti-fraud and civil liability provisions of the Securities Act, such as Sections 12(a)(2) and 17, apply to exempted transactions). Under this liability provision, an investor who purchases securities in a crowdfunding transaction may bring an action against the issuer to recover the consideration paid for the security, with interest, or damages if the person no longer holds the security.

⁸⁰ JOBS Act §302 (a)(6)(B)

⁸¹ Several commenters noted that Sections 4(a)(6)(B)(i) and (ii) technically subject some investors to two potential investment limits. The language of the statute may be read to create potential conflicts or ambiguity between the two investment limits because paragraph (i) applies if “either” annual income or net worth is less than \$100,000 and paragraph (ii) applies if “either” annual income or net worth is equal to or more than \$100,000 ... We believe that the appropriate approach to the investment limit provision is to provide for an overall investment limit of \$100,000, but within that overall limit, to provide for a “greater of” limitation based on annual income and net worth.

Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(A)(4).

⁸² Annual income and net worth are calculated in accordance with the Commission’s rules for determining accredited investor status. Consistent with these rules, the calculation of a natural person’s net worth for purposes of the investment limit would exclude the value of the primary residence of such person. A natural person’s income for purposes of the investment limit calculation would be the lower of such person’s income for each of the two most recent years as long as such person has a reasonable expectation of the same income level in the current year *See* Securities Act Rule 501(a)(5)-(6) [17 CFR 230.501(a)(5)].

⁸³ *See supra* note 69.

on an intermediary's representation that an investment will not cause an investor to exceed their limitation for the preceding twelve-month period.⁸⁴

iii. Concerning Portals

The JOBS Act created a unique class of financial intermediaries, called portals, specifically designed to facilitate crowdfunded transactions.⁸⁵ The proposed rules define a portal as “an Internet website or other similar electronic medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6).”⁸⁶ The Commission intends to limit an issuer to one portal for any given issuance of crowdfunded securities.⁸⁷ Unlike traditional broker-dealer intermediaries, crowdfunding portals cannot offer investment advice or recommendations to investors.⁸⁸ Portals are additionally prohibited from offering compensation to “promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor.”⁸⁹ Further, executives and other key employees of the portal are may not have any financial interest in an issuer using its portal to solicit funds.⁹⁰ Finally, portals must “register with any applicable self-regulatory

⁸⁴ The standard of liability is ‘reasonable belief’ meaning that if the issuer has knowledge the investor has, or would, exceed their limit they may not rely on an intermediary’s contrary representation. Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(C)(3).

⁸⁵ Portals, as well as existing broker/dealers, are the exclusive intermediaries for crowdfunded transactions. *See* JOBS Act §4A.

⁸⁶ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(A)(3). (“would accommodate other electronic media that currently exist or may develop in the future. For instance, applications for mobile communication devices, such as cell phones or smart phones, could be used to display offerings and to permit investors to make investment commitments.”)

⁸⁷ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(A)(3).

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ JOBS Act §4A(a)(11) (“prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services.”).

organization,”⁹¹ as well as be a member of a national securities association that is registered with the Commission.⁹²

II. All Bark, No Bite

Since President Obama signed the JOBS Act into law in April 2012 it has been the subject of intense scrutiny.⁹³ Proponents hail it as a disruptive securities market,⁹⁴ with the ability to facilitate access to a vast store of capital that traditional investment instruments cannot reach.⁹⁵ The legislators who championed the JOBS Act in Congress realized crowdfunding’s disruptive potential: “There is now the ability to use the Internet as a way for small investors to get the same kind of deals that up to this point only select investors have gotten”⁹⁶ Many

⁹¹ JOBS Act §4A(a)(2)

⁹² The statute requires registration with a self-regulatory organization as defined by §3(a)(80) of the Securities Exchange Act of 1934. At the time of publication, only FINRA satisfies this requirement. *See A Very Quiet Revolution*, *supra* note 21 (n. 44).

⁹³ The honeymoon period that we are experiencing around crowdfunding is beginning to come to a close, said Wil Schroter, co-founder and chief executive of Fundable. People realize there is real risk involved in investing in anything early-stage, whether it's an idea a charity or a product, and they're starting to understand they aren't buying off of Amazon.

See e.g., Jenna Wortham, *Success of Crowdfunding Puts Pressure on Entrepreneurs*, NY TIMES (Sept. 17, 2012), http://www.nytimes.com/2012/09/18/technology/success-of-crowdfunding-puts-pressure-on-entrepreneurs.html?pagewanted=all&_r=0

⁹⁴ Thousands of entrepreneurs need a disruptive financial innovation: a way to connect with the vast pool of capital in the hands of our friends, our family, and the growing number of people who believe business-led solutions allow for a deeper, more sustained impact than old models. We think impact investing can play a crucial role in solving our world's biggest needs.

FAQ, 33NEEDS, <http://www.33needs.com/pages/faq> (last visited Sept. 2, 2011).

⁹⁵ Right now, [start-ups and small businesses] can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it’s time our laws did as well. Because of [the CROWDFUND Act], start-ups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.

Barack Obama, President of the United States, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012).

⁹⁶ 158 CONG. REC. S1689 (daily ed. March 15, 2012) (statement of Sen. Mark Warner); *see id.* at S1717 (“this crowdfunding bill – which is, in essence, a way for the Internet to be used to raise capital [...]”)(statement of Sen. Mary Landrieu)

journalists and other commentators following the crowdfunding phenomenon agreed.⁹⁷

Conversely, a number of critics decried the legislation as creating a market for fraud.⁹⁸

Mary Shapiro, then-Chairperson of the SEC, initially adopted a cynical stance on the JOBS Act;⁹⁹ that attitude permeates the proposed regulations.¹⁰⁰ If the proposed regulations are adopted verbatim, the crowdfunding market would arguably become the least efficient means of capital formation—a far cry from the disruptive model that champions praised.¹⁰¹ These

⁹⁷ See Zachary J. Gubler, *Inventive Funding Deserves Creative Regulation*, WSJ (Jan. 31, 2013 @ 6:50P) available at <http://online.wsj.com/news/articles/SB10001424127887323468604578251913868617572> (“Crowdfunding has the potential to revolutionize the financing of small business, transforming millions of users of social media such as Facebook into overnight venture capitalists, and giving life to valuable business ideas that might otherwise go unfunded.”); see also *Economic Boon or Peril*, *supra* note 1 (positing that the ultimate goal of the JOBS Act is to improve the start-up economy by lowering the threshold to participation, thus allowing more companies to fail faster).

⁹⁸ What we are talking about are companies that in all likelihood are not going to be winners, and they are being invested in by people who clearly don’t have the expertise and financial smarts of venture capitalists [...]. So you put those together and you are creating a real opportunity for scams and fraud and significant losses.

See e.g., Dave Michaels, *SEC to Issue Crowdfunding Proposal Easing Investor Verification*, BLOOMBERG BUSINESSWEEK (Oct. 18, 2013), <http://www.businessweek.com/news/2013-10-17/sec-to-release-crowdfunding-rule-easing-investor-verification> (quoting Lynn Turner, former Chief Accountant of the SEC); *The JOBS Act Fails Investors and Entrepreneurs*, NASAA (Apr. 5, 2012), <http://www.nasaa.org/12092/the-jobs-act-fails-investors-and-entrepreneurs> (“Congress has just released every huckster, scam artist, and small business owner and salesman onto the internet.”) (quoting Jack Herstein, North American Securities Administrator’s Association President); *Economic Boon or Peril*, *supra* note 1 (“At best, this bill could make it easier for con artists to defraud seniors out of their entire life savings by convincing them to invest in worthless companies. At worst, this bill has the potential to create the next Enron or Arthur Andersen scandal or an even worse financial crisis.”) (quoting Senator Bernie Sanders (VT)).

⁹⁹ Too often, investors are the target of fraudulent schemes disguised as investment opportunities [...] if the balance is tipped to the point where investors are not confident that there are appropriate protections, investors will lose confidence in our markets, and capital formation will ultimately be made more difficult and expensive.

See e.g., David S. Hilzenrath, *Jobs Act Could Remove Investor Protections, SEC Chair Mary Schapiro Warns*, WASHINGTON POST (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html?hpid=z5; Ben Protess, *Regulator Seeks Feedback on JOBS Act*, DEALBOOK (Apr. 11, 2012, 4:16PM), <http://dealbook.nytimes.com/2012/04/11/regulator-seeks-feedback-on-jobs-act/> (“Mary L. Schapiro, then chairwoman of the Commission, warned the law would ‘weaken important protection’ for investors.”).

¹⁰⁰ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427.

¹⁰¹ The proposed rules are extremely impractical because of the restrictions and procedural hurdles a crowdfunding issuer, investor and funding portal will have to endure to raise capital. Compared to other forms of crowdfunding and capital raising, equity crowdfunding to the public has the worst “bang for your buck” in all of corporate finance.

unimaginative regulations fuel speculation that the Commission is hesitant to innovate in light of recent court decisions that require statistical proof to justify Commission actions.¹⁰² But crowdfunding cannot realize its potential to unlock vast stores of capital unless the Commission structures an efficient market such that issuers receive a fair price for their equity.¹⁰³

It is imperative that the entirety of industry regulations and practices jointly crafted by the Commission and portals do not inhibit the crowdfunding market from operating efficiently.¹⁰⁴ The equity-based crowdfunding market generated \$116 million in international transactions in 2012, but the market is projected to grow to over \$5 billion following the implementation of the crowdfunding exemption in the US.¹⁰⁵ Because this infusion of capital is crucial to economic vitality, the Commission must strike the proper balance between increasing access to capital while protecting the interests of investors, which will allow crowdfunding to fulfill its potential as a viable capital-formation mechanism.¹⁰⁶

A. A Novel Market Demands a Novel Mechanism

Balancing these two competing interests—access to capital versus protecting the interests of investors—is especially difficult within the crowdfunding context where there is a dearth of reliable data due to the market’s infancy.¹⁰⁷ The typical crowdfunding transaction involves financially unsophisticated individuals investing in inherently risky start-ups, which are more

Deborah L. Jacobs, *SEC Proposes Crowdfunding Rules*, FORBES (Oct. 23, 2013, 2:41 PM), <http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/>.

¹⁰² See Davidoff, *supra* note 9 (claiming the Commission adopted a “bunker mentality” after a string of adverse court decisions, resulting in a higher bar—statistical proof—to justify SEC actions).

¹⁰³ See Agrawal, *supra* note 11 at 20-21.

¹⁰⁴ *Id.*

¹⁰⁵ See *Crowdfunding Market Grows 81% in 2012*, *supra* note 14.

¹⁰⁶ The proposed rules are intended to align Cf transactions under Section 4(a)(6) with the central tenets of the original concept of CF, in which the public—or the crowd—is presented with an opportunity to invest in an idea or business and individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd.

Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §I(C)

¹⁰⁷ See Gubler, *supra* note 90.

likely to fail than the average publicly owned company, and even less likely to become profitable.¹⁰⁸ Additionally, crowdfunding differs from traditional sources of equity in several notable respects: limited risk exposure because of the investment cap,¹⁰⁹ the participation of the crowd in weeding out fraudulent issuers and discerning quality investments,¹¹⁰ the unique function of portals, the lack of a secondary market, voting rights disproportionate to ownership, as well as potentially resolving inefficiencies in the spatial allocation of capital.¹¹¹

As a novel securities market, crowdfunding demands a creative approach to securities regulation.¹¹² The Commission seemingly appreciated the delicate nature of the market,¹¹³ yet, despite employing more investment professionals than any other executive agency or Congress, the proposed rules contain only insignificant deviations from the text of the JOBS Act.¹¹⁴

B. Burdensome Disclosure

The proposed disclosure requirements will likely be so burdensome that they frustrate the JOBS Act's mission to increase access to capital and create more employment.¹¹⁵ The goal of securities regulation is to balance the benefits of capital formation against the cost of allowing

¹⁰⁸ See *Promise Unfulfilled*, *supra* note 9, at 196; see also Heminway & Hoffman, *supra* note 6 at 933 (n.275) ("Census data report that 69% of new employer establishments born to new firms in 2000 survived at least 2 years, and 51% survived 5 or more years."); see also *FAQ*, NATIONAL VENTURE CAPITAL ASSOCIATION (last visited Jan. 11, 2014), <http://www.nvca.org/index.php?Itemid=147> (stating that 40 percent of venture capital investments fail, 40 percent break about even and only 20 percent have a decent-to-high return).

¹⁰⁹ See Schwartz, *supra* note 9.

¹¹⁰ See *Promise Unfulfilled*, *supra* note 9, at 219.

¹¹¹ See Agrawal, note 11 at 34-35 (predicting that the online setting where crowdfunding is conducted will reduce the importance of factors that influence geography bias present in traditional funding).

¹¹² See Gubler, *supra* note 90.

¹¹³ We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts. [...] Rules that are unduly burdensome could discourage participation in crowdfunding. Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses)

Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §I(C)

¹¹⁴ See Davidoff, *supra* note 95.

¹¹⁵ See JOBS Act ("An Act To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."); see also Shane M. Fleenor, Comment on the JOBS Act, SEC (Apr. 27, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-35.htm>.

the offerings, including potential investor losses.¹¹⁶ This theory operates under the assumption that investors are adequately protected when all relevant aspects of the securities are fully and fairly disclosed.¹¹⁷ Disclosure is not focused on the merits of the investment, but on arming potential investors with the information necessary to make a fully informed investment decision.¹¹⁸ Congress carved out a crowdfunding exemption from the Securities Act requirements in order to alleviate the burden of compiling expensive disclosure documents for start-ups that are typically devoid of funding.¹¹⁹ Thus, a practical crowdfunding exemption should entail meaningful disclosure sufficient to enable investors to evaluate the merits of the securities without unduly burdening issuers.¹²⁰

The proposed disclosure requirements are overly burdensome because the expense of compliance is likely to render small offerings infeasible.¹²¹ Though the Commission relaxed traditional reporting-company disclosure, compliance with the mandated disclosure still imposes significant up-front expenses to prepare financial statements simply to qualify for an offering (especially considering that the quintessential crowdfunded company will have no capital until it closes the offering).¹²² Issuers might fear incurring these costs to make it to market, only to

¹¹⁶ See *Promise Unfulfilled*, *supra* note 9, at 217.

¹¹⁷ See Hazen, *supra* note 31 at 1741.

¹¹⁸ Justice Brandeis said it best: “Sunlight is the best disinfectant.” Louis Brandeis, *Chapter V: What Publicity Can Do*, Harper’s Weekly (Dec. 20, 1913), available at <http://www.law.louisville.edu/library/collections/brandeis/node/196>.

¹¹⁹ See Heminway & Hoffman, *supra* note 6 at 909 (Disclosure requirements associated with the filing of an Initial Public Offering can exceed \$100,000); see also *Direct Public Offerings*, goingpublic.us (estimating typical disclosure costs range from \$40,000-100,000 with larger offerings as high as \$1M).

¹²⁰ See Hazen, *supra* note 31 at 1767.

¹²¹ See Schwartz, *supra* note 102 at 46.

¹²² See *id.*; see also Marielle Segarra, *The JOBS Act: Crowdfunding and Emerging Businesses*, CFO (Oct. 22, 2013), <http://ww2.cfo.com/growth-companies/2013/10/the-jobs-act-crowdfunding-and-emerging-businesses/>.

discover that the crowd does not support their products; this possibility alone is likely to serve as a powerful deterrent from using crowdfunding as opposed to other exemptions.¹²³

Specifically, the audit requirement for companies seeking to raise over \$500,000 is onerous.¹²⁴ The mere cost of an audit is likely to cannibalize ten percent of the total offering amount, notwithstanding the intermediary's commission fee and the cost of compliance with additional Form C disclosure requirements.¹²⁵ This provides an incentive for entrepreneurs to minimize up-front costs by setting lower target amounts, thereby leaving the company undercapitalized and more prone to failure.¹²⁶ Offerings that involve a significant intellectual property (IP) component face an additional deterrent, as they must disclose sensitive information about their innovation and, in doing so, risk another founder imitating their concept.¹²⁷ If these fears keep otherwise-viable projects from reaching crowdfunding portals, depriving investors of the returns on these promising projects as a result, then the Commission will have effectively created a stillborn securities market.¹²⁸

Further, it is highly probable that the disclosures will have little effect on whether a project is ultimately funded, as the average crowdfunding investor is unlikely to perform

¹²³ *Id.*; See *infra* Part II.E. 'Crowdfunding: The Inferior Alternative'

¹²⁴ See Heminway, *supra* note 6 at 909 n.145; see also *Should You Pay For Audited Financial Statements?*, THE BUSINESS OWNER (last visited Nov. 23, 2013, 6:20 PM), <http://www.thebusinessowner.com/business-guidance/accounting/2009/07/should-you-pay-for-audited-financial-statements> (Estimating audit costs for a small to mid-size company range from \$7,000-50,0000).

¹²⁵ See Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §III(B)(3)

¹²⁶ See Fleenor, *supra* note 108.

¹²⁷ This risk is highest during the capital raising period, before the product is actually launched. Other sources of capital allow a founder to keep their innovation secret. See Agrawal, *supra* note 11 at 17-18.

¹²⁸ See Richard Waters, *Start-ups Seek the 'Wisdom of Crowds'*, *FINANCIAL TIMES* (Apr. 3, 2012, 7:41 PM) (quoting Naval Ravikant, Co-Founder, AngelList), <http://www.ft.com/intl/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html> ("If the top 5 percent [of start-ups] avoid crowdfunding, the crowd won't make any money.");

However, if the SEC over-burdens issuers and/or investors, there is a very real possibility that demand for crowdfunding will be choked off, and our small businesses will not obtain the capital they need to grow. The capital markets are failing our small businesses, to the detriment of our under-employed citizenry. Congress recognized this failure, and passed the JOBS Act in an attempt to rectify the situation.

see also Fleenor, *supra* note 108.

extensive due diligence before making an investment decision.¹²⁹ The investment limitation exacerbates this concern by providing a disincentive for funders to invest time and money researching companies relative to traditional forms of investment involving larger capital outlays.¹³⁰ Additionally, crowdfunded offerings are likely too small to warrant professional analysis, placing the full burden of conducting due diligence on investors.¹³¹ Empowering the crowd may alleviate this problem.¹³²

The annual investment limitation, as opposed to extensive disclosure, will function as the fundamental protection for crowdfunding investors because of the speculative information that start-ups disclose combined with the likelihood that funders might disregard these disclosures.¹³³ Crowdfunding companies are inherently risky and the online offerings raise significant fraud concerns.¹³⁴ Additionally, the crowd is composed of unsophisticated investors with relatively shallow pockets.¹³⁵ The proposed rules account for these factors by ensuring investors cannot risk more money than they can afford to lose.¹³⁶ This puts crowdfunding in stark contrast to other forms of investment—such as gambling, buying lottery tickets, or playing the stock market—where an individual can legally risk their entire life savings.¹³⁷

¹²⁹ Data from consumer contracting research suggests that online disclosures are largely ignored, similar to ‘Terms & Conditions’. See Schwartz, *supra* note 102 at 46.

¹³⁰ See Agrawal, *supra* note 11 at 19; see also Ahlers, *supra* note 18 at 1.

¹³¹ *Id.*

¹³² See *infra* Part II.C. ‘Wisdom of the Crowd’

¹³³ See Schwartz, *supra* note 102 at 46.

¹³⁴ See *id.*

¹³⁵ See *id.* at 50-51

¹³⁶ See *id.* (“This is a structural protection against losing one’s life savings to a crooked crowdfunder.”); *But compare* Hazen, *supra* note 31 at 1765-66 (“likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.”)

¹³⁷ See Schwartz, *supra* note 102 at 50-51 (“This is a structural protection against losing one’s life savings to a crooked crowdfunder.”).

Portals bear responsibility for policing the annual investment limitation, though they can fulfill this obligation by relying on investor's representations.¹³⁸ This enforcement mechanism enables individuals to invest in excess of the annual limit by misrepresenting (either intentionally or carelessly) the extent of their total investments across multiple platforms.¹³⁹ While this would constitute fraud by the funder and lead some to believe these individuals are not deserving of protection, the SEC should foreclose the possibility due to the vulnerability and modest means of the target audience.¹⁴⁰

The most burdensome aspect of the proposed disclosure requirements may ultimately prove to be issuer liability.¹⁴¹ By filing annual reports, issuers assume public-offering-style liability for misrepresentations and omissions of material information.¹⁴² Issuers will surely make disclosure mistakes in a market that forces inexperienced entrepreneurs to comply with sophisticated disclosure requirements that implicate a detailed understanding of corporate finance and law.¹⁴³ Wisely, the proposed rules include a substantial compliance provision that

¹³⁸ This method, self-certification, is commonly used to determine accredited investor status. C. Steven Bradford, SEC CROWDFUNDING RULES PROPOSAL, Bus. L. Prof. Blog (Oct. 24, 2013), http://lawprofessors.typepad.com/business_law/2013/10/sec-crowdfunding-rules-proposal.html.

¹³⁹ See Schwartz, *supra* note 102 at 60.

¹⁴⁰ See *id.*;

This ill-conceived Ponzi plan does not even require that a startup seeking funds verify compliance with what are admittedly loose investment limits. That is, a family that previously never earned more than \$40K a year (with a breadwinner that has just lost her job and is no dependent on food stamps) could easily pretend that she has \$250K in income and invest \$25K/yr. She could therefore invest her entire 401(k) retirement in a startup where the chances of success are less than 1/100

see also Faith Bautista, Comment to the Proposed Regulations, SEC (Oct. 31, 2013), <http://www.sec.gov/comments/s7-09-13/s70913-38.pdf>.

¹⁴¹ See Segarra, *supra* note 115.

¹⁴² See Segarra, *supra* note 115 (quoting Brian Korn, Securities Attorney, Pepper Hamilton).

¹⁴³ See *Promise Unfulfilled*, *supra* note 9, at 217; see also Judy Magness, *Defeating Crowdfunding Fraud*, THE SUIT (Oct. 28, 2013), <http://www.thesuitmagazine.com/business/finance/22127-defeating-crowdfunding-fraud.html> ("The sort of fraud we see in this area is often totally inadvertent, where somebody doesn't realize that what they are saying cannot be said without explaining the background behind it. Entrepreneurs need to understand exactly what their obligations are.") (quoting Sara Hanks, founder of CrowdCheck & former partner at Clifford Chance).

will protect unsophisticated founders from liability for insignificant and good faith mistakes.¹⁴⁴

In addition, civil actions will not be an appropriate remedy because of the modest damages to each funder and the likely insolvency of founders (successful investments rarely lead to litigation).¹⁴⁵ Thus, some form of cost-effective alternative dispute resolution must emerge to determine the extent of issuer liability.¹⁴⁶

C. Wisdom of the Crowd

Numerous commentators have emphasized crowdfunding's potential to induce fraudulent activity.¹⁴⁷ Studies conducted on rewards-based crowdfunding suggest that prior funding decisions of project backers exert considerable influence on the subsequent funding decisions of other backers.¹⁴⁸ This irrational herding behavior attracts fraudulent issuers, as founders might initially invest a large sum to lend the project an appearance of credibility then withdraw their capital as they approach their goal.¹⁴⁹ The classic fraudulent offering involves an issuer who accepts investments for a fictitious project and disappears after the offering closes.¹⁵⁰ Further, over 90 percent of creators propose only one crowdfunded project, so even bona fide issuers are typically unproven commodities.¹⁵¹

¹⁴⁴ See Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §VII (to be codified at 17 CFR §227.502).

¹⁴⁵ See Hazen, *supra* note 31 at 1759.

¹⁴⁶ See Mark Norych, Esq., Comment on the JOBS Act, SEC (Jul. 19, 2013), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-247.pdf> (suggesting that the most appropriate forum for crowdfunding disputes is Internet arbitration, considering the costs of travel relative to the meager potential award).

¹⁴⁷ See *supra* note 91.

¹⁴⁸ Venkat Kuppaswamy & Barry L. Bayus, *Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter* (UNC Kenan-Flagler Research Paper No. 2013-15, 2013)

¹⁴⁹ *Id.*; see also Agrawal, *supra* note 11 at 31.

¹⁵⁰ Julianne Pepitone, *Kickstarter Pulls Plug on Scam Minutes Before \$120,000 Heist*, CNN (Jun. 17, 2013, 2:22 PM), <http://money.cnn.com/2013/06/17/technology/kickstarter-scam-kobe-jerky/index.html> (Documenting a fraudulent campaign to produce Kobe Red beef jerky, which nearly succeeded in scamming 3,300 investors out of \$120,000 before Kickstarter pulled the project off its website).

¹⁵¹ See Kuppaswamy & Bayus, *supra* note 139.

But outright fraud constitutes less than 5 percent of crowdfunded projects,¹⁵² so the more realistic concern for investors is that issuers might fail to exert a good faith effort to make their project a success.¹⁵³ Once the money is in the issuer's hands, funders exhibit very little control over the use of those proceeds because they have no voting power and cannot sell their shares in a secondary market.¹⁵⁴ Their position is analogous to a shareholder in a closely held corporation, where there is high potential for oppression.¹⁵⁵ The ongoing reporting requirements provide some manner of oversight, but funders would have to resort to litigation if they are unsatisfied with their investment, which is not an economically efficient solution.¹⁵⁶

Research on non-equity crowdfunding shows that signals from issuers related to quality and preparedness exert considerable influence over investment decisions.¹⁵⁷ These signals include posting a video on the portal page, providing rapid and continuous updates on funding goals, minimizing typos, social network size, patent ownership, founders with success in other ventures, and the founders' education level.¹⁵⁸ Outside of the crowdfunding context, eBay and Amazon's rating systems demonstrate the crowds' power to influence Internet investment decisions.¹⁵⁹

D. Unique Characteristics of Portals

¹⁵² See *Mollick*, *supra* note 10 at 12; see also Waters, *supra* note 121 (fraud accounts for less than 1% of money raised on Indiegogo according to Indiegogo CEO Slava Rubin).

¹⁵³ See Davidoff, *supra* note 95 (chronicling *The Doom That Came to Atlantis*, a board game that raised \$122,000 preselling versions of the game, which the founder spent to move to Portland, Oregon before declaring the project unsuccessful).

¹⁵⁴ See Schwartz, *supra* note 102 at 54; see also Davidoff, *supra* note 95.

¹⁵⁵ See Schwartz, *supra* note 102 at 54.

¹⁵⁶ See *supra* note 136.

¹⁵⁷ This phenomenon—high-quality projects attract backers who may promote the project to other potential backers, or external media, thus increasing the draw of the project—is called the Matthew Effect. See *Mollick*, *supra* note 10 at 6. (“In a setting where amateurs are making decisions about which projects to finance, and taking into account the social networks that would tend to be sources of both funding and endorsements, the effect of these signals of quality and preparedness is unexpectedly large.”).

¹⁵⁸ See *id.*; see also Waters, *supra* note 121; see also Pepitone, *supra* note 142.

¹⁵⁹ See Schwartz, *supra* note 102 at 58; Waters, *supra* note 121.

As a matter of cost shifting, portals can shoulder the burden of policing crowdfunding.¹⁶⁰ Portals employ a revenue model that charges a four to five percent transaction fee for all successfully funded projects, which could generate up to \$200-250 million in annual revenues for portals.¹⁶¹ In addition, if trends in other crowdfunding markets translate to the equity-based market, a single platform will ultimately establish market dominance.¹⁶² The value of the platform to creators increases with the number of funders, and vice versa, thus each platform has a strong market incentive to attract high-quality projects, reduce fraud, and facilitate the efficient allocation of capital to the best ideas.¹⁶³ More importantly, as most project founders only participate in one crowdfunded project, placing too much of the regulatory burden on issuers might deter them from bringing their project to the market.¹⁶⁴ Therefore, portals are in the best position to incur up-front regulatory costs, amass pertinent information from both investors and issuers, and then spread those costs and benefits among all parties involved.¹⁶⁵

¹⁶⁰ As the ones [portals] whose business expressly involves interjecting ourselves into the middle of the financial system, of registering with the SEC and joining an SRO, of dealing with crowdfunding on a daily basis, it is only natural that we should shoulder the regulatory burden for this new crowdfunding regime. We're the ones who should be digging into the code and the rules, working with our lawyers to develop a platform that is fully compliant. We're the ones who should be responsible for ensuring that the system is sustainable, and that investors are protected.

See Fleenor, supra note 108

¹⁶¹ *See Agrawal, supra* note 11 at 15. (4-5% (the typical portal commission fee) * \$5 billion (one projected market estimate) = \$200-250 million)

¹⁶² *See id.*

¹⁶³ *See id.*

¹⁶⁴ If the SEC heavily burdens the intermediaries, it may force some participants out of the market, but there will be players willing to incur the extra burdens—we believe the supply of intermediary services will be adequate in any event. However, if the SEC over-burdens issuers and/or investors, there is a very real possibility that demand for crowdfunding will be choked off, and our small businesses will not obtain the capital they need to grow. The capital markets are failing our small businesses, to the detriment of our under-employed citizenry. Congress recognized this failure, and passed the JOBS Act in an attempt to rectify the situation.

See id.

¹⁶⁵ *See id.*

With that said, prohibiting portals from screening issuers does a great disservice to investors.¹⁶⁶ Intermediaries are tasked with implementing controls to detect fraudulent offerings.¹⁶⁷ This includes performing basic background checks and securities-enforcement regulatory-history checks on all relevant members of the issuer’s management team.¹⁶⁸ The rules currently prohibit portals from offering “investment advice or recommendations.”¹⁶⁹ This language is ambiguous and, if broadly construed, might preclude portals from screening projects with a high potential for fraud or failure.¹⁷⁰ While there is wisdom in prohibiting portals from offering investment advice, sites such as SeedInvest are extremely successful in preventing fraudulent projects from reaching their investors but do so by filtering out 98% of proposed projects.¹⁷¹ This evidence strengthens the argument that equity-based platforms would benefit similarly.¹⁷² Decreased incidences of fraud will increase trust in the crowdfunding market, leading to the optimal allocation of capital.¹⁷³ Hence, it is preferable to empower intermediaries to pre-screen projects, even if this increases the average cost of an offering.¹⁷⁴

E. Crowdfunding: The Inferior Alternative

Ultimately, crowdfunding’s problem is this—who will use it? It is plausible that the crown jewel of the JOBS Act will ultimately be Title II,¹⁷⁵ which lifted the ban on general solicitation and advertising of private placement offerings utilizing the Regulation D

¹⁶⁶ See Kuppuswamy & Bayus, *supra* note 139.

¹⁶⁷ Intermediaries are obliged to “take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule ...” See Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(C)(3).

¹⁶⁸ See *id.*

¹⁶⁹ See *Promise Unfulfilled*, *supra* note 9, at 220.

¹⁷⁰ See *id.*

¹⁷¹ See Segarra, *supra* note 115.

¹⁷² See Segarra, *supra* note 115; see also Agrawal, *supra* note 11 at 19.

¹⁷³ See Heminway & Hoffman, *supra* note 6 at 948.

¹⁷⁴ See Agrawal, *supra* note 11 at 19.

¹⁷⁵ Known as ‘Accredited Investor Crowdfunding’

exemption.¹⁷⁶ Perhaps it will be Title I, which equipped emerging growth companies with an arsenal of tools (such as ‘testing the waters’¹⁷⁷) for conducting successful IPOs.¹⁷⁸ Offerings relying on the crowdfunding exemption, by contrast, are not permitted to advertise beyond providing a link that directs investors to the platform.¹⁷⁹

Importantly, start-ups and small businesses conducting offerings in reliance on Regulation D circumvent costly disclosure requirements by allowing issuers to simply open their books to potential investors.¹⁸⁰ This is especially attractive to IP-intensive projects, as they do not have to expose potentially sensitive information to the general public or competitors.¹⁸¹ These companies would not have to file with the SEC, nor place their offering through a registered intermediary.¹⁸²

The most attractive aspect of Regulation D, however, is that it allows offerors to raise an unlimited amount of money without restricting the amount each individual investor can purchase.¹⁸³ This is a potential deal breaker for founders whom are choosing among financing

¹⁷⁶ Regulation D is a separate exemption from SEC registration requirements. While the JOBS Act permits general solicitation & advertising of Reg. D offers, only qualifying accredited investors may actually purchase the securities. See JOBS Act Title II; see also *Promise Unfulfilled*, *supra* note 9, at 222.

¹⁷⁷ Testing-the-waters meetings enable issuers to communicate with prospective investors prior to an offering in order to gauge investor interest and disseminate pertinent information to interested investors. See Tracy Cooley, *JOBS Act Deconstructed: Testing-the-Waters*, BIOTECHNOW (Oct. 14, 2013), <http://www.biotech-now.org/business-and-investments/2013/10/jobs-act-deconstructed-testing-the-waters#>; see also *The JOBS Act After One Year: A Review of the New IPO Playbook*, LATHAM & WATKINS, LLP (Apr. 5, 2013), available at <http://www.sec.gov/info/smallbus/acsec/acsec-091713-lathamreport-slides.pdf>.

¹⁷⁸ The report also lists: (1) Confidential SEC Review; (2) Scaled Financial Disclosure; (3) Internal Controls Audit; (4) Executive Compensation Disclosure; (5) Extended Phase-In for New GAAP; and (6) PCAOB Rules as mechanisms Title I permits an EGC to utilize. *JOBS Act After One Year*, *supra* note 177 at 5.

¹⁷⁹ See Jacobs, *supra* note 94.

¹⁸⁰ See *id.*

¹⁸¹ See Agrawal, *supra* note 11 at 16.

¹⁸² See Segarra, *supra* note 115.

¹⁸³ See *Promise Unfulfilled*, *supra* note 9, at 222.

alternatives, as crowdfunding's high compliance expenses compared to the low maximum investment total provide perhaps the worst "bang for your buck" in corporate finance.¹⁸⁴

Further, founders might use non-equity forms of crowdfunding to raise seed capital while signaling the quality of their project to bigger investors and receiving constructive feedback from the crowd. Thus, they avoid equity-crowdfunding altogether and are more attractive for follow-on financing from established investors whom provide status, extensive networks, and industry expertise.¹⁸⁵ It is also possible that some companies soliciting purely intrastate investment will take advantage of Direct Public Offerings, an increasingly popular trend in the start-up community.¹⁸⁶ With several more attractive financing options for quality investments, crowdfunding may become a market for projects that could not arrange financing elsewhere unless the Commission makes significant alterations to the proposed rules.¹⁸⁷

III. A Compromise: Reducing Barriers to Entry Without Sacrificing Investor Protection

When Congress inserted a blunderbuss clause in the JOBS Act, they empowered the Commission to supplement the statutory text with "such other requirements as the Commission

¹⁸⁴ See Jacobs, *supra* note 94.

¹⁸⁵ An additional benefit of using non-equity crowdfunding for the initial financing round is avoiding dilution, thereby making the company more attractive in follow-on financing rounds. See Agrawal, *supra* note 11 at 7.

¹⁸⁶ See Jenny Kassa, *The JOBS Act Leaves Crowdfunding Investors Unprotected—the SEC is Working With a Flawed Law*, VENTUREBEAT (Oct. 31, 2013, 6:19 AM), <http://venturebeat.com/2013/10/31/the-jobs-act-leaves-crowdfunding-investors-unprotected-the-sec-is-working-with-a-flawed-law/>;

In a typical public offering, a Wall Street underwriter markets shares to wealthy clients and institutional investors, taking a cut of the proceeds. In a direct offering, shares are marketed directly by the issuing company, typically to customers, supporters and, these days, social media followers. The companies may advertise the offering freely and accept funds from an unlimited number of unaccredited, or nonwealthy, investors. And the companies are not subject the quarterly reporting requirements and comprehensive registration process that come with an initial offering [...] A direct offering might cost around \$25,000 in legal fees while a formal initial public offering can cost \$1 million or more.

see also Amy Cortese, *Seeking Capital, Some Companies Turn to 'Do-It-Yourself I.P.O.'s*, NY TIMES (Jul. 31, 2013), <http://www.nytimes.com/2013/08/01/business/smallbusiness/seeking-capital-some-companies-turn-to-do-it-yourself-ipos.html>.

¹⁸⁷ See Agrawal, *supra* note 11 at 20.

may, by rule, prescribe for the protection of investors and in the public interest.”¹⁸⁸ This could, and should, be interpreted as permission to experiment with the crowdfunding market.¹⁸⁹

Crowdfunding raises a host of novel legal questions to which there are no concrete solutions.

Thus, the legislation permits, and the market demands, a trail-and-error approach to regulation.¹⁹⁰

It is important to remember that the Securities Act is not an insurance policy against investor losses.¹⁹¹ Crowdfunding’s pitfalls are well documented: increased fraud potential from relaxed disclosure requirements coupled with the Internet’s tendency to encourage irrational decision making.¹⁹² The actions of portals in non-equity crowdfunding, however, suggest that the equity-crowdfunding market will likely remedy many of its own problems if portals are free to innovate.¹⁹³ So long as the market produces a net value-add (i.e., facilitates greater incremental business creation than incremental fraud increase) crowdfunding will be a success.¹⁹⁴ Crowdfunding will not add value if burdensome regulation prevents many promising

¹⁸⁸ See *supra* note 44; see also Schwartz, *supra* note 102 at 61.

¹⁸⁹ For example, a number of commentators insist the SEC has the power to raise the maximum offering amount and doing so would create a more viable market. See Albert Hartman, Comment on the JOBS Act, SEC (Jun. 4, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-79.htm>; Robert B. Nami, Comment on the JOBS Act, SEC (Jun. 5, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-81.htm> (stating a minimum of \$5-10 million is necessary to start any business other than software); Richard W. Marks, Comment on the JOBS Act, SEC (Jun. 14, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-87.htm> (advocating raising the maximum offering amount to \$5 million); Peter Ojo, Comment on the JOBS Act (May 31, 2012), <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-76.htm> (arguing crowdfunding’s maximum offering amount should be similar to Regulation D); see also Davidoff, *supra* note 95.

¹⁹⁰ See Gubler, *supra* note 90.

¹⁹¹ See Heminway, *supra* note 6 at 934.

¹⁹² See *infra* note 91.

¹⁹³ See Agrawal, *supra* note 11 at 31 (noting how non-equity platforms almost uniformly converged on a provision-point mechanism—not disbursing funds unless a project reaches its funding threshold—absent any regulatory prodding).

¹⁹⁴ See Heminway, *supra* note 6 at 940-45.

projects from reaching the market.¹⁹⁵ Accordingly, the Commission should treat the market with a light regulatory touch.¹⁹⁶

The Commission should take advantage of Congress' broad delegation to regulate the crowdfunding market by making significant deviations from their proposed rules when promulgating final regulations. Crowdfunding is intended to attract a different type of company than traditional securities markets and, consequently, different investors.¹⁹⁷ Considering the participants, the market requires a unique regulatory structure.¹⁹⁸ Yet, the Commission resorted to old tactics.¹⁹⁹ In the final rules, the Commission should relax disclosure requirements, enable portals to pre-screen projects, and eliminate restrictions on the crowd's ability to communicate.

A. Simplifying Disclosure Requirements

An appropriate crowdfunding exemption should drastically reduce disclosure requirements given the lack of reliable information and the low maximum offering amount relative to other financing alternatives.²⁰⁰ Regulation should not discourage companies from listing their projects on portals, because a broad spectrum of projects increases the probability of profitable investment.²⁰¹ Burdensome disclosure requirements directly frustrate this goal.²⁰² Simple disclosure requirements would allow issuers to highlight the important aspects of the

¹⁹⁵ See *supra* note 121.

¹⁹⁶ See Schwartz, *supra* note 102.

¹⁹⁷ The goal of the JOBS Act is to have more companies fail faster. This isn't a side effect, this is really the main effect of improving the startup economy: getting more people to try more ideas, which inherently means more failure. But it also means more experience, it means more surprises, it means lower cost. In a way, the criminogenic argument seems to me to get halfway towards what the JOBS Act is actually targeted for in that it recognizes this lowering of the threshold to participation—but [the JOBS Act] also lowers the cost of participation.

See *Economic Boon or Peril*, *supra* note 1 (quoting Clay Shirky).

¹⁹⁸ See Davidoff, *supra* note 95.

¹⁹⁹ *Id.*

²⁰⁰ See *supra* Part II.B.

²⁰¹ See *supra* note 63.

²⁰² See *supra* notes 115-23 and accompanying text.

investment, such as the price and percentage of ownership.²⁰³ Because of the unsophisticated nature of crowdfunding investors and the infancy of crowdfunded businesses, issuers should be required to explain who they are, what they seek to produce, their basic business plan, current financial condition (focusing on definite liabilities), the intended purpose of the funds, and what the investor receives from their investment (i.e. ownership stake, voting rights, etc...).²⁰⁴

The relatively small maximum offering amount does not justify extensive disclosure.²⁰⁵ The final version of Form C should be significantly less complex than the current iteration, providing issuer's with the simple disclosure process they desire.²⁰⁶ Ideally, issuers could complete Form C by selecting from a database of stock responses, rather than paying professionals to compile their disclosures. Additionally, if the final regulations include a "testing the waters" provision with crowdfunding-appropriate modifications,²⁰⁷ then issuers could make informed decisions about where to set their target offering amount or whether they should avoid an unsuccessful offering altogether.²⁰⁸

The tiered-disclosure requirement should mimic Regulation D, where entrepreneurs have the option of providing only an audited balance sheet if obtaining fully audited financial

²⁰³ Jonathan Schatz, Comment on Proposed Regulations, SEC (Nov. 13, 2013), <http://www.sec.gov/comments/s7-09-13/s70913-53.htm>.

²⁰⁴ Robert C. Guinto, Jr., Comment on Proposed Regulations, SEC (Oct. 24, 2013), <http://www.sec.gov/comments/s7-09-13/s70913-13.htm>.

²⁰⁵ Regulation A offerings were capped at \$5 million before recent changes by JOBS Act Title IV allowed Regulation A offerings to issue as much as \$50 million of equity, subject to more stringent reporting requirements. See Dave Lynn, *SEC Proposed Long-Awaited Regulation A+ Rules*, THE CORPORATE COUNSEL (Dec. 19, 2013), <http://www.thecorporatecounsel.net/Blog/2013/12/sec-proposes-long-awaited-regulation-a-rules.html>.

²⁰⁶ Examples of a scaled-down disclosure document include Form 1-A (before JOBS Act modifications) or NASAA's 1989 Form U-7. Ideally, Form C will be less detailed than either of these examples, in proportion to crowdfunding's relatively low maximum offering amount. See Guinto, *supra* note 204.

²⁰⁷ See *supra* note 177 and accompanying text. For example, allowing issuers to conduct a survey of potential investors regarding their level of interest in the project and potential investment commitment; or, allowing investors to make a commitment contingent on more detailed disclosure.

²⁰⁸ See Fleenor, *supra* note 108 ("If issuers could, at a low cost, obtain some confidence that their raise will be successful, they may be more inclined to spend their literal bottom dollar on the legal and accounting fees necessary to undertake a crowdfunding offering.")

statements would require “unreasonable effort or expense.”²⁰⁹ It is fair to say that spending over ten percent of the total amount raised on audited statements constitutes an unreasonable expense.²¹⁰ Providing a balance sheet, though, will warn investors of the company’s existing financial obligations (if any), which pose a major impediment to profitable investment.

Minimizing disclosure requirements increases the risks for investors.²¹¹ Therefore, to maintain sufficient investor safeguards, the Commission should require portals to actively confirm that investors do not exceed their annual investment limitation. The annual investment limitation functions as the fundamental investor protection in crowdfunding.²¹² The proposed rules allow investors to self-certify their level of wealth and investment activity,²¹³ but the unique dynamics of crowdfunding demand a stricter oversight process. As it currently stands, the self-certification procedure is too easy for investors to circumvent when they discover a “can’t miss” project, but an additional investment would exceed their annual limit.²¹⁴ A competently managed portal can hire third-party providers to verify individuals’ investment sums, and then distribute these costs among market participants.²¹⁵

B. Portal Pre-Screening Power

The proposed rules prohibit portals from offering “investment recommendations or advice.”²¹⁶ The SEC should clarify what constitutes a recommendation or advice to exclude

²⁰⁹ Regulation D §502(B)(2)(B)(1)-(2).

²¹⁰ See *infra* note 112.

²¹¹ See Hazen, *supra* note 31 at 1763.

²¹² Schwartz, *supra* note 102 at 60.

²¹³ Self-certification is customary for most securities offerings. See Bradford, *supra* note 129.

²¹⁴ See Schwartz, *supra* note 102 at 60.

²¹⁵ Third party service providers will race to fill this space. For example, an Ohio startup, Crowdentals Inc., recently launched an investor accreditation verification product in response to JOBS Act Title II’s allowing general solicitation. See Lora Kolodny, *Crowdentals Wants to Make Investor Verification ‘TurboTax Easy’ Online*, WSJ (Jan. 13, 2014, 2:21 PM), <http://blogs.wsj.com/venturecapital/2014/01/13/crowdentals-wants-to-make-investor-verification-turbotax-easy-online/>.

²¹⁶ Proposed Rules on Crowdfunding, 78 Fed. Reg. 66,427 §II(A)(3).

internal pre-screening decisions. As for-profit concerns, portals have a market incentive to permit as many quality projects as possible to solicit investments on their site. Rewards-based crowdfunding suggests the market will come to be dominated by a single platform,²¹⁷ and portals operate on a model where they receive the majority of their profit from successfully funded ventures.²¹⁸ It is in their interest to ensure the platform offers attractive projects to funders in order to build a loyal base of investors, which in turn attracts more quality projects.²¹⁹

Kickstarter recently adopted a pre-screening process to maximize transaction volume.²²⁰ After undergoing a trial-and-error process, its management believes the benefit of reducing risk for funders outweigh the monitoring costs.²²¹ Likewise, the SEC should grant equity-based crowdfunding portals similar discretion to pre-screen offerings for fraud.²²² To achieve this end, portals can hire investment professionals to evaluate proposed projects, thereby submitting only bona fide projects to investors.²²³ In this way, investors will gain trust in the market and rely more on the wisdom of the crowd to discern promising investments.²²⁴

²¹⁷ See *infra* note 160 and accompanying text.

²¹⁸ See *infra* note 159 and accompanying text.

²¹⁹ See *infra* note 151 and accompanying text.

²²⁰ See Agrawal, *supra* note 11 at 26 (“These efforts are focused on fraud and acceptable uses of Kickstarter, not a creator’s ability to complete a project and fulfill. On Kickstarter, backers ultimately decide the validity and worthiness of a project by whether they decide to fund it.”).

²²¹ *Id.* (“For example, Kickstarter recently allocated additional resources to detect fraud, implying that its management believes the benefits of doing so (lower risk for funders) outweigh the costs (increased monitoring costs for the platform and higher disclosure burden on creators.”).

²²² Compare <https://www.seedinvest.com/about> (“We are not a listing service. We only feature highly vetted investment opportunities that adhere to strict requirements.”), with Beth Potter, *Funding Launchpad Changes Name, Focus*, BOULDER COUNTY BUSINESS REPORT (Aug. 22, 2013, 2:10 PM), <http://www.bcbcr.com/article/20130822/NEWS/130829972> (“Investments listed on the Grofolio.com website all will be vetted by an investment bank [...]”).

²²³ See Segarra, *supra* note 115.

²²⁴ Traditional markets for the financing of early-stage creative projects or ventures rely heavily on due diligence predicated on face-to-face interactions and personal relationships. In the crowdfunding setting, creators disclose as much information as they wish and then rely on an ethos of “trust me.” Market design may influence the efficacy of a “trust me” environment by facilitating markets for reputation. In other words, in crowdfunding markets, as in many other online markets, reputation and trust are particularly important.

In addition to fraudulent offerings, portals should be permitted to filter out impractical projects.²²⁵ For example, Kickstarter changed their guidelines to impose more stringent requirements for Hardware and Product Design projects after discovering they had a higher propensity to fail when they consisted solely of renderings or product simulations as opposed to an actual prototype.²²⁶ Additionally, some projects require far in excess of \$1 million to complete.²²⁷ Ultimately, the viability of a project should hinge on whether crowdfunders invest, but portals can add value and build trust by removing projects that clearly have no chance of success, yet might appear legitimate enough to attract investment.²²⁸

C. Collective Crowd Consensus

Crowdfunding can distinguish itself from traditional sources of capital by leveraging the “wisdom of the crowd”²²⁹ and its critical role in protecting investors from fraudulent crowdfunded projects.²³⁰ By providing open communication channels, portals allow the community of investors to share their knowledge, ranging from information about the founders to industry-wide risks, collectively arriving at an ostensibly rational decision.²³¹ If communication channels are sufficiently open to allow for the free flow of information among

See Agrawal, *supra* note 11 at 23.

²²⁵ See Perry Chen, Yancey Strickler, & Charles Adler, *FAQ: Guidelines for Hardware and Product Design Projects*, KICKSTARTER (Sept. 24, 2012), <http://www.kickstarter.com/blog/faq-guidelines-for-hardware-and-product-design-pro>.

²²⁶ See Agrawal, *supra* note 11 at 25-26; see also Perry Chen, Yancey Strickler, & Charles Adler, *Kickstarter Is Not a Store*, KICKSTARTER (Sept. 20, 2012), <http://www.kickstarter.com/blog/kickstarter-is-not-a-store>; see also *id.*

²²⁷ See *infra* note 178.

²²⁸ See, e.g., *supra* note 220; see also Bryan Taylor, *How John Keely Screwed Investors and Tricked the World With His Perpetual Motion Machine*, BUSINESS INSIDER (Dec. 10, 2013, 1:29 PM), <http://www.businessinsider.com/john-keelys-perpetual-motion-machine-2013-12> (chronicling how the purported inventor John Keely raised over \$5 million for research & development of a “etheric generator” perpetual motion machine, without ever delivering a finished product, or even a prototype, to investors before his death in 1898).

²²⁹ See *Promise Unfulfilled*, *supra* note 9, at 219-20. (“[...] the idea that ‘even if most of the people within a group are not especially well-informed or rational ... [the group] can still reach a collectively wise decision.’”).

²³⁰ See *Mollick*, *supra* note 10 at 7; see also Little Monster Productions, *Mythic: The Story of Gods and Men*, KICKSTARTER (last visited Jan. 12, 2014, 2:48 PM), <http://www.kickstarter.com/projects/273246798/mythic-the-story-of-gods-and-men/comments> (exemplifying how an active crowd can expose a fraudulent issuer).

²³¹ See *Promise Unfulfilled*, *supra* note 9, at 219-20.

the crowd, the heavy lifting in making investment decisions—filtering out the best projects and limiting fraud—will be spread among the crowd, rather than subject to the diligence of each individual.²³²

Though the locus of crowdfunding regulation is on the general lack of sophistication of crowdfunding investors, the fact is that ‘sophisticated’ investors don’t necessarily enjoy superior returns on their investments.²³³ Since the beginning of 1994, the performance of major hedge funds is nearly identical to the annual returns on the S&P 500.²³⁴ Ultimately the purpose of regulation is to ensure investors are sufficiently informed, not to ensure a successful investment.²³⁵ Extensive disclosure is especially unnecessary in crowdfunding given that it is almost entirely speculative information at the start-up stage, thus easy to distort.²³⁶ For crowd-funded projects, the pertinent information is accessible on the Internet and the crowd is unlikely to successfully fund a project if sufficient information to make an informed investment is not available.²³⁷ Therefore, it is unnecessary to unduly burden issuers with extensive disclosure when the crowd can freely disseminate information.

Conclusion

Crowdfunding carries the potential to unleash a vast store of previously inaccessible capital into the US economy, enabling a new wave of entrepreneurs to achieve the American Dream. The only way this market will realize its full potential is if the SEC implements an

²³² Waters, *supra* note 121.

²³³ Walter Kurtz, *The 20-Year Performance of Hedge Funds And The S&P 500 Are Almost Identical*, BUSINESS INSIDER (Aug. 12, 2013 @ 8:43 A.M.), <http://www.businessinsider.com/hedge-funds-and-sp-500-nearly-identical-2013-8>.

²³⁴ *See id.* (asserting that both the CS Hedge Fund Index and S&P 500 have returned 8.6% annually over the last twenty years).

²³⁵ *See infra* note 180.

²³⁶ *See* Guinto, *infra* note 194.

²³⁷ *See infra* note 196.

innovative regulatory framework befitting a novel market. The proposed rules, as they currently stand, advance a market that has little chance to succeed. In order to create a viable market, the final regulations should relax disclosure requirements, while simultaneously empowering portals to pre-screen offerings and the crowd to disseminate pertinent information. As it is operating in uncharted territory, the Commission would do well to adopt a trial-and-error approach to regulation. If the Commission can strike the proper balance of protecting investors without imposing prohibitive costs on issuers, then investors will allocate capital to the most promising projects, achieving an optimal market.