CROWDFUNDING AND THE FEDERAL SECURITIES LAWS

Draft

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Crowdfunding—the use of the Internet to raise money through small contributions from a large number of investors—could cause a revolution in small-business financing. Through crowdfunding, smaller entrepreneurs, who traditionally have had great difficulty obtaining capital, have access to anyone in the world with a computer, Internet access, and spare cash to invest. Crowdfunding sites such as Kiva, Kickstarter, and IndieGoGo have proliferated and the amount of money raised through crowdfunding has grown to billions of dollars in just a few years.

Crowdfunding poses two issues under federal securities law. First, some, but not all, crowdfunding involves selling securities, triggering the registration requirements of the Securities Act of 1933. Registration is prohibitively expensive for the small offerings that crowdfunding facilitates and none of the current exemptions from registration fit the crowdfunding model. Second, the web sites that facilitate crowdfunding may be treated as brokers or investment advisers under the ambiguous standards applied by the SEC.

I consider the costs and benefits of crowdfunding and propose an exemption that would free crowdfunding from the registration requirements, but not the antifraud provisions, of federal securities law. Securities offerings for an amount less than $250,000-500,000 would be exempted if (1) each investor invests no more than the greater of $500 or two percent of the investor's annual income and (2) the offering is made on an Internet crowdfunding site that meets the exemption's requirements.

To qualify for the exemption, crowdfunding sites would have to (1) be open to the general public; (2) provide public communication portals for investors and potential investors; (3) require investors to fulfill a simple education requirement before investing; (4) prohibit certain conflicts of interest; (5) not offer investment advice or recommendations; and (6) notify the SEC that they are hosting crowdfunding offerings. Sites that meet these requirements would not be treated as brokers or investment advisers.

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I. Introduction

Small businesses, especially startups, have a difficult time raising money. The usual sources of business finance—bank lending, venture capital, retained earnings—are not

available to small and micro-businesses. Wealthy individuals known as angel investors fill part of the funding gap, but angel investing is limited and even angel investors tend to focus on larger investments. Entrepreneurs who lack the personal resources needed to finance their businesses turn to friends, family members, and personal acquaintances, but those sources are often insufficient. As a result, many potentially successful small businesses do not get funded.

Crowdfunding, sometimes called peer-to-peer lending when it involves debt financing, is a possible solution to the small business funding problem. Crowdfunding, is, as its name indicates, funding from the crowd—raising small amounts of money from a large number of investors. Unlike typical business financing, which comes primarily from wealthy individuals and institutional investors, crowdfunding comes from the general public. In the past, the transaction costs associated with raising small amounts from a large number of investors would have made crowdfunding unworkable, but the Internet has significantly reduced those transaction costs. Crowdfunding web sites, such as Kickstarter, Lending Club, Prosper, ProFounder, IndieGoGo, and, the paragon of crowdfunding,[2] Kiva, have proliferated. Through these sites, entrepreneurs have access to anyone in the world with a computer, Internet access, and free cash. Billions of dollars have been raised through Internet-based crowdfunding since its inception just a few years ago, possibly the beginning of a revolution in how we allocate capital.[3]

The power of crowdfunding is illustrated by a recent campaign by two ad executives, Michael Migliozzi II and Brian William Flatow, to raise $300 million to buy Pabst Brewing.[4] They promised investors "certificates of ownership" and beer with a value equal to the amount invested.[5] According to their lawyer, the two were only conducting an online experiment and never actually intended to buy Pabst,[6] but they reportedly received $200 million in pledges in the six-month period before the SEC shut them down.[7]

Unfortunately, crowdfunding does not mesh well with federal securities regulation. Entrepreneurs seeking debt or equity financing through crowdfunding will often be selling securities, and offerings of securities must be registered under the Securities Act unless an exemption is available. Registration of crowdfunding offerings would be prohibitively expensive. A couple of peer-to-peer lending sites have registered their offerings, but, to do so, they had to substantially restructure how crowdfunding works, and that restructuring is unlikely to work for most crowdfunding, particularly equity

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[2] Jeff Howe, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF BUSINESS 247 (2008).

[3] *See* Kevin Lawton & Dan Marom, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 3 (2010) ("in the same way that social networking changed how we allocate our time, crowdfunding will change how we allocate capital").

[4] Chad Bray, *Huge Beer Run Halted by Those No Fun D.C. Regulators*, WALL STREET JOURNAL LAW BLOG (June 8, 2011), http://blogs.wsj.com/law/2011/06/08/huge-beer-run-halted-by-those-no-fun-d-c-regulators/?mod=WSJBlog; In the Matter of Michael Migliozzi II and Brian William Flatow, Securities Act Release No. 9216 (June 8, 2011), *available at* http://www.sec.gov/litigation/admin/2011/33-9216.pdf.

[5] In the Matter of Michael Migliozzi II, *supra* note 4,at 2.

[6] Bray, *supra* note 4.

[7] In the Matter of Michael Migliozzi II, *supra* note 4, at 3.

offerings. The current exemptions from the registration requirement also do not fit crowdfunding well. Crowdfunding sites trying to fit within these exemptions have had to restrict access either to sophisticated, wealthy investors or to preexisting acquaintances of the entrepreneur seeking funds. These restrictions eliminate the power of crowdfunding, access to the public crowd of small investors. Securities-based crowdfunding is practicable only if a new exemption is created.

Several proposals have been made to exempt crowdfunding and certain other small business securities offerings from the registration requirements of the Securities Act. All of these proposals would cap both the dollar amount of a crowdfunded offering and the amount each individual investor could invest. But the Securities Act's registration requirement is not the only potential obstacle to crowdfunding. The web sites that facilitate crowdfunding face their own regulatory issues. If crowdfunding entrepreneurs offer securities on these sites, the sites could be acting as unregistered brokers or investment advisers under opaque SEC standards. Any proposal designed to facilitate crowdfunding must deal with these issues as well.

The White House recently endorsed a crowdfunding exemption for offerings of $1 million or less, with individual investments limited to $10,000 or ten percent of an investor's annual income.[8] The Dodd-Frank Act had already ordered the General Accounting Office to study peer-to-peer lending[9] and the SEC had promised to consider crowdfunding as part of a general review of regulatory constraints on capital formation. But the White House action exponentially increases the likelihood of a crowdfunding exemption. According to one source, crowdfunding sites are "gearing up for a boom" if the SEC eases its rules.[10] Even before the White House release, the CEO of one crowdfunding site, ProFounder, indicated in May 2011 that she was "working with a legal team to lay the groundwork for online equity sales."[11]

The devil is in the details and, unfortunately, most of the proposals, including the White House proposal, are short of detail. Crafting a crowdfunding exemption requires a careful balancing of investor protection and capital formation. If, as it usually does, the SEC leans strongly toward investor protection, the resulting exemption is likely to be too costly for many small businesses. If, on the other hand, a crowdfunding exemption ignores investor protection concerns entirely, the resulting losses may create a regulatory and public relations backlash that will set back crowdfunding for years.

I argue for an exemption that would free both crowdfunded offerings and the web sites on which they are made from the regulatory requirements, but not the antifraud provisions, of federal securities law. Under the exemption, the total dollar amount of an

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[8] *See* Office of the Press Secretary, White House, FACT SHEET AND OVERVIEW (Sept. 8, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview.

[9] Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376 § 989F(a)(1) (July 21, 2010).

[10] Angus Loten, *Crowd-Fund Sites Eye Boom*, WALL STREET JOURNAL ON-LINE (May 12, 2011), http://online.wsj.com/article/SB10001424052748703806304576245360782219274.html?mod=ITP_marketplace_4. The CEO of IndieGoGo, a crowdfunding site, indicated that a regulatory change would "significantly boost activity" on her site. *Id.*

[11] *Id.*

entrepreneur's offerings would be limited to $250,000-$500,000 a year, with individual investments limited to the greater of $500 or two percent of the investor's annual income. The offerings would have to be made on publicly accessible crowdfunding web sites that, among other things, meet conflict-of-interest standards and do not provide investment advice.

Section II of the article is an introduction to the crowdfunding phenomenon. I define crowdfunding and briefly explore its precursors, crowdsourcing and micro-finance. I also distinguish among five different models of crowdfunding: the donation model; the reward model; the pre-purchase model; the lending model, sometimes called peer-to-peer lending; and the equity model. The difference among the five models relates to what, if anything, contributors are promised in return for their contributions.

In Section III, I discuss whether crowdfunding investments are securities subject to the Securities Act registration requirements. I conclude that the answer depends on the particular form of crowdfunding. Crowdfunding contributions on donation, reward, and pre-purchase sites are not securities. Crowdfunding investments on equity sites would be securities in the usual case where investors are promised some investment return other than the return of their capital. The answer with respect to lending sites is a little less certain. If investors are promised interest on their loans, those investments are probably securities. If no interest is offered, lending sites would not be offering securities.

In Section IV, I discuss the regulatory issues posed by crowdfunding sites. Even if crowdfunded offerings are exempted from registration, the web sites that facilitate crowdfunding could still be in violation of federal securities laws. They might be acting as unregistered brokers, investment advisers, or, less likely, exchanges.

Section V discusses the various proposals to exempt crowdfunding from federal securities law. I also briefly examine the SEC's authority to exempt crowdfunding and conclude that crowdfunding exemptions such as those proposed would fall within that authority.

In Section VI, I address the benefits and costs of crowdfunding. Crowdfunding would help ease the capital gap faced by start-ups and very small businesses. It would extend the geographical reach of small-business fundraising and make capital available to poorer entrepreneurs whose family, friends, and acquaintances have insufficient funds. But these gains come at a potential cost. Crowdfunding exposes relatively unsophisticated investors to the greater risks associated with small business offerings—illiquidity, increased risks of fraud and business failure, and the risk of entrepreneurial self-dealing. Properly structured, crowdfunding reduces, but does not eliminate those risks. However, investors are already exposed to those same risks in the existing, *non-securities* models of crowdfunding. A crowdfunding securities exemption would increase those investors' potential gains without increasing the risk.

Section VII considers what a crowdfunding exemption should look like.

II. An Introduction to Crowdfunding

A. What Is Crowdfunding?

The basic idea of crowdfunding is to raise money through relatively small contributions from a large number of people.[12] Using the Internet, an entrepreneur can "in real time and with no incremental cost . . . [sell] . . . to literally millions of potential investors."[13] No intermediary, such as a bank or an underwriter, is needed.[14] Anyone who can convince the public he has a good business idea can become an entrepreneur, and anyone with a few dollars to spend can become an investor.

The aspiring entrepreneur publishes a request for funding on a crowdfunding web site. The request describes what the entrepreneur intends to do with the money—the proposed product and a business plan. It also indicates what, if anything, people who contribute money to finance the business will receive in return for their contributions. Investors browse through entrepreneurs' listings and, if they find one (or more) that interests them, they can contribute anything from a few dollars to the total amount the entrepreneur is seeking. The web site on which the funding request is published typically facilitates the exchange of funds—the initial contributions from the investors to the entrepreneurs and, if investors are to receive money back, the payments from the entrepreneur back to the investors.

Crowdfunding offerings are typically rather small. One study found that the median amount raised was only $28,583.[15] But crowdfunding is not necessarily limited to very small offerings. The largest amount raised in that same study was $82.1 million.[16] And, in the aggregate, crowdfunding is huge. As of late July 2011, over 600,000 different Kiva lenders had loaned over $225 million dollars to almost 600,000 entrepreneurs.[17] Peer-to-peer lending, just one form of crowdfunding, has alone been responsible for over a billion dollars in funding, and some industry analysts believe peer-to-peer lending could exceed $5 billion annually by 2013.[18]

The basic concept of crowdfunding is not new. Politicians have been collecting small campaign donations from the general public for generations; that, in essence, is

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[12] *See* Paul Belleflamme, Thomas Lambert, and Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 2 (Jan. 24, 2011), *available at*: http://ssrn.com/abstract=1836873.

[13] Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1, 6 (2007). Crowdfunding can be used for non-business purposes, but this article focuses only on crowdfunding as a way for businesses to raise money.

[14] *See* Andrew Verstein, *The Misregulation of Peer-to-Peer Lending*, 5, (May 3, 2011), 45 UC Davis L. Rev. (forthcoming 2011), *available at* http://ssrn.com/abstract=1823763

[15] Belleflamme, et al., *supra* note 12, at Table 2, 32, 33. The mean was $3.5 million. *Id.*, at Table 2, 32-33.

[16] *Id.*, at Table 2, 32. *See also* Armin Schwienbacher & Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures* 3 (Dec. 28, 2010), HANDBOOK OF ENTREPRENEURIAL FINANCE (forthcoming from Oxford University Press), *available at*: http://ssrn.com/abstract=1699183 (discussing plans of Trampoline Systems, a British software company to raise £1 million in four tranches).

[17] *See Statistics*, KIVA, http://www.kiva.org/about/stats (last visited July 22, 2011).

[18] Verstein, *supra* note 14, at 2.

crowdfunding.[19] But Internet-based crowdfunding is relatively new. Kiva, the leading crowdfunding site today, did not open for business until 2005,[20] and the term "crowdfunding" did not appear until 2006.[21] In the brief time since Internet-based crowdfunding appeared, it has grown exponentially. It "is becoming a big business, with a steady parade of services joining the fray."[22] One crowdfunding site, Kiva, is so popular that it sometimes exhausts its available lending opportunities, resulting in "check back later" signs on its web site.[23]

Crowdfunding has been especially popular in the entertainment industry,[24] but there are crowdfunding sites for all types of projects. Some crowdfunding sites are limited to specific businesses or types of projects, such as book publishing,[25] gaming,[26] music,[27] journalism,[28] or agriculture and ranching.[29] Crowdfunding is even being used to fund scientists' research projects.[30] Other sites limit themselves to broader categories, such as "creative projects"[31] or "sustainable or Fair Trade" projects.[32] Others are directed at

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[19] Crowdfunding has "been the backbone of the American political system since politicians started kissing babies." Howe, *supra* note 2, at 253.

[20] *See History*, KIVA, http://www.kiva.org/about/history (last visited Aug. 23, 2011).

[21] Lawton & Marom, *supra* note 3, at 66.

[22] Brian Oliver Bennett, *Crowdfunding 101: How Rising Startups Use the Web as a VC Firm*, LAPTOP: THE PULSE OF MOBILE TECH (July 9, 2011), http://blog.laptopmag.com/crowdfunding-101-how-rising-startups-use-the-web-as-a-vc-firm.

[23] Howe, *supra* note 2, at 248; Jilian Mincer, *Microlending for Microbankers*, WALL STREET JOURNAL (March 20, 2008), http://online.wsj.com/article/SB120597508026550479.html?mod=googlenews_wsj.

[24] *See* Belleflamme, et al, *supra* note 12, at 2-3; Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOYOLA L.A. ENTERTAINMENT L. REV. 375, 375-76 (2009) (Crowdfunding "has been increasingly used in the entertainment industry by independent filmmakers, artists, writers, and performers"). Not surprisingly, politicians have adapted their crowdfunding to the Internet as well. Barak Obama used the Internet in his 2008 presidential campaign to raise over $750 million from just under four million donors. Tahman Bradley, *Final Fundraising Figure: Obama's $750M*, ABC NEWS (Dec. 5, 2008), http://abcnews.go.com/Politics/Vote2008/Story?id=6397572&page=1.

[25] *See* UNBOUND: BOOKS ARE NOW IN YOUR HANDS, http://www.unbound.co.uk/ (last visited Aug. 23, 2011). *See also* Keith Wagstaff, *Is Crowdfunding the Future of Book Publishing?*, THE UTOPIANIST (June 22, 2001), http://utopianist.com/2011/06/is-crowdfunding-the-future-of-book-publishing/ (discussing how crowdfunding works in book publishing).

[26] *See* 8-BIT FUNDING: BECAUSE EVERY DEVELOPER NEEDS A 1UP, http://www.8bitfunding.com/index.php (last visited Aug. 23, 2011). *See also The Power of Crowd Funding*, EDGE (June 20, 2011), http://www.next-gen.biz/features/power-crowdfunding (discussing how crowdfunding works in the video game industry).

[27] *See* MY MAJOR COMPANY, http://www.mymajorcompany.co.uk/ (last visited July 10, 2011); SELLABAND: WHERE FANS INVEST IN MUSIC, https://www.sellaband.com/ (last visited July 10, 2011). Crowdfunding works in the music industry "because most of the market is controlled by a handful of risk-averse major labels and there's a huge underground that wants to break in." John Tozzi, *Scoring Money from an Online Crowd*, BLOOMBERG BUSINESSWEEK (Sept. 10, 2007), http://www.businessweek.com/smallbiz/content/sep2007/sb20070910_540342.htm (quoting Pim Tetist, one of the founders of SellaBand).

[28] *See* SPOT.US: COMMUNITY-FUNDED REPORTING, http://spot.us/ (last visited July 10, 2011).

[29] *See* HEIFER INTERNATIONAL, http://www.heifer.org/ (last visited July 10, 2011).

[30] *See* Thomas Lin, *Scientists Turn to Crowds on the Web to Finance Their Projects*, NEW YORK TIMES (July 11, 2011), http://www.nytimes.com/2011/07/12/science/12crowd.html?_r=2&ref=science&pagewanted=all.

[31] *See Intro to RocketHub*, ROCKETHUB, http://rockethub.com/learnmore/intro (last visited July 12, 2011) ("creative products and endeavors"); *Frequently Asked Questions: Kickstarter Basics*, KICKSTARTER,

particular types of entrepreneurs, such as female-owned businesses[33] or the poor.[34] But many crowdfunding sites are open to entrepreneurial projects generally.[35]

Crowdfunding is not just a U.S. innovation. There are crowdfunding sites serving, among other locations, Great Britain,[36] Hong Kong,[37] Brazil,[38] Germany,[39] the Netherlands,[40] and sub-Saharan Africa.[41] Some of those sites claim to be global, open to investors and entrepreneurs everywhere.[42] Not surprisingly, given the international reach of the Internet, some of those foreign sites sell to U.S. investors,[43] and some of the investments they sell would almost certainly be securities under U.S. law. That raises a host of jurisdictional issues under U.S. securities law,[44] but I leave those issues to another article. In this article, I focus on the issues posed by domestic crowdfunding sites—web sites operated by U.S. companies that bring together U.S. entrepreneurs and U.S. investors.

B. Types of Crowdfunding

One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model;

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http://www.kickstarter.com/help/faq/kickstarter%20basics (last visited July 12, 2011) ("Kickstarter is focused on creative projects. We're a great way for artists, filmmakers, musicians, designers, writers, illustrators, explorers, curators, performers, and others to bring their projects, events, and dreams to life.")

[32] *See* THE HOOP FUND, http://www.hoopfund.com/learn.webui (last visited July 10, 2011).

[33] *See* INUKA, http://inuka.org/ (last visited July 10, 2011).

[34] *See What We Do*, MICROPLACE, https://www.microplace.com/howitworks/what_we_do (last visited July 10, 2011); *About Us*, KIVA, http://www.kiva.org/about (last visited July 10, 2011).

[35] *See, e.g.*, PROFOUNDER, www.profounder.com (last visited July 10, 2011); GROW VENTURE COMMUNITY, http://www.growvc.com/main/ (last visited July 10, 2011); Peerbackers: Crowdfunding Big Ideas, http://www.peerbackers.com/ (last visited July 10, 2011); INDIEGOGO: THE WORLD'S LEADING INTERNATIONAL FUNDING PLATFORM, http://www.indiegogo.com/ (last visited July 10, 2011); MICROVENTURES, http://www.microventures.com/ (last visited July 10, 2011).

[36] *See* My Major Company, *supra* note 32; *Company Information*, UNBOUND, http://www.unbound.co.uk/company (last visited Aug. 23, 2011). *See generally* Catherine Burns, *Small Firms Seek Crowd Funding*, BBC (May 26, 2011), http://www.bbc.co.uk/news/business-13569912.

[37] *See About*, GROW VC, http://www.growvc.com/main/about/ (last visited Aug. 23, 2011).

[38] *See Brazil: Crowdfunding Potential*, GLOBAL VOICES: ENGLISH (May 24, 2011), http://globalvoicesonline.org/2011/05/24/brazil-crowdfunding-potential/.

[39] *See generally* Karsten Wenzlaff, *Crowdfunding is on the Rise in Germany*, CROWDSOURCING.ORG (Jun. 27, 2011), http://www.crowdsourcing.org/editorial/crowdfunding-is-on-the-rise-in-germany/4962.

[40] *See* SYMBID, http://www.symbid.com/ (last visited Aug. 23, 2011); *About Us*, SELLABAND, https://www.sellaband.com/en/pages/about_us (last visited Aug. 23, 2011).

[41] *See* Introducing INUKA, http://inuka.org/ (last visited Aug. 23, 2011).

[42] *See, e.g.*, *About*, GROW VC, *supra* note 43 ("Grow Venture Community (Grow VC) is the first global, transparent, community-based platform dedicated to entrepreneurs and their needs. . . . We are located all over the world and growing constantly. We wish to establish a presence in all the most entrepreneurial countries on the planet."); *About Kiva*, KIVA, http://www.kiva.org/about (last visited Aug. 23, 2011) ("Kiva is creating a global community of people connected through lending.").

[43] For instance, an in-depth study of Sellaband, an Amsterdam-based crowdfunding site, found that its investors were concentrated in Europe and the eastern United States. Ajay Agrawal, Christian Catalini, & Avid Goldfarb, *The Geography of Crowdfunding* 8 (Jan. 6, 2011), *available at* http://ssrn.com/abstract=1692661.

[44] *See generally* THOMAS LEE HAZEN, 6 TREATISE ON THE LAW OF SECURITIES REGULATION 403-421 (6TH ED. 2009). The answers to these questions are complicated by the Supreme Court's recent opinion in Morrison v. National Australian Bank Ltd., --- U.S. ---, 130 S. Ct. 2869 (2010).

(3) the pre-purchase model; (4) the lending model; and (5) the equity model. Some crowdfunding sites encompass more than one model; it is especially common to see the reward and pre-purchase models on a single web site. Other sites rely on only a single model.

1. Donation Sites

The contributions on donation sites are, as the name would indicate, donations. Investors receive nothing in return for their contribution, not even the eventual return of the amount they contributed. However, although the contributor's motive is charitable, the recipient's need not be. Donations can fund for-profit enterprises.

Pure donation sites are rare, and those that exist focus on request by charities and other non-profit institutions, rather than businesses.[45] Some of the reward and pre-purchase sites also allow unrewarded requests for donations,[46] but one study found that only 22% of all crowdfunding initiatives were requests for donations, with no rewards offered.[47]

GlobalGiving is an example of a pure donation site.[48] It allows donors to direct contributions to development projects around the world.[49] The GlobalGiving Foundation, which operates the site, takes a 15% fee,[50] and guarantees that the remainder of the donation will reach the project within 60 days.[51] However, GlobalGiving, like other pure donation sites, is limited to non-profit organizations.[52] None of the leading crowdfunding sites available to business entrepreneurs uses the pure-donation model.

2. Reward and Pre-Purchase Sites

The reward and pre-purchase crowdfunding models are similar to each other, and often appear together on the same sites. The reward model offers something to the investor in return for the contribution, but not interest or a part of the earnings of the business. The reward could be small, such as a key chain, or it could be something with a little more cachet, such as the investor's name on the credits of a movie.[53]

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[45] *See, e.g.*, GLOBALGIVING, http://www.globalgiving.org/ (last visited Aug. 23, 2011); DONORSCHOOSE.ORG, http://www.donorschoose.org (last visited Aug. 23, 2011).

[46] IndieGoGo, for example, recommends, but does not require that fundraisers offer what it calls "perks." *See Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) [click on the "Creating a Campaign" tab].

[47] Belleflamme, et al., *supra* note 12, at 9.

[48] GlobalGiving, *supra* note 45. Another example is DonorsChoose.org, which allows donors to donate to specific classroom projects in public schools. *See* DonorsChoose.org, *supra* note 45.

[49] About GlobalGiving, *supra* note 45.

[50] About GlobalGiving *supra* note 45.

[51] *How Global Giving Works*, GLOBALGIVING, http://www.globalgiving.org/howitworks.html (last visited Aug. 23, 2011).

[52] *See GlobalGiving is Always Looking for More Incredible Grassroots Projects*, GLOBALGIVING, http://www.globalgiving.org/non-profits/join-globalgiving/ (last visited Aug. 23, 2011).

[53] *See, e.g.*, Kappel, *supra* note 24, at 376 (2009) (patrons receive perks "such as the use of their name in the film credits or album liner notes, advanced autographed copies of the work, or backstage access at a performer's show.")

The pre-purchase model, the most common type of crowdfunding,[54] is similar. As with the reward model, contributors do not receive a financial return—interest, dividends, or part of the earnings of a business. Instead, they receive the product that the entrepreneur is making. For example, if the entrepreneur is producing a music album, contributors would receive the album, or the right to buy the album at a reduced price, upon completion.

Kickstarter[55] and IndieGoGo[56] are the leading reward/pre-purchase crowdfunding sites.[57] The two sites are similar. Kickstarter requires its projects to offer what it calls "rewards,"[58] and, according to Kickstarter, rewards are typically of the pre-purchase variety: "Rewards are typically items produced by the project itself — a copy of the CD, a print from the show, a limited edition of the comic."[59] Typically, the "donation" required to receive the product is below the planned retail price. For example, Dan Provost and Tom Gerhardt, who designed a tripod mount for the iPhone, offered one of the mounts to anyone who donated $20.[60] They planned to sell the mount for a retail price of $34.95.[61] But Kickstarter's rewards are not limited to pre-purchases. Other rewards it suggests include "a visit to the set, naming a character after a backer, [or] a personal phone call."[62] The creators of the iPhone tripod mount, for example, offered to dine with anyone who contributed $250.[63]

IndieGoGo, unlike Kickstarter, does not require campaigns to offer what it calls "perks," but it does recommend them.[64] Many of the perks offered on the IndieGoGo site follow

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[54] Belleflamme, et al, *supra* note 12, at Table 3, 34-35 (66.7% of crowdfunding offerings not involving pure donations offered the right to receive a product).

[55] *Kickstarter: A New Way to Fund & Follow Creativity*, KICKSTARTER, http://www.kickstarter.com/ (last visited Aug. 23, 2011).

[56] *IndieGoGo: The World's Leading International Funding Platform*, INDIEGOGO, http://www.indiegogo.com/ (last visited Aug. 23, 2011).

[57] There are a number of other rewards/pre-purchase sites. *See, e.g.*, PEERBACKERS, *supra* note 40; ROCKETHUB, http://www.rockethub.com/ (last visited Aug. 23, 2011); 8-BIT FUNDING, *supra* note 31.

[58] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project.

[59] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project [under the heading "Rewards'].

[60] Farhad Manjoo, *Adopt a Genius: Kickstarter, the Brilliant Site that Lets You Fund Strangers' Brilliant Ideas*, SLATE (Jan. 27, 2011), http://www.slate.com/id/2282436.

[61] *See, e.g.*, TikTok+LunaTik Multi-Touch Watch Kits, Kickstarter, http://www.kickstarter.com/projects/1104350651/tiktok-lunatik-multi-touch-watch-kits (For a $25 pledge, donors would receive a watch kit that will sell for $34.95; for a $50 pledge, donors would receive a watch kit that would sell for $69.95).

[62] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project (last visited Aug. 23, 2011) [under the heading "Rewards'].

[63] Manjoo, *supra* note 60.

[64] *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) [click on the "Creating a Campaign" tab].

the pre-purchase model, but some go well beyond that. Here, for example, are some of the perks Josh Freese, the Nine Inch Nails drummer, offered to help fund an album: [65]

Contribution Amount	Perk
$7	Digital download of the album and videos
$15	CD/DVD set and digital download
$50	CD/DVD set T-shirt A "Thank you" phone call from Josh
$75,000	Signed CD/DVD Digital download T-shirt Tour with Josh for a few days Have Josh write, record and release a 5-song EP about you and your life story One of Josh's drum sets "Take shrooms and cruise Hollywood in Danny from Tool's Lamborghini OR play quarters and then hop on the Ouija board for a while" "Josh will join your band for a month … play shows, record, party with groupies, etc. If you don't have a band he'll be your personal assistant for a month (4-day work weeks, 10 am to 4 pm)." "Take a limo down to Tijuana and he'll show you how it's done (what that means exactly we can't legally get into here)" "If you don't live in Southern California (but are a U.S. resident) he'll come to you and be your personal assistant/cabana boy for 2 weeks" "Take a flying trapeze lesson with Josh and Robin from NIN, go back to Robin's place afterwards and his wife will make you raw lasagna"

[65] *See, e.g., Want Ideas for VIP Perks? Listen to Nine Inch Nail's Former Drummer*, GOGO BLOG, INDIEGOGO, http://www.indiegogo.com/blog/2009/02/want-ideas-for-vip-perks-listen-to-nine-inch-nails-former-drummer.html (last visited Aug. 23, 2011). One hopes that at least a couple of the listed perks are intended as jokes.

Both Kickstarter and IndieGoGo take a cut of the money collected. Kickstarter uses an "all-or-nothing" funding model and does not allow projects to be funded unless they reach their stated funding goal.[66] If a project reaches its funding goal, Kickstarter collects a 5% fee;[67] if not, Kickstarter does not charge a fee.[68] IndieGoGo allows project creators to draw on pledged funds immediately, whether or not the funding goal is reached,[69] but the fee depends on whether the funding goal is met. IndieGoGo charges a 4% fee if the funding goal is reached[70] and a 9% fee if it is not.[71]

3. Lending Sites (Peer-to-Peer Lending)

The lending model of crowdfunding is often called peer-to-peer lending. Peer-to-peer lending involves, as the name indicates, a loan. Contributors are only providing the funds temporarily and repayment is expected. In some cases, investors are promised interest on the funds they loan. In other cases, they receive only their principal back.

a. Sites Not Offering Interest

Kiva is, without a doubt, the leading crowdfunding site using the lending model,[72] and probably the leading crowdfunding site of any type. One source calls Kiva "the hottest nonprofit on the planet."[73]

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[66] *Frequently Asked Questions: The Basics*, KICKSTARTER, , http://www.kickstarter.com/help/faq/kickstarter%20basics (last visited Aug. 23, 2011) [Click on "All-or-nothing funding?"].

[67] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project (last updated) [Click on "What fees does Kickstarter charge?"].

[68] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project (last visited Aug. 23, 2011) [Click on "What fees does Kickstarter charge?"].

[69] *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) [click on the "Creating a Campaign" tab] ("If you don't meet your funding goal, you still keep the money you raise with your campaign"; "contributions are disbursed immediately to the campaign as the funds are raised.")

[70] *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) [click on the "General FAQs" tab].

[71] *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) [click on the "Creating a Campaign" tab].

[72] *See* http://www.kiva.org/. Another example of a lending site that does not charge interest is Inuka, which is limited to requests from female entrepreneurs. *See* Introducing INUKA, Inuka.org, http://inuka.org/ (last visited Aug. 23, 2011).

[73] Jeffrey M. O'Brien, *The Only Nonprofit That Matters*, CNNMONEY (Feb. 26, 2008), http://money.cnn.com/magazines/fortune/fortune_archive/2008/03/03/103796533/index.htm?postversion=2008022611. Kiva was originally not open to entrepreneurs in the United States, but it changed that policy in 2009. *See* Tamara Schweitzer, Microloans for All?, INC. (June 10, 2009), http://www.inc.com/the-kiva-connection/2009/06/microloans_for_all.html; Michael Liedtke, Kiva to Feed Cash-Starved US Small Businesses, USA TODAY (June 10, 2009), http://www.usatoday.com/tech/hotsites/2009-06-10-kiva_N.htm.

Kiva does not lend directly to entrepreneurs, but instead partners with microfinance lenders around the world, which Kiva calls "field partners."[74] The local institutions make loans to entrepreneurs, often before the loan request is even posted on Kiva.[75] Each entrepreneur's loan request is posted on the Kiva web site, where potential lenders can browse the requests and fund each one in any amount from $25 to the full amount of the loan.[76] Kiva collects and distributes this money back to the field partners, and credits lenders with any repayments the entrepreneurs make.[77] Lenders on the Kiva site only get their principal back; the field partners use any interest received to cover their operating costs.[78]

b. Sites Offering Interest

Prosper and Lending Club are the two leading peer-to-peer lending sites that offer interest.[79] Not all of the loans on these sites are for business purposes. Most of the loans are for personal expenses,[80] but the amount of the small business lending on these sites is increasing.[81]

Prosper and Lending Club operate similar, but not identical, platforms.[82] Borrowers submit requests for loans in amounts from $1,000 to $25,000.[83] Potential lenders review

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[74] *How Kiva Works*, KIVA, http://www.kiva.org/about/how (last visited Aug. 23, 2011).

[75] *Id. See also* Stephanie Strom, *Confusion On Where Money Lent Via Kiva Goes*, NEW YORK TIMES (Nov. 8, 2009), http://www.nytimes.com/2009/11/09/business/global/09kiva.html (noting that "[t]he person-to-person donor-to-borrower connections created by Kiva are partly fictional" and that "most Kiva users do not realize this.")

[76] *How Kiva Works*, *supra* note 74.

[77] *How Kiva Works*, *supra* note 74.

[78] *How Kiva Works*, *supra* note 74.

[79] PROSPER, http://www.prosper.com/ (last visited Aug. 23, 2011); LENDING CLUB, http://www.lendingclub.com/home.action (last visited Aug. 23, 2011). *See also* Verstein, *supra* note 14Verstein, *supra* note 14, at 5 (Prosper and Lending Club "dominate . . . [peer-to-peer lending] . . . in American.") Other lending sites that offer interest are Microplace, http://www.microplace.com, and the Calvert Foundation, http://www.calvertfoundation.org/.

[80] *See* Angus Loten, *Peer-to-Peer Loans Grow: Fed Up With Banks, Entrepreneurs Turn to Internet Sites*, WALL STREET JOURNAL (June 17, 2011), http://online.wsj.com/article/SB10001424052748703421204576331141779953526.html?mod=ITP_marketplace_3; Jonnelle Marte, *Credit Crunch Gives 'Microlending' a Boost*, WALL STREET JOURNAL(Sept. 26, 2010), http://online.wsj.com/article/SB10001424052748703905604575514340314712872.html?KEYWORDS=credit+crunch.

[81] Loten, *supra* note 80. As of May 2011, about 7.5% of Lending Club's loans and about 11% of Prosper's loans were for small business. *Id.*

[82] For a more detailed discussion of the operations of Prosper and Lending Club, *see generally* Verstein, *supra* note 14.

[83] *See Form S-1 Registration Statement, Prosper Marketplace, Inc.* 8 (July 13, 2009), *available at* http://www.sec.gov/Archives/edgar/data/1416265/000141626509000017/prosper_s-1a6.htm [hereinafter Prosper Registration Statement]; *Form S-1 Registration Statement, LendingClub* Corporation 8 (Oct. 9, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1409970/000095013408017739/f41480a3sv1za.htm [hereinafter Lending Club Registration Statement].

those requests and decide which to fund.[84] The minimum investment for each loan request is $25.[85] When a loan receives sufficient commitments to close, the borrower executes a three-year unsecured note for the amount of the loan.[86]

The nature of investors' participation in these loans has changed since Prosper and Lending Club first launched. Originally, borrowers on both sites issued notes directly to the crowdfunding lenders, with the site maintaining custody of the notes and servicing them for a one percent fee.[87] Now, however, lenders on the two sites do not make loans directly to the underlying borrowers.[88] Instead, lenders purchase notes issued by Prosper or Lending Club themselves, and the site uses those funds to make loans, through WebBank,[89] to the underlying borrowers.[90] However, although the site is the issuer of the notes lenders purchase, the site is obligated to pay only if the underlying borrower repays the corresponding loan.[91] In effect, the site acts as a pass-through conduit for borrower payments, taking one percent of the payments before passing them along to the lenders.[92] Both Prosper and Lending Club also charge borrowers an origination fee on each loan; the amount of the fee depends on the credit risk.[93]

Prosper and Lending Club set interest rates on the notes (and on the underlying loans) differently. Lending Club evaluates each borrower and sets an interest rate on each loan based on the "loan grade" it assigns to the loan.[94] Prosper also rates each potential loan,[95] but those scores are used only to set a minimum rate for the loans.[96] The actual interest rate is determined by an auction process. Each lender bids the minimum percentage he is

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[84] All of the Lending Club lenders must meet suitability standards based on gross income and/or net worth. Lending Club Registration Statement, *supra* note 83, at 5. Prosper imposes suitability standards only on lenders living in certain states. Prosper Registration Statement, *supra* note 83, at 6.

[85] Prosper Registration Statement, *supra* note 83, at 12; Lending Club Registration Statement, *supra* note 83, at 48.

[86] Prosper Registration Statement, *supra* note 83, at 8; Lending Club Registration Statement, *supra* note 83, at 7. Prosper has said it plans to vary the terms of its loans in the future, with a range between three months and seven years. Prosper Registration Statement, *supra* note 83, at 8.

[87] Prosper Registration Statement, *supra* note 83, at 72; Lending Club Registration Statement, *supra* note 83, at 89.

[88] *See* Prosper Registration Statement, *supra* note 83, at 8; Lending Club Registration Statement, *supra* note 83, at 7. The change resulted directly from the SEC's position that the sites were illegally offering securities without registration. *See* In the Matter of Prosper Marketplace, Inc., Securities Act Release No. 8984 (Nov. 24, 2008).

[89] Prosper Registration Statement, *supra* note 83, at 5; Lending Club Registration Statement, *supra* note 83, at 6.

[90] Prosper Registration Statement, *supra* note 83, at 8; Lending Club Registration Statement, *supra* note 83, at 7.

[91] Prosper Registration Statement, *supra* note 83-, at 8; Lending Club Registration Statement, *supra* note 83, at 4, 7-8. Each loan involves a different series of note. The notes are registered pursuant to a Form S-1 shelf registration and each loan requires a different prospectus supplement. Verstein, *supra* note 14, at 34.

[92] Prosper Registration Statement, *supra* note 83, at 5; Lending Club Registration Statement, *supra* note 83, at 3.

[93] Andrew Verstein, *supra* note 14, at 6.

[94] Lending Club Registration Statement, *supra* note 83, at 37-43.

[95] Prosper Registration Statement, *supra* note 83, at 12, 41-43.

[96] Prosper Registration Statement, *supra* note 83, at 4.

willing to accept,[97] and the interest rate on each loan (and on the notes issued by Prosper) is the minimum percentage acceptable to enough lenders to fund the entire loan.[98]

4. Equity Sites

Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund. The equity model is the one that most clearly involves the sale of a security, and, because of the regulatory issues that raises, the equity crowdfunding model is not common in the United States. Equity crowdfunding is more common elsewhere; one study found that one-third of all the crowdfunding that offered rewards to investors offered stock.[99]

Until recently, the leading equity-model crowdfunding site in the U.S. was ProFounder.[100] However, ProFounder announced in June 2011 that it would no longer be offering securities on its site.[101] It is unclear why they did this; Jessica Jackley, ProFounder's CEO,[102] provided little information.[103] As a result of this change, there are no major, publicly accessible equity crowdfunding sites in the United States, although there are sites facilitating private equity offerings to sophisticated and accredited investors.[104]

When it was operating, ProFounder offered two different types of investment, which it called "public raises" and "private raises."[105] The two types of offerings differed in two ways: (1) the return offered to investors; and (2) the investors allowed to participate. In public raises, the amount paid back to investors was limited to the amount they contributed, without any return on their investment; investors in private raises could receive more than what they invested.[106] Public raises were open to the general public;

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[97] Prosper Registration Statement, *supra* note 83, at 4.

[98] Prosper Registration Statement, *supra* note 83, at 4.

[99] Belleflamme, et al., *supra* note 12, at Table 3, 34, 35. Another 22.2% offered direct cash payments other than dividends on stock. *Id.*

[100] PROFOUNDER, https://www.profounder.com/ (last visited July 11, 2011). See also Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities And Exchange Commission to Approve a Small Offering Exemption*, forthcoming, 13 U. PA. J. BUS. L. 101, 106-109 (discussing a few direct Internet offerings not mediated through crowdfunding sites).

[101] *See Changes to Our Site*, PROFOUNDER, THE BLOG (June 27, 2011), http://blog.profounder.com/2011/06/27/changes-to-our-site/.

[102] *The Team*, PROFOUNDER, http://www.profounder.com/about/team (last visited July 11, 2011).

[103] "We're still very much in start-up mode (just 6 months post-launch) and we are constantly testing and learning. Last week, we just decided to focus on some other high-value, simpler pieces of our product. More to come!" *Why is ProFounder No Longer Offering the Transactions of Securities?*, QUORA (June 27, 2011, 7:18PM), http://www.quora.com/Why-is-ProFounder-no-longer-offering-the-transactions-of-securities.

[104] *See* MICROVENTURES, http://www.microventures.com/investors (last visited Aug. 23, 2011) (shares sold in private offerings); Terms, GrowVC, http://www.growvc.com/main/tour/terms/ (limited to accredited investors).

[105] *See* Matt Ferner, *Financing for Ecommerce: ProFounder.com Can Help Ecommerce Merchants Raise Money*, PRACTICAL COMMERCE: INSIGHTS FOR ONLINE MERCHANTS (Dec. 27, 2010), http://www.practicalecommerce.com/articles/2478-Financing-for-Ecommerce-ProFounder-com-Can-Help-Ecommerce-Merchants-Raise-Money.

[106] *See* Ferner, *supra* note 105.

private raises were limited to friends, family members and existing acquaintances of each entrepreneur, an attempt to fit within the SEC's Rule 504 exemption from registration.[107]

Investors on ProFounder were promised a percentage of the gross revenues of the business—as ProFounder described it, "basically . . . all of the money coming in to your business, before you take anything out for expenses."[108] The exact percentage of revenues to be paid to investors and the period over which investors were to receive those funds was determined by the individual entrepreneur,[109] but the maximum payout period was five years.[110] This share of revenues was the only equity interest investors received. They did not receive stock or any other ownership interest.[111]

Entrepreneurs had to pay to list on ProFounder, but the amount and structure of those payments is a little unclear. According to the ProFounder web site, entrepreneurs had to pay an initial fee of $100 to post a fundraising appeal.[112] But, according to ProFounder's CEO, the initial fee for a private round was $1,000.[113] For a public raise, the entrepreneur had to pay five percent of the amount raised if the fundraising was successful.[114] If a private raise was successful, both the ProFounder web site and one interview of its CEO indicated that the entrepreneur had to pay an additional $1,000.[115] But the CEO indicated in another interview that no additional fee was charged for a private raise—that entrepreneurs paid a flat $1,000 fee, whether or not the offering was successful.[116]

Entrepreneurs had thirty days to raise the funds needed.[117] If entrepreneurs failed to reach their goal, they received none of the pledged funds.[118] Investors did not sign a term sheet or make any payments until the goal was met.

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[107] *See* Section III.B.2.c., *infra*.

[108] David Lang, *Entrepreneurs--Read This First!*, PROFOUNDER (Nov. 4, 2010 12:20), http://support.profounder.com/entries/321128-common-questions-read-this-first (last visited Jan. 27, 2011). ProFounder did not explain why investors shared gross revenues rather than profits, but this was probably an attempt to avoid creating a partnership between the entrepreneur and the investors. Under the Uniform Partnership Act, profit-sharing is presumptive evidence of the existence of a partnership, UNIFORM PARTNERSHIP ACT (1997) § 202(c)(3). Sharing gross returns is not. *Id.*, § 202(c)(2).

[109] *Id.*

[110] *Id.*

[111] *Investment Terms*, PROFOUNDER, https://www.profounder.com/investors/investment-terms/ (last visited July 19, 2011).

[112] *FAQs*, PROFOUNDER, http://www.profounder.com/entrepreneurs/faq (last visited Jan. 27, 2011). *See also* Lang, *supra* note 108.

[113] *Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, QUORA (Nov. 30, 2010), http://www.quora.com/ProFounder/Is-ProFounder-in-violation-of-any-securities-laws-with-their-crowdsourced-model-for-funding-startups.

[114] *Company Terms and Conditions*, PROFOUNDER ¶ 15, https://www.profounder.com/legal/terms_and_conditions (last visited Jan. 27, 2011); *Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, *supra* note 113.

[115] *FAQs*, PROFOUNDER, http://www.profounder.com/entrepreneurs/faq (last visited Jan. 27, 2011). *See also* Lang, *supra* note 108. Ferner, *supra* note 105.

[116] *See Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, *supra* note 113 (statement by Jessica Jackley).

[117] *FAQs*, PROFOUNDER, http://www.profounder.com/entrepreneurs/faq (visited Jan. 27, 2011).

C. The Antecedents of Crowdfunding

Internet-based crowdfunding is a merger of two distinct antecedents, crowdsourcing and microfinance.[119] Crowdsourcing is, quite simply, "collecting contributions from many individuals to achieve a goal."[120] It divides "an overwhelming task . . . into small enough chunks that completing it becomes . . . feasible."[121] Wikipedia is probably the most prominent example of crowdsourcing—an entire encyclopedia consisting of articles written and edited by the general public.[122] Linux, the open source computer operating system, was developed through crowd-sourcing, and other software companies, including IBM, have adopted the open-source model.[123] From astronomy to stock photography to prediction markets to eBay, platforms based on the collective contributions of a large number of people are commonplace today.[124] Even the all-pervasive Google search system is crowdsourcing; Google's algorithm captures the sites that all of us collectively are linking to and visiting.[125] The Internet significantly reduces the transaction costs of decentralized group action [126] and "opens . . . the economy to new Linux-like projects every day."[127] The "rigid institutional structures" previously required to organize economic action are, in many cases, no longer necessary.[128]

The other antecedent of crowdfunding is micro-lending, sometimes called microfinance. Micro-lending involves lending very small amounts of money, typically to poorer

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[118] *Company Terms and* Conditions ¶ 2, *ProFounder Terms and Conditions for Services*, PROFOUNDER, https://www.profounder.com/legal/terms_and_conditions (last visited Jan. 27, 2011).

[119] *See* Belleflamme, et al., *supra* note 12 (Crowdfunding is rooted in crowdsourcing); *When Small Loans Make a Big Difference*, FORBES.COM (June 3, 2008), http://www.forbes.com/2008/06/03/kiva-microfinance-uganda-ent-fin-cx_0603whartonkiva.html (crowdfunding is a merger of social networking and micro-finance); Nick Mendoza, *How Filmmakers Use Crowdfunding to Kickstart Productions*, PBS MEDIASHIFT (Sept. 21, 2010), http://www.pbs.org/mediashift/2010/09/how-filmmakers-use-crowdfunding-to-kickstart-productions264.html (crowdfunding is a mix of crowdsourcing, marketing and fundraising); Schwienbacher & Larralde, *supra* note 16, at 5.

[120] Tina Rosenberg, *Crowdsourcing a Better World*, OPINIONATOR, NEW YORK TIMES (Mar. 28, 2011), http://opinionator.blogs.nytimes.com/2011/03/28/crowdsourcing-a-better-world.

[121] Howe, *supra* note 2, at 11.

[122] *See* Howe, *supra* note 2, at 56-61; Don Tapscott & Anthony D. Williams, WIKINOMICS: HOW MASS COLLABORATION CHANGES EVERYTHING 71-77 (2006); Chris Anderson, THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE 65-70 (2006).

[123] *See* Howe, *supra* note 2, at 47-70; Tapscott and Williams, *supra* note 122, at 77-83; Clay Shirky, HERE COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS 237-243 (2008).

[124] For a more detailed look at crowdsourcing, *see generally* Howe, *supra* note 2; Tapscott & Williams, *supra* note 122.

[125] Yochai Benkler, THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM 76 (2006). *See also* James Surowiecki, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS 16-17 (2004) (Google is an example of the wisdom of the crowds).

[126] Benkler, *supra* note 125, at 3; Shirky, *supra* note 123, at 48.

[127] Tapscott & Williams, *supra* note 122, at 24. However, crowdsourcing predates the Internet. For example, since 1900, the National Audubon Society has been organizing bird-watchers to do an annual count of birds in the Western hemisphere. *See* Rosenberg, *supra* note 120. The famous Pillsbury Bake-Off is a long-standing means of crowd-sourcing recipes. *See id.*

[128] Shirky, *supra* note 123, at 21-22.

borrowers.[129]Micro-lending can be traced back to Irish loan funds in the 1700s,[130] but it became prominent in recent times through the work of Muhammad Yunus and the Grameen Bank.[131] Yunus's project began when he loaned $27 of his own money to 42 villagers in Bangladesh.[132] He subsequently established a multi-branch bank, the Grameen Bank, that specialized in such loans.[133] In 2006, Yunus and the Grameen Bank shared the Nobel Peace Prize. Micro-lending has its detractors,[134] but it has ballooned into a multi-billion dollar industry.[135]

Micro-lending is defined primarily by the recipient—very small entrepreneurial ventures. Crowdsourcing is defined primarily by the contributor—small contributions from a large number of people to achieve a common goal. Crowdfunding is just a combination of those two ideas—small contributions from a large number of people to fund small entrepreneurial ventures.

III. Are Crowdfunding Investments Subject to the Registration Requirements of the Securities Act?

Crowdfunding raises two different sets of issues under federal securities laws. The first issue relates to the offerings themselves: are the entrepreneurs raising funds on crowdfunding sites offering securities subject to the registration requirements of the Securities Act of 1933? The second set of issues relates to possible violations of securities law by the crowdfunding sites which facilitate those offerings. I address the first issue in this section; the next section focuses on the securities law status of the crowdfunding sites.

Section 5 of the Securities Act and the SEC rules associated with section 5 are a morass of prohibitions, exceptions, conditions, and exceptions to exceptions,[136] but the basic

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[129] *See* Mincer, *supra* note 23.

[130] Sarah B. Lawsky, *Money for Nothing: Charitable Deductions for Microfinance Lenders*, 61 SMU L. Rev. 1525, 1529 (2008).

[131] *See* Walker, Olivia E. *The Future of Microlending in the United States: A Shift from Charity to Profits?*, 6 OHIO ST. BUS. L. J. 383, 384 (2011); Mincer, *supra* note 23; Kathleen Kingsbury, *Microfinance: Lending a Hand*, TIME (Apr. 5, 2007), http://www.time.com/time/magazine/article/0,9171,1607256,00.html.

[132] Muhammad Yunus, BANKER TO THE POOR: MICRO-LENDING AND THE BATTLE AGAINST WORLD POVERTY 49-50 (2003).

[133] *Id.*, at 89-97.

[134] *See* Kingsbury, *supra* note 131 (noting complaints that microcredit does little to alleviate overall poverty, crowds out locally owned banks, and can leave the poor drowning in debt).

[135] *See id.* (as of 2007, about 10,000 microfinance institutions held more than $7 billion in outstanding loans).

[136] Consider, for example, Securities Act Rule 433. Whether a communication falls within the Rule 433 safe harbor can depend on, among other things:

(1) whether the issuer has filed a registration statement, Rule 433(a);
(2) characteristics of the company issuing the securities, such as its size and how long it has been a reporting company, Rule 433(b);
(3) the content of the communication, Rule 433(b)(2)(i), (c);
(4) who is making the communication, Rule 433(d), (f);
(5) where the information in the communication originally came from, Rule 433(d)(1)(i)(B), (h)(2);

prohibitions are clear. Absent an exemption, an issuer may not offer a security for sale until a registration statement has been filed with the SEC.[137] And an issuer may not sell a security[138] until that registration statement has become effective.[139] But the registration requirements apply only if the entrepreneurs on crowdfunding sites are offering securities.[140] If crowdfunding investments are not securities, the federal securities laws do not apply.

A. Are Crowdfunding Investments Securities?

Each federal securities statute has its own definition of "security," but the language of the various definitions, for purposes of the issues raised here, is roughly the same.[141] The most expansive part of the definition of security, the catch-all category, is the term "investment contract." The Supreme Court's *Howey* case defined an investment contract 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.[142] Both the Supreme Court and the lower courts have refined the *Howey* test over the years, but its basic elements remain unchanged, with one significant exception. The word "solely" has been eliminated from the efforts-of-others part of the test. Instead, the question is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[143]

Crowdfunding offerings of the donation, reward, and pre-purchase type clearly do not involve securities for purposes of federal law. Crowdfunding sites organized on the lending model probably are offering securities if the lender is promised interest. Crowdfunding sites organized on the equity model are usually offering securities.[144]

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(6) whether the information in the communication is otherwise available to the general public, Rule 433(d)(8)(ii); and

(7) whether the issuer or anyone else associated with the offering paid for the communication, Rule 433(b)(2)(i), (f)(1)(i).

[137] Securities Act § 5(c), 15 U.S.C. §77e(c) (2010).

[138] "Selling" includes entering into a contract of sale. *See* Securities Act § 2(a)(3), 15 U.S.C. §77b(a)(3) (2010).

[139] Securities Act § 5(a)(1), 15 U.S.C. §77e(a)(1) (2010).

[140] Even if they are offering securities, an exemption may be available. *See* section III.B.2, *infra*.

[141] *See* Securities Act § 2(a)(1), 15 U.S.C. §77b(a)(1) (2010); Securities Exchange Act § 3(a)(10), 15 U.S.C. §78c(a)(10) (2010); Investment Company Act § 2(a)(36), 15 U.S.C. §80a-2(a)(36) (2010); Investment Advisers Act § 202(a)(18), 15 U.S.C. §80b-2(a)(18) (2010). For convenience, I will generally refer to the Securities Act definition unless there is some relevant difference.

[142] SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946).

[143] SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973). *Accord*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974).

[144] Heminway and Hoffman have similarly concluded that at least some crowdfunding offerings are securities under the *Howey* investment contract test. *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933* 10-24 (July 29, 2011), *available at* http://ssrn.com/abstract=1875584.

1. The Donation Model

Donation-model crowdfunding sites are not offering securities to investors. Contributors receive absolutely nothing in return for their contributions, so they clearly have no expectation of profits, a requirement for something to be an investment contract under *Howey*. And contributors to donation-model sites are offered nothing else, such as stock[145] or notes,[146] that falls within the general definition of security.[147] Gratuitous contributions, even to a business entity, simply are not securities.

2. The Reward and Pre-Purchase Models

The reward and pre-purchase models also do not involve securities under federal law, as long as the reward or the pre-purchased product is all the investor is promised in return for her contribution. The Supreme Court has drawn a clear distinction between investment and consumption. An investment contract is present only when an investor is offered a financial return on his investment, such as capital appreciation or a participation in earnings[148] or even a fixed rate of interest.[149] If "a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."[150] It does not matter that the contributor is promised a lower price for the product than the general public will pay.

Contributors on reward or pre-purchase sites are offered no financial return of any kind. They are promised only a product or service—a consumption item. Therefore, no investment contract is being offered. And, because investors on reward or pre-purchase sites are not offered stock, notes, or anything else that falls within the definition of security, federal securities law does not apply.

3. The Equity Model

Equity-model crowdfunding would usually involve securities. If investors receive ordinary corporate stock in exchange for their contributions, they clearly are purchasing securities. The definition of security includes "stock,"[151] and the Supreme Court has held

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[145] *See* Landreth Timber Co., v. Landreth, 471 U.S. 681 (1985) (holding that ordinary corporate stock is a security).

[146] *See* Reves v. Ernst & Young, 494 U.S. 56 (1990) (applying the "family resemblance" test to determine whether a note is a security).

[147] Securities Act § 2(a)(1), 15 U.S.C. §77b(a)(1) (2010).

[148] United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 853 (1975).

[149] SEC v. Edwards, 540 U.S. 389, 397 (2004).

[150] United Housing Foundation v. Forman, 421 U.S. at 852-853. It is possible that these might be securities under state law. Some states use a risk capital test to define securities. The risk capital test has three elements: "(1) an investment, (2) in the risk capital of an enterprise, and (3) the expectation of a benefit. Joseph C. Long, 12 BLUE SKY LAW 2-135 (2011). The benefit expected need not be an interest in profits, but can be any benefit that motivates the investor to invest. *Id.*, at 2-136; 1 HAZEN, *supra* note 44, at 110. *See also* Silver Hills Country Club v. Sobieski, 361 P.2d 906 (Cal. 1961) (finding a security where a country club pre-sold club memberships to raise capital to build the club).

[151] Securities Act § 2(a)(1), 15 U.S.C. §77b(a)(1) (2010).

that ordinary corporate stock is a security, with no additional analysis required.[152] But, even if crowdfunding investors are offered some participation in the return of the business that does not involve corporate stock, their investments would still be securities. Interests in partnerships and limited liability companies, and other non-stock equity interests are analyzed under the *Howey* investment contract test.[153] The interests offered to investors on equity-model sites would clearly be investment contracts under *Howey*.

Crowdfunding almost by definition involves a common enterprise among many different investors. The whole point of crowdfunding is to collect small amounts of money from a number of different investors. The business pools these investors' funds and the investors share in the returns of the business. Although there is some disagreement among the lower courts about what exactly constitutes a common enterprise, all courts agree that horizontal commonality of this sort meets the *Howey* test.[154]

Investors on equity-model sites would also have an expectation of profits. Contributors are providing cash in return for some sort of revenue or profit sharing.[155] The "public raise" type of funding offered by ProFounder[156] would not meet this requirement, however. Public-raise investors are promised a share of the entrepreneur's revenues, but only until their original contribution is repaid. A person who contributed $1,000 would receive, at most, only $1,000 back, no matter how well the business did. Since no profits are expected, public-raise investments would not be securities.

Finally, the profits expected are to come solely from the efforts of the promoters or other third parties. Crowdfunding investors will not usually be involved in the operation of the business in which they invest and, even if the crowdfunding site allows them some minor role, the "essential managerial efforts which affect the failure or success of the enterprise"[157] will be those of the entrepreneur.

4. The Lending Model

The analysis is most complicated for lending-model crowdfunding.[158] The federal securities laws are not limited to equity interests in businesses; the definition of security

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[152] Although calling something stock is not alone enough to make it a security, United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1975), "[i]nstruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition." Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1985).

[153] *See, e.g.*, United States v. Leonard, 529 F.3D 83 (2d Cir. 2008) (LLCs); Williamson v. Tucker, 645 F. 2d 404 (5th Cir. 1981) (partnerships).

[154] *See* 1 HAZEN, *supra* note 44, at 98 ("Horizontal commonality clearly satisfies the *Howey* common enterprise requirement").

[155] Even if investors are offered a fixed return, rather than one that depends on how well the business does, that would still meet the *Howey* requirement of an expectation of profits. *See* SEC v. Edwards, 540 U.S. 389 (2004) (holding that an agreement to pay investors $82 a month constituted a security).

[156] *See* text accompanying notes 105-107, *supra*.

[157] SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

[158] Many lending sites offer consumer loans, and not just loans to business entrepreneurs. The following discussion is limited to loans to businesses and business projects. Loans for consumer purposes are less likely to be treated as securities. *See* Verstein, *supra* note 14, at 22, 23-24 (arguing that consumer notes would not be securities under either the *Howey* or *Reves* tests). For a general introduction to peer-to-peer

clearly encompasses some forms of debt,[159] and an investment may be a security even though the return consists of a fixed payment or a fixed rate of interest.[160] *Howey* is still relevant, but, if investors are offered notes, the Supreme Court's analysis in *Reves v. Ernst & Young* must also be considered. Under those tests, sites like Kiva that offer investors no interest or other return, only a return of their principal, are probably not offering securities, but, if investors are promised interest, their investments probably are securities.

Consider first whether crowdfunding sites offering interest are selling investment contracts. Contributors are investing money with an expectation of profits. A fixed rate of interest, such as what is offered on the Lending Club and Prosper sites, would be "profit" for purposes of *Howey*.[161] If more than one lender contributes to each business, there is a horizontal common enterprise. And the profits are going to result solely, or at least primarily, from the efforts of the entrepreneur. Thus, investments made on lending sites that offer investors interest would be investment contracts under the *Howey* test. However, if the site, like Kiva, offers investors only a return of their principal, without any interest or other gain, investors would have no expectation of profits,[162] and, because of that, the investment contract test would not be met.[163]

Investments made through lending-model sites might also involve notes, and thus be securities under another part of the definition.[164] Some of the lending sites, such as Kiva, do not give investors a formal note in return for their investments; others, such as

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lending, *see* Verstein, *supra* note 14; Kevin E. Davis & Anna Gelpern, Peer-to-Peer Financing for Development: Regulating the Intermediaries (Oct. 1, 2010), *available at* http://ssrn.com/abstract=1618859.

[159] The definition of security includes, among other things, "notes", "bonds", "debentures", and "evidence of indebtedness." *See* Securities Act § 2(a)(1), 15 U.S.C. §77b(a)(1) (2010).

[160] SEC v. Edwards, 540 U.S. 389 (2004) (holding that an investment offering a fixed return of $82 a month was an investment contract).

[161] *Id.*

[162] *See* Verstein, *supra* note 14, at 41 (agreeing with this analysis). This is why Kiva does not offer interest to investors. According to Matt Flannery, a co-founder of Kiva, Kiva would like to offer investors interest. Matt Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, 2 INNOVATIONS (Nos. 1-2) 31, 53 (Winter/Spring 2007). They decided not to after he had a conversation with an attorney in the SEC's Office of Small Business Policy and concluded that the key to avoiding SEC interference was not to pay interest. *Id.*, at 41.

[163] Davis and Gelpern concede that sites like Kiva are not offering securities under current law, Davis & Gelpern, *supra* note 158, at 1241, but argue that such investments *should* be regulated. *Id.*, at 1258-1259.

[164] When an instrument is a note, the applicability of the *Howey* investment contract analysis is a little unclear. Most courts have applied the *Howey* investment contract test and the *Reves* note test in the alternative with little analysis. *See, e.g.*, SEC v. U.S. Reservation Bank & Trust, 289 Fed. Appx. 228, 230-31 (9th Cir. 2008); Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1539 (10th Cir. 1993); SEC v. Novus Technologies, LLC, 2010 WL 4180550 (D. Utah Oct. 20, 2010); In Re Tucker Freight Lines, Inc., 789 F. Supp. 884, 888-889 (W.D. Mich. 1991); Reeder v. Succession of Palmer, 736 F. Supp. 128, 131-132 (E.D. La. 1990). *See also* Dennis S. Corgill, *Securities as Investments at Risk*, 67 TUL. L. REV. 861, 900 (1993) (concluding that a note that is not a security under the *Reves* test could still be a security under the *Howey* investment contract test). *But see* Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1231 (2003) (arguing against applying a second-stage investment contract analysis to something that is not a security under *Reves*).

Lending Club and Prosper, do. The term "note" appears in the definition of security,[165] but not all notes are securities.

The Supreme Court applies a different analysis, first articulated in *Reves v. Ernst & Young*,[166] to determine whether a note is a security. Crowdfunding notes that promise to pay interest to investors would probably be securities under the *Reves* test. The *Reves* analysis, known as the family resemblance test, begins with a rebuttable presumption that every note is a security.[167] It then applies a list of notes that are not securities, but crowdfunding loans to businesses would not fit any of the categories on that list.[168] We therefore must move to the final step of the *Reves* analysis: applying a four-part test to determine whether crowdfunding notes bear sufficient family resemblance to the listed non-securities that crowdfunding notes should also not be treated as securities. The four factors are (1) the motivations of the buyer and seller of the note; (2) the plan of distribution of the notes; (3) the reasonable expectations of the investing public; and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the securities Acts unnecessary."[169] In applying this test, it is important to keep in mind that the presumption is in favor of treating notes as securities.

We can dismiss the last factor immediately. Crowdfunding loans, like the notes at issue in *Reves*, are uncollateralized and uninsured, and no other federal regulatory scheme covers them. They "would escape federal regulation entirely if the . . . [federal securities laws] . . . were held not to apply."[170]

The motivations factor clearly supports treating interest-bearing crowdfunding notes as securities. The entrepreneur's purpose, or in the case of sites like Lending Club and Prosper that issue their own notes to finance entrepreneurs, the site's purpose, "is to raise money for the general use of a business," a securities purpose.[171] Investors are "interested primarily in the profit the note is expected to generate,"[172] with profit defined by the Court to include ordinary interest.[173] This is also a securities purpose. But investors on sites that offer no interest are not interested in profit because no profit is expected.[174] Their motivations are of a more charitable nature, which cuts against security status. This alone might be enough to keep the loans on sites like Kiva from being securities.

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[165] *See* Securities Act § 2(a)(1), 15 U.S.C. §77b(a)(1) (2010).
[166] 494 U.S. 56 (1990).
[167] *Id.*, at 63.
[168] *Reves* accepted the following categories of non-securities: "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, . . . a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized), . . . [and] . . . notes evidencing loans by commercial banks for current operations." *Id.*, at 65.
[169] *Id.*, at 67.
[170] *Id.*, at 69.
[171] Id., at 66.
[172] *Id.*, at 66.
[173] *Id.*, at 68 n. 4.
[174] *See* Verstein, *supra* note 14, at 41 (agreeing with this analysis).

The plan-of-distribution factor also appears to point toward securities status. Some of the crowdfunding sites are tied to trading markets where investors buy notes from, or sell them to, other investors. Notes purchased on the Lending Club and Prosper sites, for example, may be traded on a platform maintained by FOLIOfn Investments, a registered broker-dealer.[175] But notes can meet the plan-of-distribution test even if there is no trading market. After first indicating that the plan-of-distribution factor depends on whether "there is 'common trading for speculation or investment,'"[176] the *Reves* opinion said it was sufficient if the notes are "offered and sold to a broad segment of the public," even if, as in *Reves*, there is no market to trade the notes.[177] Crowdfunding lending sites are open to the public, and, by definition, crowdfunding involves investments by a number of small investors. The number of investors will not always be as many as the 1600 purchasers in *Reves*,[178] but it will typically be more than a few. Thus, notes sold on crowdfunding sites could meet this part of the *Reves* test even if there is no trading market.

The final factor to consider is the investing public's reasonable expectations. *Reves* said little about this factor, other than to indicate that notes might be treated as securities on the basis of such public perceptions, "even where an economic analysis of the circumstances of the particular transaction" would suggest otherwise.[179] In applying this factor, the Supreme Court noted only that the notes there were characterized as investments and nothing "would have led a reasonable person to question this characterization."[180] The question, as analyzed in the lower courts, seems to be "whether a reasonable member of the investing public would consider these notes as investments."[181] That, in turn, probably depends on whether interest is offered and on whether or not the note is presented to investors as an investment.[182] If purchasers are buying the notes for the interest they promise, they appear to be investments, no matter

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[175] *See* Prosper Registration Statement, *supra* note 83, at 11; Lending Club Registration Statement, *supra* note 83, at 11.

[176] *Id.*, at 66 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).

[177] *Id.*, at 68.

[178] *Id.*, at 59.

[179] *Id.*, at 66.

[180] *Id.*, at 69. *See also* Stoiber v. SEC, 161 F.3d 745, 751 (D.C. Cir. 1998) (describing this factor as a "one-way ratchet" that does not allow notes that are securities under the other factors to escape the securities laws).

[181] McNabb v. SEC, 298 F.3d 1126, 1132 (9th Cir. 2002). *Accord*, SEC v. Wallenbrock, 313 F.3d 532, 539 (9th Cir. 2002); Stoiber v. SEC, 161 F.3d 745, 751 (D.C. Cir. 1998).

[182] "When a note seller calls a note an investment, in the absence of contrary indications 'it would be reasonable for a prospective purchaser to take the [offeror] at its word.' . . . Conversely, when note purchasers are expressly put on notice that a note is not an investment, it is usually reasonable to conclude that the 'investing public' would not expect the notes to be securities." Stoiber v. SEC, 161 F.3d 745, 751 (D.C. Cir. 1998). *But see* SEC v. Wallenbrock, 313 F.3d 532, 539 (9th Cir. 2002) (the fact that the promoter "did not use the term "investment" to describe the notes is of little import, given the nature of the transactions").

how the crowdfunding site characterizes them.[183] Sites like Kiva that offer no interest are less likely to meet this factor.[184]

As indicated earlier,[185] Lending Club and Prosper have changed their business models since their inception. Originally, lenders on those sites made loans directly to the underlying borrowers and received notes from those borrowers in return. Now, Lending Club and Prosper issue their own notes to lenders and lenders are not directly lending to the underlying borrowers. As far as the definitions of investment contract and note are concerned, this difference is irrelevant.[186] Nothing in the analysis above depends on who the issuer is.[187]

The SEC certainly believes that interest-bearing crowdfunding notes are securities. It has forced both Lending Club and Prosper to register the notes they offer.[188] Prior to that registration, the SEC entered a consent cease-and-desist order against Prosper, finding that Prosper was improperly selling securities without registration.[189] Both companies' registration statements indicate that it is "reasonably possible" that the sites will be liable to lenders for securities sold prior to registration,[190] and Prosper is currently fighting a class action lawsuit brought by pre-registration lenders.[191]

The use of notes adds one additional complication. The Exchange Act definition of security excepts notes with "a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."[192] The Securities Act definition of security includes no such exception,

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[183] *See* SEC v. Wallenbrock, 313 F.3d 532, 539 (9th Cir. 2002) (the reasonable expectations factor is closely related to the motivations factor, and the fact that the promoter did not describe the notes as investments is "of little import").

[184] *See* Verstein, *supra* note 14, at 41 (agreeing with this analysis).

[185] *See* text accompanying notes 87-92, *supra*.

[186] *See* In the Matter of Prosper Marketplace, Inc., Securities Act Release No. 8984 (Nov. 24, 2008) (taking the position that the notes offered by Prosper, under its original model, were securities).

[187] Who the issuer is might matter for purposes of registration. If Lending Club and Prosper have no obligation on the notes they issue and payment depends entirely on the success of the underlying borrower, should the sites really be considered the issuers for purposes of registration and the disclosure requirements? *See* Stefan J. Padfield, *Peer-to-Peer Lending: Who Is the Issuer?*, BUSINESS LAW PROF BLOG (June 16, 2011), http://lawprofessors.typepad.com/business_law/2011/06/peer-to-peer-lending-who-is-the-issuer.html. *See also* Heminway & Hoffman, *supra* note 144, at 38-42 (discussing whether the entrepreneur, the crowdfunding site, or both are the issuer for purposes of registration).

[188] *See* Prosper Registration Statement, *supra* note 83; Lending Club Registration Statement, *supra* note 83.

[189] In the Matter of Prosper Marketplace, Inc., Securities Act Release No. 8984 (Nov. 24, 2008).

[190] Prosper Registration Statement, *supra* note 83, at F-40; Lending Club Registration Statement, *supra* note 83, at 90.

[191] Prosper Registration Statement, *supra* note 83, at 75. A blog has been set up to monitor and report on that case. *See* PROSPER CLASS ACTION SUIT MONITOR, http://prosperclassaction.wordpress.com/ (last updated Aug. 17, 2011). Prosper has also entered into a settlement with the North American Securities Administrators Association of regulatory claims under state securities law and has agreed not to sell securities unless it complies with state securities laws. Prosper Registration Statement, *supra* note 83, at 75; *Prosper Marketplace Inc. Enters Settlement With State Securities Regulators Over Sales of Unregistered Securities*, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION (Dec. 1, 2008), http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9906.cfm.

[192] Securities Exchange Act § 3(a)(10), 15 U.S.C. §78c(a)(10) (2010).

but section 3(a)(3) of the Securities Act exempts from some, but not all,[193] of the Act's requirements

> Any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[194]

Crowdfunders might try to avoid the application of federal securities law by promising repayment within nine months.[195] However, both the Exchange Act exception and the Securities Act exemption have traditionally been read to cover only prime-quality commercial paper bought by sophisticated traders.[196] Four dissenters in *Reves* questioned this interpretation of the Exchange Act exception,[197] but that long-standing reading still stands for now. The risky debt issued by start-up entrepreneurs to the general public would not qualify as commercial paper.[198]

B. Registration and Exemption of Crowdfunded Securities Offerings

1. Registration

Offerings of securities must be registered with the SEC unless an exemption is available.[199] Unfortunately, registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital.[200] It is too expensive and time-consuming for crowdfunded offerings.

The cost of registration will in most cases exceed the amount small entrepreneurs want to raise.[201] The direct costs of preparing and filing the registration statement—registration fees, accounting fees, legal fees, and printing costs—can be hundreds of thousands of

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[193] *See* Securities Act §§ 12(a)(2), 17(c), 15 U.S.C. §§77l(a)(2), 77q(c) (2010).

[194] Securities Act § 3(a)(3), 15 U.S.C. §77c(a)(3) (2010).

[195] As far as I could determine, none of them currently do. Prosper and Lending Club, for example, sell notes with three-year terms. Prosper Registration Statement, *supra* note 83, at 8; Lending Club Registration Statement, *supra* note 83, at 7.

[196] *See* 1 HAZEN, *supra* note 44, at 460 (Exemption in section 3(a)(3) of the Securities Act "applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public"); Wendy Gerwick Couture, *The Securities Acts' Treatment of Notes Maturing in Less Than Nine Months: A Solution to the Enigma*, 31 SEC. REG. L. J. 496, 505 (2003) ("Almost every court addressing the issue has held that the §3(a)(3) exemption and the §3(a)(10) exclusion apply to the same notes.").

[197] Reves v. Ernst & Young, 494 U.S. 56, 76 (1990) (Rehnquist, C.J., dissenting).

[198] For a full discussion of the commercial paper test, *see* Couture, *supra* note 196, at 512-531.

[199] Section 5(c) of the Securities Act provides that no one may offer securities until a registration statement has been filed with the SEC. Securities Act § 5(c), 15 U.S.C. § 77e(c) (2010). Section 5(a)(1) of the Act prohibits sales of those securities until the registration statement has become effective. Securities Act § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2010).

[200] Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They "Suitable" for the Retail Investor?*, 72 S. CAL. L. REV. 67, 75 (1998); William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 Fla. St. L. Rev. 1, 8 (2004); Cohn & Yadley, *supra* note 13, at 7-8.

[201] *See* Tim Kappel, *supra* note 24, at 384.

dollars, even excluding underwriting costs.[202] Smaller offerings are less expensive to register than larger ones,[203] but the cost is disproportionately greater for smaller offerings.

Registration also takes too much time. Small companies often need to raise capital quickly;[204] today's rapid changes in technology mean "a compressed life-time and a quicker requisite time-to-market."[205] A 1996 report indicated that the average delay between filing and effectiveness for an initial public offering on special, simplified forms then available to small businesses was 103.7 days.[206] That does not include the time required to prepare for filing. The total time from inception to effectiveness can be up to six months or even longer.[207]

Registration, however, is not impossible. Peer-to-peer lenders Prosper and Lending Club register the notes they offer, but they had to totally restructure their business models to make it work. Instead of investors providing money directly to the underlying entrepreneurs, investors loan money to the sites themselves and the sites issue non-recourse notes dependent on payment by the underlying borrower.[208] Prosper and Lending Club file a single shelf registration statement for all of the notes they issue, with each funding treated as a separate series requiring its own prospectus supplement.[209] This mechanism is costly and burdensome, and would not translate easily to equity crowdfunding.

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[202] A GAO report estimated the average cost for a $25 million underwritten public offering to be $2.3 million, but much of that was underwriting discounts and commissions. U.S. General Accounting Office, Report to the Chairman, Comm. on Small Business, U.S. Senate, Small Business Efforts to Facilitate Equity Capital Formation 23 (Sept. 2000) [hereinafter "GAO Report"]. The estimated cost included $9,914 for SEC registration fees, $160,000 for accounting fees and expenses, $200,000 for legal fees and expenses, and $100,000 for printing fees and expenses. *Id.* Another source provides the following estimates for a Form S-1 public offering: underwriting fees 7-15% of the offering amount; registration fees 1/29 of 1%; printing costs $25,00-75,000; engraving of certificates $2,500-4,000; legal costs ¾-3% of the offering amount; accounting costs $25,000-250,000; experts $300-15,000; state filing fees $150-4,000 per state; and NASD filing fees $500-30,500. William M. Prifti, 24 SECURITIES: PUBLIC AND PRIVATE OFFERINGS 1A-108 (2d ed. 2010). *See also* William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 575-576 (2001) (legal, accounting, filing, and other fees for an underwritten public offering generally range from $300,000 to $500,000).

[203] Carl W. Schneider, et al, *Going Public: Practice, Procedure and Consequences*, 27 VILL. L. REV. 1, 32 (1981).

[204] Cohn & Yadley, *supra* note 13, at 80; Lawton & Marom, *supra* note 3, at 37-38.

[205] Lawton & Marom, *supra* note 3, at 37.

[206] SEC, Report of the Advisory Committee on the Capital Formation and Regulatory Processes, [1996-97 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834, at 88,439 Table 2 (July 24, 1996), *available at* http://www.sec.gov/news/studies/capform.htm.

[207] *See* Cohn & Yadley, *supra* note 13, at 7.

[208] *See* text accompanying notes 87-92, *supra*.

[209] *See* Verstein, *supra* note 14, at 34. This requires them to file two or three prospectus supplements a day. *Id.* Each of those prospectus supplements must contain all of the information available on the platform, "no matter how trivial," about the particular borrower. *Id.*, at 33.

2. Possible Exemptions Under Current Law

Companies selling securities on crowdfunding sites could avoid registration if an exemption were available.[210] Several exemptions might possibly apply: the private offering exemption in section 4(2) of the Securities Act[211] or its regulatory safe harbor, Rule 506 of Regulation D;[212] Section 4(5) of the Securities Act;[213] Rule 504 of Regulation D;[214] Rule 505 of Regulation D;[215] or Regulation A.[216] Unfortunately, none of those exemptions is conducive to crowdfunding.[217]

a. Section 4(2), Rule 506, and Section 4(5)

Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."[218] The exact boundaries of this exemption are hazy,[219] but the Supreme Court held in the *Ralston Purina* case that the exemption's availability turns on whether offerees "[need] the protection of the Act" or are "able to fend for themselves."[220] Subsequent cases have focused on the sophistication of the offerees and their access to information about the issuer.[221]

Crowdfunded offerings are not limited to sophisticated investors. Most crowdfunding sites are open to the general public; the whole point of crowdfunding is to appeal to this "crowd." Because of that, section 4(2) would not be available.

The SEC has adopted a regulatory safe harbor for section 4(2), Rule 506 of Regulation D,[222] but that safe harbor would also not be helpful. Purchasers in a Rule 506 offering must either be "accredited investors" or meet a sophistication requirement.[223] Accredited investors are primarily sophisticated institutions or individual investors who meet wealth

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[210] These exemptions would only free entrepreneurs from the registration requirements of the Securities Act. Entrepreneurs selling securities would still be subject to the antifraud provisions of the Securities and Exchange Act, including Rule 10b-5.

[211] Securities Act § 4(2), 15 U.S.C. §77d (2) (2010).

[212] Rule 506, 17 C.F.R. §230.506 (2007).

[213] Securities Act § 4(5), 15 U.S.C. §77d(5) (2007).

[214] Rule 504, 17 C.F.R. §230.504 (2007).

[215] Rule 505, 17 C.F.R. §230.505 (2007).

[216] Rules 251 *et seq.*, 17 C.F.R. §230.251 *et seq.* (2007).

[217] *See* Cohn & Yadley, *supra* note 21, at 35 ("[S]mall companies are hard pressed to find an exemption consistent with their timing, financing, and marketing needs.")

[218] Securities Act § 4(2), 15 U.S.C. §77d(2) (2007).

[219] *See* 1 HAZEN, *supra* note 44, at 573 ("an issuer relying on the statutory section 4(2) exemption . . . may be subjecting itself to a great deal of uncertainty").

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

[221] *See* 1 HAZEN, *supra* note 44, at 565.

[222] Offers and sales that satisfy the conditions of Rule 506 "shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act." Rule 506(a), 17 C.F.R. §230.506(a) (2007).

[223] Rule 506(b)(2)(ii), 17 C.F.R. §230.506(b)(2)(ii) (2007). If a purchaser is not an accredited investor, he or his purchaser representative must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." *Id.* The rule is satisfied even if the purchaser does not meet this standard, as long as the issuer reasonably believes he does. *Id.*

or income standards.[224] Not all of the purchasers on a publicly accessible crowdfunding site would meet these requirements.

In addition, Rule 506 prohibits "general solicitation" and "general advertising" of the offering.[225] The SEC and its staff take the position that any solicitation of an investor with whom the issuer or its sales representatives do not have a preexisting relationship violates the general solicitation restriction.[226] Offerings to the general public on crowdfunding sites would clearly violate this prohibition.[227] Finally, sales under Rule 506 are limited to no more than 35 non-accredited investors.[228] Some crowdfunding offerings might meet this limit on the number of purchasers, but, given the small amounts contributed by each investor, others would not.[229]

Section 4(5) of the Securities Act, until recently section 4(6), is similar to Rule 506.[230] It allows offers and sales solely to accredited investors provided there is no "advertising or public solicitation."[231] Thus, section 4(5), like Rule 506, is of little use to small businesses engaged in crowdfunding.[232]

b. Rule 505

Rule 505 exempts offerings of up to $5 million.[233] Rule 505 is not restricted to accredited or sophisticated purchasers, but it is subject to the same general solicitation prohibition as Rule 506.[234] And, as under Rule 506, an issuer may sell to no more than 35 non-accredited investors.[235] These conditions make Rule 505 unsuitable for crowdfunding.

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[224] *See* Rule 501(a), 17 C.F.R. §230.501(a) (2007).

[225] Rule 502(c), 17 C.F.R. §230.502(c) (2007).

[226] *See, e.g.*, In the Matter of Kenman Corporation, Exchange Act Release No. 21962, 1985 WL 548507, at n. 6 (SEC Apr. 19, 1985). *See generally* 1 HAZEN, *supra* note 44, at 540; Sjostrom, *supra* note 200, at 13-14 According to Sjostrom, the SEC has indicated that a preexisting relationship is not the only way to avoid the general solicitation ban, but the SEC has not granted any no-action relief where a preexisting relationship is absent. *Id.*, at 13-14.

[227] *See* Heminway & Hoffman, *supra* note 144, at 35 (concluding that "[t]he most serious obstacle to the use of Regulation D to exempt crowdfunded offerings from Securities Act registration is Regulation D's overall prohibition of general solicitation and general advertising.")

[228] *See* Rule 506(b)(2)(i), 17 C.F.R. §230.506(b)(2)(i) (2007).

[229] *See* Cohn & Yadley, *supra* note 13, at 12 (Small companies are likely to need to sell to a large number of investors and cannot do that within the numerical limits imposed by Rules 505 and 506).

[230] Unlike Rule 506, section 4(5) limits the amount of the offering to $5 million. Securities Act §§ 4(5), 3(b), 15 U.S.C. §§77d(5),77c(b) (2010)

[231] Securities Act § 4(5), 15 U.S.C. §77d(5) (2010).

[232] *See* Cohn & Yadley, *supra* note 13, at 24.

[233] Rule 505(b)(2)(i), 17 C.F.R. §230.505(b)(2)(i) (2007).

[234] *See* Rule 502(c), 17 C.F.R. §230.502(c) (2007).

[235] Rule 505(b)(2)(ii), 17 C.F.R. § 230.505(b)(2)(ii) (2007) (no more than 35 purchasers); Rule 501(3)(1)(iv), 17 C.F.R. §230.501 (2007) (accredited investors not included in counting the number of purchasers).

c. Rule 504

Rule 504 exempts offerings of up to $1 million,[236] but Rule 504, like Rules 505 and 506, is subject to the general solicitation restriction.[237] The only exception is if the Rule 504 offering is subject to state registration requirements or sold pursuant to a state exemption that limits sales to accredited investors.[238] One major crowdfunding site, ProFounder, attempted to fit within this rule[239] by limiting access to friends, family members, and preexisting acquaintances of each entrepreneur—in other words, those with whom the issuer has a preexisting relationship.[240] This may solve the general solicitation problem, but it eliminates much of the value of crowdfunding. A publicly accessible crowdfunding offering could not use Rule 504 unless the offering was registered at the state level, and that state registration would be prohibitively expensive.[241]

d. Regulation A

Regulation A is available to offerings by non-reporting companies[242] of up to $5 million.[243] Unlike Regulation D, Regulation A does not prohibit general solicitation. It does, however, require issuers to file a disclosure document,[244] and, like section 5 of the Securities Act, Regulation A includes rather extensive limits on communications with investors, tied to the filing and disclosure requirements.[245] Regulation A is, in effect, a "mini-registration," a less expensive version of what the Act itself requires absent an exemption.[246] Regulation A is not cheap; the average cost of a Regulation A offering in

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[236] Rule 504(b)(2), 17 C.F.R. §230.504(b)(2) (2007).

[237] Rule 502(c), 17 C.F.R. §230.502(c) (2007). The SEC eliminated the general solicitation ban for Rule 504 offerings in 1992, but reinstated it in its current form in 1999. *See* Sjostrom, *supra* note 200, at 25.

[238] Rule 502(c), 17 C.F.R. §230.502(c) (2007) ("Except as provided in § 230.504(b)(1), . . ."); Rule 504(b)(1), 17 C.F.R. §230.504(b)(1) (2007) (sold in one or more states requiring registration and delivery of a disclosure document to investors or pursuant to a state exemption allowing general solicitation in offerings limited to accredited investors).

[239] *See* Lang, *supra* note 108 ("ProFounder facilitates compliance with Regulation D, Rule 504.") As previously discussed, ProFounder is no longer selling securities. *See* text accompanying notes 101-103, *supra*.

[240] Entrepreneurs were instructed to "invite investors who are friends, family, or others who you know in your community." Lang, *supra* note 108. Entrepreneurs were cautioned not to invite anyone with whom the company "does not personally have a substantial, pre-existing personal relationship." *ProFounder Terms and Conditions for Services*, PROFOUNDER, ¶ 3, http://www.profounder.com/legal/terms_and_conditions (last visited July 20, 2011).

[241] *See* Section VII.D, *infra*. *See also* Heminway & Hoffman, *supra* note 144, at 36.

[242] Rule 251(a)(2), 17 C.F.R. § 230.251(a)(2) (2007).

[243] Rule 251(b), 17 C.F.R. § 230.251(a)(2) (2007).

[244] Rules 251(d)(1)(i), 252, 17 C.F.R. § 230.251 (d)(1)(i), 252 (2007).

[245] *See* Rule 251(d), 17 C.F.R. §230.251(d) (2007).

[246] *See* 1 HAZEN, *supra* note 44, at 509 (calling Regulation A a "mini-registration"); 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3A SECURITIES AND FEDERAL CORPORATE LAW 6-67 (2011 rev.) ("The Regulation A procedures are designed to emulate the procedures relating to the filing and processing of registration statements with some insubstantial exceptions.").

1997 was $40,000-60,000.[247] This is too expensive for the very small offerings that crowdfunding attracts.[248]

IV. The Status of Crowdfunding Sites Under Federal Securities Law

The proposals to exempt crowdfunding focus primarily on the offerings themselves and the need for an exemption from Securities Act registration. But crowdfunding can function effectively only through web sites that bring entrepreneurs and potential investors together, and the operation of those sites raises a different set of issues under federal securities law. If the investments offered on crowdfunding sites are securities, the operators of those sites could be brokers subject to regulation under the Exchange Act or investment advisers regulated by the Investment Advisers Act. They would not, however, be regulated as exchanges.

Unfortunately, the definitions of "broker" and "investment adviser" are ambiguous, so the status of crowdfunding sites is uncertain. There is a strong possibility that crowdfunding sites would be brokers and a somewhat smaller chance that they would be investment advisers.

A. Are Crowdfunding Sites Exchanges?

At first blush, crowdfunding sites might seem to be securities "exchanges" required to register under the Exchange Act. Section 3(a)(1) of the Exchange Act defines "exchange" as an "organization, association, or group of persons" that "constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood."[249] Crowdfunding sites bring together investors buying securities and the entrepreneurs selling them and facilitate execution of the sales much as a securities exchange would.

In spite of this superficial resemblance, it is reasonably clear that crowdfunding sites, unless they engage in additional activities, would not be exchanges under federal securities law. Rule 3b-16 provides that, to fall within the definition of exchange, a trading system must, among other things, "[bring] together the orders for securities of

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[247] 1 HAZEN, *supra* note 44, at 512 n. 20. *See also* 24 PRIFTI, *supra* note 202, at 1A-108 (Costs of a Regulation A offering include: filing fee $100; underwriting costs 10-18% of the offering amount; printing costs $7,500-15,000; engraving stock certificates $1,500; legal costs ¾-3% 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 .01% of the offering amount).

[248] "On the small offering end of the Regulation A spectrum, . . . issuers are discouraged from using Regulation A by the complexities of the filing, disclosure, and other requirements and by the difficulties in many instances of meeting state blue sky law requirements. Together, the costs of meeting these federal and state requirements overwhelm any benefit a small business would attain from utilizing Regulation A." Rutheford B Campbell, *Regulation A: Small Businesses' Search for 'A Moderate Capital,'* 31 DEL. J. CORP. L. 77, 111 (2006). *See also* 3A BLOOMENTHAL & WOLFF, *supra* note 246, at 6-49 (Small businesses do not use Regulation A much); Sjostrom, *supra* note 200, at 26 ("preparing a Regulation A offering statement can cost a small company a significant amount of money and management time").

[249] Exchange Act § 3(a)(1), 15 U.S.C. §78c(a)(1).

multiple buyers and sellers."[250] In other words, for a system's trading of a particular security to make it an exchange, there must be more than one person on each side of the transactions in that security. The Commission made it clear that "systems in which there is only a single seller, such as systems that permit issuers to sell their own securities to investors, would not be included within Rule 3b-16."[251]

Crowdfunding sites fit this single-seller model and therefore would not be exchanges. Although each company's security has a large number of buyers, meeting the multiple-buyer requirement, there is only one seller, the issuer itself. Crowdfunding sites list the securities of a number of different sellers, but the question is not whether there are multiple sellers on the site, but whether there are multiple sellers *for a particular security*. According to the SEC, "a system that has multiple sellers, but only one seller for each instrument, . . . would not be considered to meet the "multiple parties" requirement."[252] Unless the sites get involved in post-funding trading of listed company's securities,[253] none of the securities offered would have multiple sellers. Therefore, crowdfunding sites would not be exchanges.

B. Are Crowdfunding Sites Brokers?

Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[254] The Exchange Act provides no further guidance as to what it means to be "engaged in a business" or "effecting transactions in securities." The law in this area is uncertain.[255] Whether an individual or entity is a broker is "one of the more nebulous questions in U.S. securities regulation."[256]

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[250] Exchange Act Rule 3b-16, 17 C.F.R. §200.12b (2011).

[251] Regulation of Exchanges and Alternative Trading Systems, Release No. 34-40760, 63 Fed. Reg. 70844-01, 70849 (Dec. 22, 1998).

[252] Regulation of Exchanges and Alternative Trading Systems, Release No. 34-39884, 63 Fed. Reg. 23504-01, 23508 (Apr. 29, 1998) (interpreting the proposed rule that became Rule 3b-16).

[253] *See* Section VII.C.3, *infra*, for a discussion of issues involving the resale of crowdfunded securities.

[254] Exchange Act § 3(a)(4), 15 U.S.C. §78c(a)(4). The Exchange Act distinguishes a "dealer," who is "engaged in the business of buying and selling securities *for such person's own account*." Exchange Act § 3(a)(15), 15 U.S.C. §78c(a)(15) (emphasis added). A dealer, in other words, acts as a principal, trading for itself, whereas a broker acts as an agent for someone else. However, the distinction "often becomes blurred," with cases and administrative analyses indiscriminately using the two terms together. 15 DAVID A. LIPTON, BROKER-DEALER REGULATION 1-42 (2010).

[255] *See* 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION 5-15 (4th ed. 2009) ("some uncertainty" as to whether finders who bring together two parties who wish to engage in a securities transaction are brokers); 5 HAZEN, *supra* note 44, at 228 ("it is not always easy to tell when a finder's activities would require broker-dealer registration"); Abraham J. B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 136 (2010) ("it is difficult to derive . . . a single, comprehensible framework for evaluating broker-dealer status, and this can be a source of frustration when trying to analyze the regulatory status of new developments").

[256] John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 Ariz. St. L. J. 861, 903 (2005).

The case law is limited, so most of the guidance in this area comes from SEC no-action letters.[257] The SEC staff "does not typically provide a rationale for its position" in those letters, forcing the reader "to speculate which of numerous facts recited in the response and/or letter of inquiry triggered the staff reaction."[258] The analysis is "extremely flexible,"[259] and therefore inherently unpredictable.

It is impossible to state definitively whether crowdfunding sites would be brokers if they hosted securities offerings. None of the major crowdfunding sites has received no-action relief from the SEC. [260] However, the SEC's view of what constitutes a broker is expansive and crowdfunding sites deviate in important ways from what the SEC has allowed in other contexts. Because of this, there is a strong possibility that sites hosting crowdfunded securities offerings would be required to register as brokers.

1. Engaged in the Business

Crowdfunding sites would satisfy the "engaged in the business" part of the definition. To be "engaged in the business," one must be effecting securities transactions with some regularity; a single, isolated transaction does not make one a broker.[261] However, securities transactions need not be the sole, or even the primary, business of the companies operating such sites.[262] One can be a broker even though securities transactions are "only a small part of . . .[one's] . . . business activities."[263]

If the crowdfunding sites are effecting transactions in securities, they undoubtedly are "engaged in the business" of doing so. Their activity is regular; they match investors and entrepreneurs on a continuous basis. And, with the exception of sites like Kiva, which operates on a donation basis, they do so for a business purpose, to earn a profit.[264] Thus, the real question is whether crowdfunding sites are effecting transactions in securities.

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[257] 15 LIPTON, *supra* note 254, at 1-222. No-action letters express the views of the staff and are not the official view of the SEC. 17 C.F.R. § 202.1(d). The SEC does not consider them binding precedent. *Adoption of Section 200.81 (17 CFR 200.81), Concerning Public Availability of Requests for No-Action and Interpretative Letters and the Responses Thereto by the Commission's Staff, and Amendment of Section 200.80 (17 CFR 200.80)*, Securities Act Release No. 33-5098, 1970 WL 10582, at *2 (Oct. 29, 1970). "Nonetheless, as a practical matter, practitioners place significant reliance on" them and "they clearly influence judicial opinions." 15 LIPTON, *supra*, at 1-223, 1-224.

[258] 15 LIPTON, *supra* note 254, at 1-226. "Even comparing the facts cited in one no-action letter with those in numerous other letters does not necessarily indicate which factors were most persuasive for the staff because the staff has placed different emphasis on the same factors at varying times." *Id.*

[259] 15 LIPTON, *supra* note 254, at 1-48.

[260] Prosper, one of the peer-to-peer lending sites, submitted a no-action request shortly after its launch, but withdrew it before the staff responded. Verstein, *supra* note 14, at 19.

[261] SEC v. Kenton Capital, Ltd., 69 F. Supp.2d 1, 12 (D.D.C. 1998) ; Mass. Financial Services, Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass. 1976), *aff'd* 545 F.2d 754 (1st Cir. 1977); 15 LIPTON, *supra* note 254, at 1-42.4-1-42.5; 1 POSER & FANTO, *supra* note 255, at 5-11; 5 HAZEN, *supra* note 44, at 213.

[262] UFITEC, S.A. v. Carter 571 P.2d 990, 994 (Cal. 1977); 15 LIPTON, *supra* note 254, at 1-42.8; 1 POSER & FANTO, *supra* note 255, at 5-11.

[263] SEC v. Kenton Capital, Ltd., 69 F. Supp.2d 1, 13 (D.D.C. 1998).

[264] *See* Section IV.B.2.e, *infra*.

2. Effecting Transactions in Securities

a. General Guidance

What exactly does it mean to effect transactions in securities? The stereotypical stock broker who buys and sells securities on a stock exchange for a customer's account is clearly covered,[265] but crowdfunding sites do not fit that stereotype. The definition also includes companies whose involvement in securities transactions is less direct, "so long as the person participates in significant stages or points of a securities transaction, such as solicitation, structuring, negotiation, and receipt or transmission of funds."[266] The question, broadly phrased, is whether the person has "a certain regularity of participation in securities transactions at key points in the chain of distribution."[267]

It does not matter how the site and its users characterize the site's services. One cannot avoid being a broker "by describing the work . . . in terms which suggest a non broker-client relationship."[268] Therefore, statements such as that on ProFounder's web site that it "is not a broker, dealer or underwriter of securities"[269] have no effect.

An SEC interpretive release cautions that the operators of web sites that match investors with issuers need to consider registration as brokers when those sites are not affiliated with registered broker-dealers.[270] In addition a guide released by the SEC's Division of Trading and Markets warns that anyone finding investors for a company, including venture capital, angel financings, and private placements, may need to register as a broker. [271] The Guide poses four questions, and says a "yes" answer to "any" of the four may indicate a need to register:

- "Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?"
- "Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? . . . Do you receive any other transaction-related compensation?"
- "Are you otherwise engaged in the business of effecting or facilitating securities transactions?"

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[265] *Guide to Broker-Dealer Registration,* Division of Trading and Markets, SEC, (Apr. 2008), *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

[266] 1 POSER & FANTO, *supra* note 255, at 5-14. *See also* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 16-5 (3d ed. 2005).

[267] Mass. Financial Services, Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass. 1976), aff'd 545 F.2d 754 (1st Cir. 1977). *Accord,* SEC v. Martino, 255 F.Supp.2d 268, 283 (S.D.N.Y. 2003); SEC v. National Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

[268] 15 LIPTON, *supra* note 254, at 1-51. *See also* SEC v. Martino, 255 F.Supp.2d 268, 284 (S.D.N.Y. 2003) (finding a broker even though the written agreements described the work as "consulting services").

[269] *ProFounder Terms and Conditions for Services*, PROFOUNDER (Aug. 16, 2010), http://www.profounder.com/legal/terms_and_conditions (¶ 1).

[270] Use of Electronic Media, SEC Release No. 33-7856, 2000 WL 502290, at *12-13 (Apr. 28, 2000).

[271] *Guide to Broker-Dealer Registration,* Division of Trading and Markets, SEC, (Apr. 2008), *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

- "Do you handle the securities or funds of others in connection with securities transactions?"[272]

More specific guidance comes from a series of no-action letters involving Internet- or computer-based matching services that connect entrepreneurs seeking funds with potential investors.[273] The services granted relief in those letters share a number of important features:

- They were run by non-profit entities and any fees collected were used only to cover administrative expenses.
- Fees did not depend on whether a successful match occurred or whether the entrepreneur raised the desired funds.
- The matching site's role was essentially completed when the entrepreneur and the investor were introduced. From that point forward, everything occurred off-site.
- The matching service was not involved in negotiating or closing any transactions between the entrepreneur and investors.
- The matching service did not handle any funds or securities in connection with the financing.
- The matching service provided no advice to either entrepreneurs or investors and did not assist them in completing the financing.

b. Transaction-Based Compensation

Unlike the matching services in the no-action letters, many of the crowdfunding sites charge fees that depend on whether the financing is successful.[274] Kickstarter's fee is five percent of the funds raised; if the fundraising is unsuccessful, entrepreneurs pay no fee.[275] IndieGoGo takes four percent of the funds raised.[276] Prosper and Lending Club each charge a one-percent fee.[277] When ProFounder was selling securities, at least part of its fee apparently depended on whether the offering was successful.[278]

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[272] *Id.*

[273] *See* Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Mid-Atlantic Investment Network, SEC No-Action Letter, 1993 WL 173768, Fed. Sec. L. Rep. Para. 76,651 (May 18, 1993); Private Investor Network, SEC No-Action Letter, 1987 WL 108869 (Oct. 2, 1987, publicly available Nov. 2, 1987); VCN of Texas, SEC No-Action Letter, 1987 WL 108250 (May 18, 1987, Publicly Available June 18, 1987); Venture Match of New Jersey, SEC No-Action Letter, 1987 WL 108917 (May 11, 1988, publicly available June 11, 1988); Atlanta Economic Development Corp., SEC No-Action Letter, 1987 WL 107835 (Feb. 17, 1987, publicly available Mar. 19, 1987); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985).

[274] Kiva, however, operates exclusively on a donation basis; it does not receive a fee from either entrepreneurs or borrowers, although it does accept donations from its lenders. *See About Us,* KIVA, http://www.kiva.org/about (last visited Aug. 23, 2011).

[275] *See Frequently Asked Questions*, KICKSTARTER, www.kickstarter.com/help/faq (last visited Aug. 23, 2011) (under the heading "Fees").

[276] *See Pricing*, INDIEGOGO, http://www.indiegogo.com/about/pricing (last visited Aug. 23, 2011). IndieGoGo actually charges a higher fee (9%) to entrepreneurs who do not meet their funding goals. *See id.*

[277] Prosper Registration Statement, *supra* note 83, at 5; Lending Club Registration Statement, *supra* note 83, at 3.

[278] *See* Section II.A.3, *supra*.

The SEC staff has indicated that transaction-based compensation like this "is a key factor in determining whether a person or entity is acting as a broker-dealer."[279] According to an American Bar Association Task Force, "[t]ransaction-based compensation has come under intense scrutiny by the SEC"[280] and the staff may be moving to a position where transaction-based compensation in connection with a securities transaction is alone sufficient to make one a broker.[281] The staff's concern is apparently that transaction-based compensation would give the person "a 'salesman's stake in the proposed transactions and . . . create heightened incentive for . . . [the person] . . . to engage in sales efforts."[282]

However, it is possible to receive transaction-based compensation in connection with securities transactions and still not be considered a broker. A recent district court case recognized that transaction-based compensation "is the hallmark of a salesman,"[283] but nevertheless held that an individual who received transaction-based compensation for merely bringing people together for a securities transaction was not a broker.[284] And the SEC has occasionally granted no-action relief to finders who received transaction-based compensation. The most well-known of these no-action letters involved the entertainer Paul Anka, who provided the names of potential investors to the Ottawa Senators Hockey Club in return for a finder's fee equal to ten percent of the amount the investors invested.[285]

The Paul Anka letter and the other no-action letters allowing transaction-based compensation involved finders who were not involved in negotiations, consummation of the financing, or transferring funds or securities to effect the deal.[286] Anka, for instance,

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[279] Birchtree Financial Services, Inc., SEC No-Action Letter, 1998 WL 652151 (Sept. 22, 1998). *Accord*, Brumberg, Mackey & Wall, P.C., SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010); Herbruck, Alder & Co., SEC No-Action Letter, 2002 WL 1290291 (May 3, 2002); 1st Global, Inc., SEC No-Action Letter, 2001 WL 499080 (May 7, 2001). *See also* Division of Trading and Markets, SEC, Guide to Broker-Dealer Registration (Apr. 2008) (""Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? . . . Do you receive any other transaction-related compensation?");15 LIPTON, *supra* note 254, at 1-70.1 (listing transaction-based compensation as one factor); 5 HAZEN, *supra* note 44, at 210 (same); SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992) (same).

[280] Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 975 (2005). *See also* Orcutt, *supra* note 256, at 908 (transaction-based compensation has "garnered substantial attention").

[281] *Id.*, at 977. *See also* 1 POSER & FANTO, *supra* note 255, at 5-17 (transaction-based compensation "may be the determinative factor").

[282] Brumberg, Mackey & Wall, P.C., SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010); 1st Global, Inc., SEC No-Action Letter, 2001 WL 499080 (May 7, 2001). *See also* Orcutt, *supra* note 256, at 910; John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 Cath. U. L. Rev. 787, 814 (1991).

[283] SEC v. Kramer, -- F.Supp.2d --, 2011 WL 1230808, at *10 (M.D. Fla. Apr. 1, 2011)

[284] *Id.*, at *12, *14-15 (M.D. Fla. Apr. 1, 2011).

[285] Paul Anka, SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,797, 1991 WL 176891 (July 24, 1991).

[286] *See* Dana Investment Advisers, SEC No-Action Letter, 1994 WL 718968 (Oct. 12, 1994); John DiMeno, SEC No-Action Letter, 1979 WL 13717 (Apr. 1, 1979), reconsidering John DiMeno, SEC No-Action Letter, Fed. Sec. L. Rep. Para. 81,940, 1978 WL 12130 (Oct. 11, 1978); Moana/Kauai Corp., SEC No-Action Letter, 1974 WL 8804 (Aug. 10, 1974).

only provided the names of potential investors to the Club; he did not solicit or even contact the potential investors and was not involved in negotiations between the Club and the investors.[287] David Lipton reads these letters as allowing finders to receive transaction-based compensation only if the finder is "totally isolated from the process of selling the units."[288] In such cases, the incentive "to engage in abusive or sharp selling practices" that transaction-based compensation might otherwise create cannot be acted on.[289]

Finders who go beyond simple introductions risk being treated as brokers if they receive transaction-based compensation. Involvement in structuring or negotiating the terms of a securities transaction would make one a broker under the SEC's analysis.[290] If one receives transaction-based compensation, merely contacting investors and describing the deal in general terms may cross the line between broker and non-broker.[291] Paul Anka had originally proposed to contact the investors to describe the potential investment and forward investors' names to the Club only if they expressed interest. The SEC staff granted the request only after a follow-up letter limited Anka's role to providing names.[292] The SEC staff may not even still accept the limited position it took in the Paul Anka letter.[293] It currently views even the limited activity of introducing a potential buyer and seller of securities "with skepticism when coupled with transaction-based compensation."[294]

Consider, for example, the staff's recent response in *Brumberg, Mackey & Wall, P.C.*[295] A law firm proposed to introduce potential investors to a company seeking financing in return for a percentage of the money raised from those investors. The firm was not going to be involved in negotiations, provide the potential investors with any information about the company, recommend or have any responsibility for the terms of any agreement, or have any other involvement in obtaining financing for the transactions. The staff's response noted that transaction-based compensation "is a hallmark of broker-dealer activity. Accordingly, any person receiving transaction-based compensation in

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[287] *Id.* Anka was doing this on a one-time basis, so, even if he was effecting transactions in securities, he arguably was not in the business of doing so, and would not be a broker for this reason as well.

[288] 15 LIPTON, *supra* note 254, at 1-87.

[289] Orcutt, *supra* note 256, at 910. *Accord*, Polanin, *supra* note 282, at 814; 15 LIPTON, *supra* note 254, at 1-87.

[290] *See., e.g.*, In the Matter of Ram Capital Resources, LLC, Exchange Act Release No. 34-60149, 96 S.E.C. Docket 459, 2009 WL 1723950 (SEC June 19, 2009); Mike Bantuveris, SEC No-Action Letter, 1975 WL 10654 (Sept. 23, 1975); May-Pac Management Co., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,679, 1973 WL 10806 (Nov. 20, 1973); Fulham & Co., SEC No-Action Letter, 1972 WL 9129 (Nov. 20, 1972).

[291] See Richard S. Appel, SEC No-Action Letter, 1983 WL 30911 (Jan. 13, 1983) (denying a no-action request from a finder whose only role would be to contact existing business associates and friends, describe potential oil and gas investments in general terms, and provide the approximate cost of drilling a well).

[292] Paul Anka, SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,797, 1991 WL 176891 (July 24, 1991).

[293] *See* Task Force on Private Placement Broker-Dealers, *supra* note 280, at 977 ("Based on staff comments at a recent Business Law Section meeting, the SEC staff may . . . be reconsidering its position in the Paul Anka letter situation and might not issue such a letter today.")

[294] *Id.*, at 966.

[295] Brumberg, Mackey & Wall, P.C., SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010).

connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer."[296]

As discussed below, crowdfunding sites typically do more than just bring entrepreneurs together with potential investors. They solicit investors and are actively involved in the resulting transactions. This, coupled with transaction-based compensation, puts them at serious risk of being treated as brokers.

Unfortunately, a relatively recent district court case muddies the water and casts doubt on the validity of the SEC staff's position with respect to transaction-based compensation. In *SEC v. M & A West, Inc.*,[297] the defendant worked with the shareholders of private companies to identify suitable public companies for reverse mergers, actually prepared the documents for those transactions, and coordinated among the parties.[298] The defendant (or his nominees) received shares in the completed transactions for his work,[299] clearly transaction-based compensation, but the court nevertheless held that he was not a broker. According to the court, although the defendant facilitated securities transactions, his actions were not "effecting" transactions in securities.[300]

c. Involvement in the Transactions

The extent of a site's involvement in the actual securities transactions is also important. The matching sites and other finders approved in the favorable no-action letters merely brought investors and entrepreneurs together. Once that introduction was made, the matching site's work was done. The site "was not assisting the purchase or sale of specific securities,"[301] and was not otherwise involved in the transactions.[302]

Crowdfunding sites do more than just bring entrepreneurs and investors together. They provide a platform for investors and entrepreneurs to negotiate; they facilitate ongoing communications between investors and entrepreneurs; and they transmit funds and investment documents back and forth between investors and entrepreneurs. That, coupled with the receipt of transaction-based compensation, could be enough to make them brokers.

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[296] *Id.* Even in this letter, it is hard to isolate transaction-based compensation as the sole determining factor. The staff also believed that the firm's introduction of only contacts with a potential interest in the company would necessarily involve some "pre-selling" of the company and some "pre-screening" of potential investors. *Id.*

[297] 2005 WL 1514101 (N.D. Cal. June 20, 2005).

[298] *Id.*, at *3.

[299] *Id.*, at *3-4.

[300] *Id.*, at *9. The court granted summary judgment to the defendant sua sponte.

[301] 15 LIPTON, *supra* note 254, at 1-100 to 1-101.

[302] *Id.*, at 1-102.

(1) Providing advice or recommendations

Providing advice or recommendations to investors is a factor in deciding whether one is a broker,[303] but most crowdfunding sites provide only general advice, and do not recommend or rate particular investment opportunities. Kickstarter, for example, provides general advice to investors about how to avoid fraud.[304] And some of the sites do provide general advice to entrepreneurs about how to structure a successful fundraising campaign. The Kickstarter site, for example, includes advice about how much money to ask for and "the secret" to successful fundraising.[305] IndieGoGo and ProFounder offer general advice about how to create a fundraising campaign and what to offer in return for contributions.[306]

Other crowdfunding sites provide more specific advice to entrepreneurs and investors. Both Lending Club and Prosper rate borrowers, effectively advising investors as to the quality of the loans. ProFounder, before it quit offering securities, helped entrepreneurs structure and complete their offerings. It agreed to make a good faith effort "to provide all documents necessary for compliance with securities and other laws applicable to Company's issuance of securities and Investor's PRIVATE investment," although it noted that compliance was ultimately the entrepreneur's responsibility.[307] ProFounder also provided term sheets and "compliance tools" to entrepreneurs[308] and helped entrepreneurs track compliance requirements and filing fees.[309]

(2) Structuring the transaction

Involvement in structuring a securities transaction is another factor pointing toward broker status.[310] Prosper and Lending Club each specify the terms of the loans on their sites.[311] Other sites restrict the structure of the resulting transaction. IndieGoGo and ProFounder, for example, limit how long a funding request may be open.[312] ProFounder required quarterly payments to investors and imposed a five-year limit on how long an

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[303] 1 POSER & FANTO, *supra* note 255, at 5-12; 5 HAZEN, *supra* note 44, at 210; 15 LIPTON, *supra* note 254, at 1-70.1; Task Force on Private Placement Broker-Dealers, *supra* note 280, at 975.

[304] *See* Frequently Asked Questions, KICKSTARTER, www.kickstarter.com/help/faq (last visited Aug. 23, 2011) (under the heading "Fees"). (heading Pledging).

[305] *See Start Your Project,* KICKSTARTER, http://www.kickstarter.com/start (last visited Aug. 23, 2011).

[306] *See Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011); Lang, *supra* note 108.

[307] *ProFounder Terms and Conditions for Services*, PROFOUNDER, http://www.profounder.com/legal/terms_and_conditions (¶ 4) (last visited Aug. 16, 2011). *See* Lang, *supra* note 108 ("ProFounder facilitates compliance with Regulation D, Rule 504.")

[308] *See Why Crowdfund?*, PROFOUNDER, http://www.profounder.com/entrepreneurs/why_crowdfund (last visited Jan. 27, 2011).

[309] *See* Lang, *supra* note 108.

[310] Orcutt, *supra* note 256, at 904-905; Division of Trading and Markets, SEC, *supra* note 279.

[311] *See generally* Prosper Registration Statement, *supra* note 83; Lending Club Registration Statement, *supra* note 83.

[312] *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited July 11, 2011) (Tab Creating a Campaign; "FAQs") (120-day limit); *FAQs*, PROFOUNDER, http://www.profounder.com/entrepreneurs/faq (last visited Jan. 27, 2011) (30-day limit).

entrepreneur could share returns with investors.[313] ProFounder also allowed entrepreneurs to exit their commitments early only if they paid investors twice their investment.[314]

(3) Receipt or transmission of funds/continued involvement after the financing

The receipt or transmission of funds or securities is another criterion considered in determining whether someone is a broker.[315] All of the major crowdfunding sites actually collect funds from investors and forward them to the entrepreneurs.[316] The sites where entrepreneurs offer financial rewards also transfer those funds back to investors.[317] Sites are also involved in other ways after completion of the transaction. At ProFounder, entrepreneurs had to report their revenues on a quarterly basis and even upload their tax returns each year to verify the reported revenues.[318] Similarly, Kickstarter and IndieGoGo encourage entrepreneurs to post project updates.[319]

(4) Involvement in negotiations

Another relevant factor is involvement in negotiations between investors and entrepreneurs. A person involved in the negotiation of securities transactions is "virtually always" treated as a broker.[320] Crowdfunding sites are not actively involved in negotiations between the entrepreneurs who list on the sites and potential investors. The communications portals on crowdfunding sites obviously facilitate negotiations, but merely facilitating the exchange of information or documents is not sufficient to make one a broker.[321]

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[313] Lang, *supra* note 108.

[314] *Id.* However, this early repayment option is not done through the ProFounder web site. *Id.*

[315] 15 LIPTON, *supra* note 254, at 1-43. *See also* SEC v. Margolin, 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992) ("possessing client funds and securities"); 1 POSER & FANTO, *supra* note 255, at 5-12 ("taking custody of clients' funds and securities"); Division of Trading and Markets, SEC, *Guide to Broker-Dealer Registration* (Apr. 2008) ("Do you handle the securities or funds of others in connection with securities transactions?")

[316] *See, e.g.,* Frequently Asked Questions, KICKSTARTER, www.kickstarter.com/help/faq (last visited Aug. 23, 2011) (under the heading "Pledging").; *How Kiva Works*, *supra* note 74 (About Us at "Contributing to Campaigns" tab); *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011); Lang, *supra* note 108 (ProFounder).

[317] *See, e.g., How Kiva Works*, *supra* note 74; Lang, *supra* note 108.

[318] *See* Lang, *supra* note 108.

[319] *See Frequently Asked Questions*, KICKSTARTER, www.kickstarter.com/help/faq (last visited Aug. 23, 2011)(under the Project Updates heading); *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011)(under the tab "Creating a Campaign").

[320] 15 LIPTON, *supra* note 254, at 1-74. *See also* 1 POSER & FANTO, *supra* note 255, at 5-12 (listing involvement in negotiations as a factor pointing towards broker status); 5 HAZEN, *supra* note 44, at 210 (same).

[321] Task Force on Private Placement Broker-Dealers, *supra* note 280, at 978.

d. Solicitation and Advertising

Another factor relevant to broker status is whether the person is actively advertising or otherwise soliciting investors.[322] Solicitation is defined fairly broadly; the question is whether the possible broker is contacting investors with whom it has a preexisting relationship or is actively identifying previously unknown third parties.[323] A public web site, by definition, is engaged in continued public solicitation, even if it does not otherwise advertise. And "mere repeated advertising to purchase or sell securities would trigger the broker-dealer registration requirement."[324]

However, the SEC staff has approved several web-based electronic matching systems, so a web presence alone is not sufficient to make one a broker. The line between acceptable and unacceptable solicitation and advertising is hazy. The SEC "has not provided much guidance on what activities constitute solicitation or advertising sufficient to trigger broker-dealer registration.[325] For example, the SEC staff granted no-action relief to Venture Capital Resources, Inc., which planned to publicize its system through one-on-one discussions with potential investors, asking CPAs and attorneys if they had clients who might be interested, a "selected mailing program," press releases, advertisements, and distributing brochures through local financial institutions.[326] Another non-profit matching service granted relief planned to publicize the system through accounting firms, law firms, local universities, and non-profit organizations interested in economic development, as well as by distributing pamphlets and brochures to interested individuals and groups.[327] But another SEC staff response indicated that a for-profit web site would be a broker because, among other things, it "actively solicits investors to purchase oil and gas interests (for example, by targeting potential investors with direct mailings and follow-up e-mail)."[328]

e. For-Profit Status

Finally, many crowdfunding sites are for-profit entities. Almost all of the no-action letters have involved "state instrumentalities, private non-profit corporations, and quasi-governmental organizations,"[329] and the staff has generally required representations that these systems would be run solely on a cost-recovery basis, and not for profit.[330] For-profit status does not automatically make one a broker. The SEC staff has granted no-action relief to a few private matching sites, but none of those sites received transaction-

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[322] 15 LIPTON, *supra* note 254, at 1-42.13; 1 POSER & FANTO, *supra* note 255, at 5-12; 5 HAZEN, *supra* note 44, at 210; Task Force on Private Placement Broker-Dealers, *supra* note 280, at 975; SEC v. Margolin, 1992 WL 279735, at *5 (S.D.N.Y. Sept. 30, 1992); SEC v. National Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

[323] Orcutt, *supra* note 256, at 914.

[324] 15 LIPTON, *supra* note 254, at 1-42.13.

[325] Task Force on Private Placement Broker-Dealers, *supra* note 280, at 979.

[326] Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985). *See also*

[327] Atlanta Economic Development Corp., SEC No-Action Letter, 1987 WL 107835 (Feb. 17, 1987).

[328] Oil-N-Gas, Inc., SEC No-Action Letter, 2000 WL 1119244 (June 8, 2000).

[329] Polanin, *supra* note 282, at 821.

[330] *Id.*, at 821.

based compensation and, in all those cases, the ultimate securities transactions were negotiated and completed, and funds transferred, off the site.[331]

3. Conclusion: Would Crowdfunding Sites Be Brokers?

What is one to make of all this? Given the messy state of the law, no definitive answer is possible, but there is a very strong possibility that crowdfunding sites would be considered brokers if they listed offerings of securities. The crowdfunding sites' receipt of transaction-based compensation, continued involvement in the investor-entrepreneur relationship, public advertising, and for-profit status may cumulatively be too much to avoid broker status.

C. Are Crowdfunding Sites Investment Advisers?

Crowdfunding sites might also be investment advisers within the meaning of the Investment Advisers Act of 1940. Unfortunately, what "investment adviser" means in this context is as unclear as what "broker" means; if anything, there is less guidance available on the investment-adviser question. Two issues must be addressed: (1) do crowdfunding sites fall within the general definition of investment adviser; and (2) if they do, does the "publisher" exception in that definition exclude them?

1. The General Definition of Investment Adviser

The basic definition of investment adviser, in Section 202(a)(11) of the Investment Advisers Act,[332] has two parts, either of which suffices to make one an investment adviser. First, a person is an investment adviser if he, "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[333] Alternatively, a person is an investment adviser, if he, "for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[334] Under either part of the definition, three basic requirements must be met:

(1) The person must be providing advice or issuing reports or analyses concerning securities;
(2) The person must be in the business of doing so; and
(3) The person must be doing so for compensation.[335]

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[331] *See* Investex Investment Exchange Inc., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 79,649, 1990 WL 286331 (Apr. 9, 1990); Petroleum Information Corp., SEC No-Action Letter, 1989 WL 246625 (Nov. 28, 1989); Internet Capital Corp., SEC No-Action Letter, 1997 WL 796944 (Dec. 24, 1997). *Compare* OilOre.com, SEC No-Action Letter, 2000 WL 546573 (April 21, 2000) (no-action relief refused to a for-profit entity that was to receive compensation contingent on the investor making an investment).

[332] Investment Advisers Act § 202(a)(11), 15 U.S.C. §80b-2(a)(11)(2007).

[333] Investment Advisers Act § 202(a)(11), 15 U.S.C. §80b-2(a)(11)(2007).

[334] *Id.*

[335] Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. IA-1092, 52 Fed. Reg. 38400-01, 38402, 1987 WL 154624 (Oct. 16, 1987) [hereinafter "Investment Advisers Release"]; U.S. v. Elliott, 62 F.3d 1304, 1309-10 (11th Cir. 1995).

Crowdfunding sites clearly would meet the last two requirements; the first is more difficult.

2. In the Business

The business requirement is phrased slightly differently in the two parts of section 202(a)(11). The first alternative uses the phrase "engages in the business" and the second alternative requires that the analysis be given "as part of a regular business,"[336] but the SEC interprets the business element identically for both parts of the definition.[337]

Some regularity is required; isolated instances of investment advice do not make one an investment adviser.[338] But investment advice does not have to be the person's principal business, as long as the advice is given on a regular basis.[339] Crowdfunding sites would undoubtedly meet this regularity requirement. If their services constitute securities advice or analysis, they are providing that service on an ongoing, regular basis.

As with broker status, transaction-based compensation is important. The SEC has indicated that a person meets the "business" requirement if he "receives transaction-based compensation if the client implements the investment advice."[340] Thus, it is reasonably clear that for-profit crowdfunding sites would meet the "business" requirement.

3. For Compensation

For one to be an investment adviser, the advice or analysis must be provided for compensation.[341] Any economic benefit is sufficient to meet this requirement; the adviser does not have to charge a separate fee for the advisory portion of the services.[342] Most crowdfunding sites charge a fee of some kind, whether it's a flat fee, a percentage of the amount raised, or interest.[343] This would satisfy the compensation requirement.[344]

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[336] Investment Advisers Act § 202(a)(11), 15 U.S.C. §80b-2(a)(11)(2007).

[337] Investment Advisers Release, *supra* note 335, at 38402.

[338] Investment Advisers Release, *supra* note 335, at 38402; Zinn v. Parrish, 644 F.2d 360 (7th Cir. 1981); 7 HAZEN, *supra* note 44, at 29.

[339] Investment Advisers Release, *supra* note 335, at 38402; 7 HAZEN, *supra* note 44, at 27; THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS 5 (2011).

[340] According to the SEC, a person is in the business if he "(i) holds himself out as an investment adviser or as one who provides investment advice, (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, *or* receives transaction-based compensation if the client implements in the investment advice, *or* (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice." Investment Advisers Release, *supra* note 335, at 38402 (emphasis added).

[341] "The rendering of investment advice without compensation is likely to take the person rendering the advice out from under the purview of the Investment Advisers Act." 7 HAZEN, *supra* note 44, at 29.

[342] Investment Advisers Release, *supra* note 335, at 38403; U.S. v. Elliott, 62 F.3d 1304, 1311 (11th Cir. 1995); LEMKE & LINS, *supra* note 339, at 4; Thomas v. Metropolitan Life Ins. Co., 631 F.3d 1153, 1164 (10th Cir. 2011).

[343] Kiva is an exception. It funds itself through donations.

[344] "If a website offering investment advice grants access only to those who pay a subscription fee, clearly its sponsor is receiving compensation for investment advice." FRIEDMAN, *supra* note 266, at 17-5.

4. Advice, Analyses, or Reports Concerning Securities

Most crowdfunding sites are not offering advice "as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[345] They may, however, be issuing "analyses or reports concerning securities,"[346] assuming that securities are being offered on the site. But the case law and guidance from the SEC are simply too uncertain to offer a definitive conclusion.

Consider first the advice portion of the definition. Most of the existing crowdfunding sites do not advise investors as to the merits of particular opportunities, or evaluate or rate the potential investments. Advice does not have to relate to specific securities to make one an investment adviser.[347] A discussion of the relative advantages of investing in securities rather than other investments would suffice,[348] but crowdfunding sites typically do not even do this.

The obvious exceptions are Prosper and Lending Club, which assign ratings to individual loans. If Prosper and Lending Clubs were selling those loans directly to lenders, as they did prior to registration, the case for investment adviser status would be strong. Their current pass-through programs cloud the analysis. Now, they are, in effect, commenting on the value of their own notes, not advising investors as to securities issued by others. Almost every issuer of securities discusses the value of the securities it issues; if that were enough to make one an investment adviser, then every company would be an investment adviser. Thus, as long as the SEC continues to treat Prosper and Lending Club as the "issuers" of these securities, it is difficult to see them as investment advisers.

For the other crowdfunding sites, the problem, if there is one, comes under the second part of the definition. Crowdfunding sites may be issuing "analyses or reports concerning securities." The SEC staff has indicated that someone providing investors with statistical data on companies or a listing of investment opportunities is not issuing analyses or reports if

> (1) the information is readily available to the public in its raw state;
> (2) the categories of information presented are not highly selective; and
> (3) the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security.[349]

Friedman notes that the question would be more difficult if the web site were funded only by advertisements. *Id.*

[345] *See* Investment Advisers Act § 202(a)(11), 15 U.S.C. §80b-2(a)(11)(2007).

[346] *Id.*

[347] Investment Advisers Release, *supra* note 335, at 38402.

[348] *Id. See also* LEMKE & LINS, *supra* note 339, at 6-7.

[349] *See, e.g.*, Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995); Media General Financial Services, Inc., SEC No-Action Letter, 1992 WL 198262 (July 20, 1992); Investex Investment Exchange Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,649, 1990 WL 286331 (Apr. 9, 1990); Charles Street Securities, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 78,424, 1987 WL 107616 (Jan. 28, 1987). *See generally* LEMKE & LINS, *supra* note 339, at 7; Friedman, *supra* note 266, at 17-3.

These requirements seem problematic for crowdfunding sites. The entrepreneur's information is not readily available to the public other than through the crowdfunding site. And the whole point of the listing is to suggest that investors purchase a security by investing in the entrepreneurs' companies. However, the SEC staff has granted no-action relief to several matching services. Like crowdfunding sites, those matching services are created to promote the purchase of entrepreneurs' securities and, as with crowdfunding sites, the information provided by those small business entrepreneurs is not typically publicly available.

No cases directly address whether crowdfunding sites are investment advisers, but other investment-adviser cases support treating crowdfunding sites as investment advisers. Two cases have held that general partners' financial reports to limited partners on the status of the partnerships' investments constituted investment advice for purposes of the definition.[350] Those reports, like the company reports available to investors on some crowdfunding sites, included financial statements and a calculation of investors' returns.[351] Even though the defendants were not offering the limited partners any actual advice in these reports, only providing performance data, the courts concluded that the Advisers Act applied because the limited partners would use the reports to decide whether to continue their investments in the partnership.[352] Similarly, even though crowdfunding sites are not advising investors to invest in a particular company, they are providing the reports the investors will use to make investment decisions.

Most crowdfunding sites, however, do not independently generate reports on the companies listed; they merely post funding requests and other information produced by the entrepreneurs themselves. Because they function as mere conduits for this information and do not create anything themselves, they arguably are not providing any "advice" or "analyses" or "reports" at all. However, at least two cases have rejected this "mere conduit" argument. In *SEC v. Wall Street Transcript Corp.*,[353] the defendant published a weekly tabloid containing verbatim reprints of reports on securities issued by brokers. The district court concluded that "there can be no doubt that, for purposes of the . . . [Investment Advisers Act], . . . [the defendant] . . . 'issues' analyses and reports concerning securities . . That a publication acts as a mere conduit for investment advice written by others obviously does not insure against the possibility that the publisher will engage in the fraudulent activities the Act was designed to prevent."[354] Similarly, in *Zinn v. Parrish*,[355] a sports agent occasionally transmitted to one of his clients securities recommendations made by others.[356] The court held that the agent was not "in the

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[350] *See* Abrahamson v. Fleschner, 568 F.2d 862, 870 (2d Cir. 1977); SEC v. Saltzman, 127 F.Supp.2d 660, 669 (E.D. Pa. 2000).

[351] *See* Abrahamson v. Fleschner, 568 F.2d at 866; SEC v. Saltzman, 127 F.Supp.2d at 669.

[352] In those cases, the general partners were also actually making investment decisions for the partnership, but both courts seemed to see the reports themselves as sufficient to make one an investment adviser.

[353] 454 F. Supp. 559 (S.D.N.Y. 1978).

[354] *Id.*, at 565. However, after finding that the defendant fell within the general definition of investment adviser, the court concluded that the exception in that definition for publishers was available. *Id.*, at 567. *See* Section IV.C.6, *infra* (discussion of the exception for publishers).

[355] 644 F.2d 360 (7th Cir. 1981).

[356] *Id.*, at 364.

business" of offering investment advice, but noted that, if the agent had passed along such recommendations more regularly, he might be an investment adviser.[357]

5. SEC No-Action Letters

The primary source of guidance on the investment adviser issue is SEC no-action letters. The SEC staff has issued a large number of no-action letters to companies that either attempt to match investors and entrepreneurs[358] or merely present investment opportunities for investors' unguided choice.[359] The staff has dealt with so many no-action requests in this area that it is no longer responding to them "unless they present novel or unusual issues."[360] In granting these requests, the staff has emphasized a number of features of these services without explaining why the particular feature matters:[361]

- the network is operated by a non-profit organization;[362]
- the network does not give any advice on the merits or shortcomings of particular investments,[363] or otherwise endorse, analyze, or recommend the listed investment opportunities;[364]

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[357] *Id.*, at 364.

[358] *See* Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Technology Capital Network, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 76,273, 1992 WL 175694 (June 5, 1992); Heartland Venture Capital Network, SEC No-Action Letter, available at http://intelliconnect.cchy.com, File No. 060187009 (March 26, 1987); Venture Capital Network of New York, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 78,381, 1986 WL 67371 (Oct. 10, 1986); University of Arkansas, SEC No-Action Letter, 1986 WL 67354 (Sept. 26, 1986); Investment Contacts Network, SEC No-Action Letter, 1986 WL 68350 (Aug. 25, 1986); Venture Capital Exchange, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 78,310, 1986 WL 66613 (March 24, 1986); Indiana Institute for New Business Ventures, Inc., Fed. Sec. L. Rep. (CCH) [1985-86 Transfer Binder] ¶ 78,189 (Dec. 11, 1985); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985); Venture Capital Network, Inc., Fed. Sec. L. Rep. Para. 77,660, 1984 WL 45334 (Apr. 5, 1984)

[359] *See* Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995); Investex Investment Exchange Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,649, 1990 WL 286331 (Apr. 9, 1990); Petroleum Information Corp., SEC No-Action Letter, 1989 WL 246625 (Nov. 28, 1989); Richmond Venture Capital Network, Inc., SEC No-Action Letter, 1989 WL 246296 (May 12, 1989).

[360] *See* Environmental Capital Network, 1995 SEC No-Act. LEXIS 1030 (Dec. 28, 1995); Colorado Capital Alliance, Inc., Fed. Sec. L. Rep. Para. 77,051, 1995 WL 271123 (May 4, 1995); Missouri Innovation Center, Inc., 1995 WL 643949 (Oct. 17, 1995); Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993).

[361] Almost all of the letters share these common features. The following notes cite to letters where the staff expressly noted the feature in granting the investment adviser relief.

[362] Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Venture Capital Exchange, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 78,310, 1986 WL 66613 (March 24, 1986). *But See* Technology Capital Network, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 76,273, 1992 WL 175694 (June 5, 1992) (non-profit status "is not solely determinative" of whether a company is an investment adviser).

[363] Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Venture Capital Exchange, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 78,310, 1986 WL 66613 (March 24, 1986); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985).

[364] Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995).

- the network receives only a small application fee, typically used to offset administrative costs,[365] and no employees of the network will receive any compensation based on the outcome of investment transactions;[366]
- the network is not involved in negotiating any purchase or sale,[367] and will not provide any information concerning how to complete a transaction;[368]
- the network does not handle any funds or securities involved in completing a transaction.[369]

Thomas Hazen reads these no-action letters as allowing the use of "passive" bulletin boards to post information about securities as long as two conditions are met: (1) the bulletin boards are not involved in any negotiations regarding investments arising from using of the bulletin board; and (2) the board operator gives no advice "regarding the merits or shortcomings of any particular trade."[370] Thomas Lemke and Gerald Lins add a third condition: the bulletin board operator may not "receive compensation in connection with the purchase or sale of any stock listed on the bulletin board."[371]

Crowdfunding sites differ from these approved matching networks in several ways that make it more likely they will be treated as investment advisers. Crowdfunding sites typically are operated for profit, not by a non-profit institution. They often charge transaction-based compensation. Although the site operator does not directly participate in negotiations, negotiation and completion of the transactions occurs on the crowdfunding site, not directly between the investor and the entrepreneur. And crowdfunding sites do handle funds and securities; both the initial investments and the returns paid to investors flow through the site. Whether these differences are enough to make crowdfunding sites investment advisers is unclear.

One important distinction between crowdfunding sites and matching services points in the opposite direction. Matching services, by definition, attempt to match investors with suitable offerings. When a match is made, the service is, in effect, "advising" the investor that the particular offering fits the investor's needs. Crowdfunding sites do not typically screen investment opportunities in that way. Investors can see all of the opportunities and

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[365] Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985). In Heartland Venture Capital Network, SEC No-Action Letter, available at http://intelliconnect.cchy.com, File No. 060187009 (March 26, 1987), the staff indicated that the fee need not be a one-time fee; a renewal fee is acceptable.

[366] Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Technology Capital Network, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 76,273, 1992 WL 175694 (June 5, 1992).

[367] Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Capital Resources Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985).

[368] Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985).

[369] Venture Capital Resources, Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985, publicly available Nov. 25, 1985).

[370] 7 HAZEN, *supra* note 44, at 30.

[371] LEMKE & LINS, *supra* note 339, at 10.

it is up to the investor to screen the opportunities. The element of "advice or "analysis" is arguably missing.

The SEC staff has granted no-action relief to several sites that merely posted available opportunities, with no attempt to match investors to those opportunities,[372] but those sites differed in other important ways from crowdfunding sites. Moreover, only one no-action letter suggests that this distinction is important. In its response to Venture Capital Network, Inc.,[373] the staff indicated that a matching network was issuing analyses or reports concerning securities because it "represents that, on the basis of the investors' responses to the questionnaire drawn up by VCN and the information provided by the entrepreneurs in response to questionnaires drawn up by VCN, the information provided by VCN concerns an investment opportunity in a company or companies which satisfy the investors' indicated investment criteria."[374] Crowdfunding sites do not ordinarily do that, but, given the limited discussion, it is unclear if that is enough to keep them from being investment advisers.

6. The Publisher Exception

Section 202(a)(11) of the Investment Advisers Act contains several exceptions to the general definition of investment adviser. One of those exceptions, the subsection (D) exception for "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation,"[375] might apply to crowdfunding sites. The exception covers "publications," but it is "clear that the exclusion for publishers is not limited to publications or paper media."[376] It has been applied to Web sites,[377] Internet postings,[378] electronic messages,[379] and a private video information network,[380] so Internet-based crowdfunding sites could potentially use it.

The United States Supreme Court outlined the parameters of the subsection (D) exclusion in 1985 in *Lowe v. SEC*.[381] According to the Court, Congress "was primarily interested in

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[372] *See* Missouri Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995); Investex Investment Exchange Inc., SEC No-Action Letter, Fed. Sec. L. Rep. Para. 79,649, 1990 WL 286331 (Apr. 9, 1990); Petroleum Information Corp., SEC No-Action Letter, 1989 WL 246625 (Nov. 28, 1989); Richmond Venture Capital Network, Inc., SEC No-Action Letter, 1989 WL 246296 (May 12, 1989).

[373] Fed. Sec. L. Rep. Para. 77,660, 1984 WL 45334 (Apr. 5, 1984).

[374] *Id.*

[375] Investment Advisers Act § 202(a)(11)(D), 15 U.S.C. §80b-2(a)(11)(D)(2007).

[376] FRIEDMAN, *supra* note 266, at 17-7.

[377] SEC v. Park, 99 F.Supp.2d 889 (N.D. Ill. 2000) (rejecting the application of the subsection (D) exception for other reasons).

[378] *See* SEC v. Park, 99 F. Supp.2d 889, 894-896 (N.D. Ill. 2000) (rejecting the application of the subsection (D) exception for other reasons).

[379] *See* SEC v. Terry's Tips, Inc., 409 F.Supp.2d 526 (D. Vt. 2006) (holding that the publisher exception applies to non-personalized e-mail, but nevertheless finding the defendants to be investment advisers); Mr. Russell H. Smith, SEC No-Action Letter, 1996 WL 282564 (May 2, 1996) (noting that a person providing advice through electronic mail could qualify for the publisher exception).

[380] *See* Reuters Information Services, SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 79,695, 1991 WL 176539 (Jan. 17, 1991) (applying the publisher exception to a private video information network).

[381] 472 U.S. 181 (1985).

regulating the business of rendering personalized investment advice."[382] Communications that "do not offer individualized advice attuned to any specific portfolio or to any client's particular needs" are not within the purpose of the Act,[383] and are at least presumptively within the subsection (D) exclusion.[384] A few cases since *Lowe* have concluded that publications offering non-personalized advice to investors are not investment advisers.[385]

The SEC staff derives three requirements from *Lowe*. The publication must

> (1) offer only impersonalized advice, i.e., advice not tailored to the individual needs of a specific client or group of clients;
> (2) be 'bona fide' or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and
> (3) be of general and regular circulation, i.e., not timed to specific market activity or to events affecting or having the ability to affect the securities industry.[386]

Crowdfunding sites clearly do not offer personalized investment advice. Everyone who enters a publicly available crowdfunding site receives exactly the same information. In fact, unlike most of the electronic matching services, most crowdfunding sites do not even attempt to collect information about investors that would allow them to match investors to particular offerings. Therefore, crowdfunding sites would fall within the publisher exception if they are "bona fide" and "of general and regular circulation."[387] These two requirements, according to *Lowe*, are designed to eliminate "hit and run tipsters" and "touts" from using the exception.[388] According to the Court, the exception is intended for publications that "contain disinterested commentary and analysis as opposed to promotional material disseminated by a 'tout.'"[389]

Crowdfunding sites are not designed to tout particular stocks; they are open to any entrepreneur who wishes to raise money and the sites do not attempt to promote particular issues. Moreover, they are not "personal communications masquerading in the

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[382] *Id.*, at 204.
[383] *Id.*, at 208. Prior to *Lowe*, courts made no distinction between personal and impersonal investment advice in applying subsection (D). Lani M. Lee, *The Effects of Lowe on the Application of the Investment Advisers Act of 1940 to Impersonal Investment Advisory Publications*, 42 BUS. LAW. 507 (1987)
[384] *Lowe* might be interpreted to require that one offer personalized advice to be an investment adviser at all, but the majority opinion clearly indicates that "on its face, the basic definition applies to petitioners." 472 U.S. at 203-204. Thus, the better reading is that the distinction between personalized and impersonal advice relates to the publisher exception. David B. Levant, *Financial Columnists as Investment Advisers: After Lowe and Carpenter*, 74 CAL. L. REV. 2061, 2093 (1986). *See also* SEC v. Park, 99 F.Supp.2d 889, 894-895 (N.D. Illinois) (holding that publications that do not offer personalized advice could still be investment advisers if the publications are not bona fide).
[385] *See* Compuware Corp. v. Moody's Investors Services, Inc., 273 F. Supp. 2d 914 (E.D. Mich. 2002); SEC v. Wall Street Publishing Institute, 664 F. Supp. 554 (D.D.C. 1986).
[386] Nito GmbH, SEC No-Action Letter, 1996 WL 473433 (Aug. 9, 1996). *See also, e.g.*, Mr. Russell H. Smith, SEC No-Action Letter, 1996 WL 282564 (May 2, 1996); InTouch Global, LLC, SEC No-Action Letter, Fed. Sec. L. Rep. Para. 77,209, 1995 WL 693301 (Nov. 14, 1995); David Parkinson, Ph.D., SEC No-Action Letter, 1995 WL 619930 (Oct. 19, 1995).
[387] *See* Investment Advisers Act § 202(a)(11)(D), 15 U.S.C. §80b-2(a)(11)(D)(2007).
[388] 472 U.S. at 206.
[389] *Id.*, at 206.

clothing of" general publications.[390] Every investor receives exactly the same content. However, the materials on crowdfunding sites are not "disinterested commentary;" they are intended to be "promotional." The whole point of the entrepreneurs' postings is to convince people to invest, and the crowdfunding sites, which receive transaction-based compensation, have a pecuniary interest in investors following that "advice." This alone may be sufficient to preclude application of the publisher exception.[391]

Unfortunately, the case law in this area is a little confused. One district court opinion has essentially read the "bona fide" requirement out of the *Lowe* opinion, holding that publications that did not offer individualized advice were not investment advisers even though they "do not contain completely disinterested commentary, and do contain promotional material."[392] And another district court held that a magazine was a bona fide publication that fit within the exception even though much of the magazine's content was provided by featured companies and their public relations agents.[393]

To fall within the publisher exception, crowdfunding sites must also be of general and regular circulation. Web sites are, by definition, continually published and crowdfunding sites are open to the general public. But the Supreme Court indicated that a publication is not regular if its publication is "timed to specific market activity, or to events affecting or having the ability to affect the securities industry."[394] It is not clear exactly what this means in the context of a web site. Although crowdfunding sites are continually available, they are changed each time an entrepreneur posts a new fundraising request. Thus, in a sense, each "new edition" of the site is timed to specific market activity—a new securities offering by an entrepreneur. The SEC might seize on this to argue that crowdfunding sites are not regularly published, and therefore do not qualify for the exception.

V. Proposals to Exempt Crowdfunding

As crowdfunding has grown, proponents of crowdfunding have, not surprisingly, turned their attention to federal securities law and the possibility of selling securities through crowdfunding. Several proposals have been made to exempt crowdfunding from

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[390] *Id.*, at 209.

[391] *See* SEC v. Laurins, 930 F.2d 920 (Table), Memorandum opinion *available at* 1991 WL 57933, at *2 (9th Cir. Apr. 16, 1991) (where the publisher of an investment report had an undisclosed pecuniary interest in the advice contained in the report, the publication was not bona fide, and the publisher therefore was an investment adviser); SEC v. Park, 99 F.Supp.2d 889 (N.D. Illinois 2000) (publication may not be bona fide, and therefore may not be entitled to the publisher exception, where the defendants were promoting stocks "in which they either had an interest or for which they were being paid to recommend without revealing their interests").

[392] SEC v. Terry's Tips, Inc. 409 F.Supp.2d 526, 532 (D. Vt. 2006). The court still held that the defendants were investment advisers because of individualized advice they gave to individual investors in phone calls and e-mail. *Id.*, at 532.

[393] *See* SEC v. Wall Street Publishing Institute, Inc., 664 F. Supp. 554, 555 (D.D.C. 1986), reversed on other grounds, 851 F.2d 365 (D.C. Cir. 1988). The magazine is described in any earlier opinion, SEC v. Wall Street Publishing Institute, 591 F. Supp. 1070, 1075-77 (D.D.C. 1984), stayed, 1984 WL 21133 (D.C. Cir. Aug. 10, 1984).

[394] *Id.*, at 209.

Securities Act registration. Even the White House has endorsed a crowdfunding exemption.

These crowdfunding exemption proposals, including President Obama's, are sketchy. At best, they represent bare frames on which an exemption could be erected. But all of them share two common features: (1) an overall cap on the dollar amount of the offering; and (2) a limit on the amount each investor may invest.

The SEC, under pressure from Congress, had agreed to look at crowdfunding even before the White House announcement. But the White House endorsement definitely raises the ante and makes it more likely that the SEC will act.

A. The Sustainable Economies Law Center Petition

The first exemption proposal came in 2010. The Sustainable Economies Law Center petitioned the SEC to exempt offerings of up to $100,000, provided that no single investor contributed more than $100.[395] The proposed exemption includes additional limitations: (1) the offerors must be individual U.S residents, not entities; (2) each offeror may make only one offering at a time; and (3) all offering materials and communications must include a disclaimer "stating the possibility of total loss of the investment, and the necessity of careful evaluation of each offeror's trustworthiness."[396] The petition itself is an illustration of the power of crowdfunding; it was funded by a campaign on the crowdfunding web site, IndieGoGo.[397]

The Center's petition argues that the Securities Act registration requirements "impose considerable hurdles" on "low-budget creative ventures"[398] and that the proposed exemption could be "a powerful source of grassroots and local funding for developing small businesses."[399] It points to existing crowdfunding ventures, and argues that allowing crowdfunders to receive a financial participation in the ventures they funded would make these sites "even richer sources of innovation and capital formation."[400]

The petition argues that the $100 individual investment limit would prevent investors "from incurring significant financial risk" because "[e]ven a total loss of $100 is unlikely to be financially crippling for anyone."[401] Further, the required disclaimer would ensure that investors were aware of this risk.[402] The Center also argues that allowing only individuals, and not companies, to use the exemption would limit fraud because the

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[395] *Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration*, SEC, File No. 4-605, *available at* http://www.sec.gov/rules/petitions.shtml.
[396] *Id.*, at 7.
[397] *See Crowdfunding Campaign to Change Crowdfunding Law*, INDIEGOGO, http://www.indiegogo.com/Change-Crowdfunding-Law (last visited Aug. 23, 2011); Lawton & Marom, *supra* note 3, at 187-188.
[398] *Id.*, at 1.
[399] *Id.*, at 2.
[400] *Id.*, at 3-4.
[401] *Id.*, at 7.
[402] *Id.*

identity of each offeror could be verified and no one could "hide behind a corporate shell."[403]

The SEC dutifully logged the petition[404] and began accepting comments. Aided by a mention on the BoingBoing blog,[405] the petition has generated dozens of individual comments, almost all supportive, plus almost a hundred form comments.[406] The petition even has its own web site.[407] Moreover, the final report of the 2010 SEC Government-Business Forum on Small Business Capital Formation recommended an exemption like this, although the recommendation does not specifically name the Center.[408]

B. The Small Business & Entrepreneurship Council Proposal

Near the end of 2010, the Small Business & Entrepreneurship Council proposed a similar exemption.[409] The Council's exemption was also included in, but not directly endorsed by, the final report of the most recent Annual SEC Government-Business Forum on Small Business Capital Formation.[410]

The maximum offering amount under the Council's proposal would be $1 million and the maximum for any individual investor would be either $10,000 or ten percent of the person's prior year "stated income."[411] Offerings could be made on SEC-approved web sites.[412] To participate in such an offering, an investor would be required to take an online

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[403] *Id.*

[404] *See Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration*, SEC, File No. 4-605, *available at* http://www.sec.gov/rules/petitions.shtml.

[405] *See* Paul Spinrad. *Crowdfunding Exemption Action: File No. 4-605*, BOINGBOING (Jul. 3, 2010, 3:26 AM), http://www.boingboing.net/2010/07/03/sec-crowdfunding-exe.html.

[406] *See Comments on Rulemaking Petition: Request for rulemaking to exempt securities offerings up to $100 from registration under Section 5 of the Securities Act of 1933*, SEC, http://www.sec.gov/comments/4-605/4-605.shtml (last visited May 9, 2011). Some of those comments proposed raising the maximum offering amount and the maximum individual investment. *See, e.g.*, the comments of Michael Sauvante (Nov. 9, 2010); James J. Angel (Sept. 21, 2010); Andres La Saga (Aug. 24, 2010), *available at Comments on Rulemaking Petition: Request for rulemaking to exempt securities offerings up to $100 from registration under Section 5 of the Securities Act of 1933*, SEC, http://www.sec.gov/comments/4-605/4-605.shtml (last visited May 9, 2011). *See also* Pope, *supra* note 100, at 124 (discussing the SELC proposal and arguing that the per-investor cap should be increased to $1,000 and the aggregate offering limit should be increased to $250,000).

[407] *See* Change Crowdfunding Law, http://crowdfundinglaw.com/ (last visited Aug. 21, 2011).

[408] The Forum's Priority 15A is to "exempt from 1933 Act registration aggregate offerings of up to $100,000, where each individual may invest no more than a certain maximum amount, say $100 per individual." *2010 Annual SEC Government-Business Forum on Small Business Capital Formation, Final Report 21*, SEC (June 2011), *available at* http://www.sec.gov/info/smallbus/gbfor29.pdf.

[409] The *SBE Council Proposal*, SEC, *available at* http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf.

[410] *See 2010 Annual SEC Government-Business Forum on Small Business Capital Formation, Final Report 29-30*, SEC (June 2011), *available at* http://www.sec.gov/info/smallbus/gbfor29.pdf.

[411] *Id.*, at 4. It is not clear from the proposal exactly what "stated income" means or whether the individual limit is the greater or the lesser of the two amounts.

[412] *Id.*, at 5. The Council's proposal suggests that the organizations hosting such sites vet the issuers and investors, which could create issues under the Investment Advisers Act. That aspect of the Council's proposal is not discussed here.

test, but, if the Council's single proposed question for this test is representative, the test is more an interactive disclaimer than a test of investment sophistication. The Council's proposed question asks whether investors understand that all of their capital is at risk.[413] The Council's proposed exemption would not completely free issuers from SEC disclosure requirements. Issuers would have to provide disclosure on something similar to the Small Company Offering Registration (SCOR) form used by the states.[414]

The Council argues that the current law stifles "all but a select few" startups, in addition to only allowing "the super elite to participate as investors/lenders to businesses, which effectively locks out the average American from helping businesses in their own community."[415] The Council argued that the antifraud rules would protect investors,[416] and that, in any event, the companies that would use the proposed rule "are small enough and transparent enough to prevent fraud."[417]

C. The Startup Exemption Proposal

Entrepreneur Sherwood Neiss[418] has created an on-line petition in favor of another crowdfunding exemption.[419] The petition calls for a $1 million exemption, available only to businesses with annual gross revenues over the last three years of $5 million.[420] All investors would have "to complete a questionnaire to determine their aptitude to participate . . . and answer a series of disclosures" to demonstrate they have sufficient knowledge and experience to invest.[421] Unaccredited investors would not be able to invest more than $10,000.[422] The platforms hosting these offerings would be required to register with the SEC, but would not need a broker's license.[423] Offerings pursuant to the exemption would also be exempted from state registration requirements, but would have to file a notice with the states.[424]

D. The White House Proposal

On September 8, 2011, the White House released a "Fact Sheet and Overview" detailing President Obama's proposed job-creating measures.[425] Buried in that ten-page document

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[413] *See id.*, at 5.
[414] *See id.*, at 4. The SCOR form is *available at SCOR Forms,* NASAA, http://www.nasaa.org/industry___regulatory_resources/corporation_finance/564.cfm (last visited July 20, 2011).
[415] *Id.*, at 1.
[416] *Id.*, at 3.
[417] *Id.*, at 4.
[418] *See About Us*, STARTUP EXEMPTION, http://www.startupexemption.com/?page_id=91#axzz1T9YWT6vM (last visited Aug. 3, 2011).
[419] *See* Startup Exemption, http://www.startupexemption.com/#axzz1T9YWT6vM.
[420] Exemption Framework ¶ 1, Startup Exemption, http://www.startupexemption.com/?page_id=92#axzz1T9YWT6vM.
[421] Exemption Framework ¶ 3, Startup Exemption, *supra* note 447.
[422] Exemption Framework ¶ 2, Startup Exemption, *supra* note 447.
[423] Exemption Framework ¶¶ 6, 8, Startup Exemption, *supra* note 447. It is unclear exactly what this registration would entail.
[424] Exemption Framework ¶ 5, Startup Exemption, *supra* note 447.
[425] Office of the Press Secretary, *supra* note 8.

is a single sentence about crowdfunding: "The administration also supports establishing a 'crowdfunding' exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to $10,000 or 10% of investors' annual income) . . . ."[426] No further details are provided. The proposed offering and individual investment limits obviously match those in the Small Business & Entrepreneurship Council proposal, but the release neither acknowledges that proposal nor indicates whether the President supports the other requirements in that proposal.

E. H.R. 2930

On September 14, 2011, Congressman Patrick McHenry introduced H.R. 2930, which would add to the Securities Act a new statutory exemption for crowdfunding.[427] H.R. 2930 would exempt offerings of $5 million or less, with individual investments limited to the lesser of $10,000 or 10 percent of an investor's annual income. Issuers could rely on investors' self-certifications of their income. Offerings sold pursuant to the exemption would also be exempted from state registration requirements.

Shortly after Congressman McHenry introduced the bill, the House Oversight and Government Reform Committee's Subcommittee on TARP, Financial Services & Bailouts of Public and Private Entities held hearings on crowdfunding.[428]

F. The SEC Response

The SEC has not yet proposed a crowdfunding exemption or officially responded to any of the exemption proposals detailed above. However, even before the White House release and the House Subcommittee hearing, the SEC had agreed to consider crowdfunding.

On March 22, 2011, Congressman Darrell Issa, chairman of the House Committee on Oversight and Government Reform, sent a seventeen-page letter to Mary Schapiro, chairman of the SEC, criticizing the SEC's treatment of private capital formation and posing a number of questions about regulation and the capital formation process.[429] Congressman Issa's letter specifically asked whether the SEC had considered creating exemptions for crowdfunding.[430]

Chairman Schapiro responded to Congressman Issa on April 6, 2011.[431] She told Issa that she was creating a new Advisory Committee on Small and Emerging Companies and that the SEC staff was "taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation."[432] She

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[426] *Id.*, at 2.
[427] H.R. 2930 (Sept. 14, 2011).
[428] A video of the hearing is available at http://www.youtube.com/watch?v=_IwvL_K1LMM.
[429] *Letter from Darrell E. Issa to Mary L. Schapiro* (March 22, 2011), *available at* KNOWLEDGE MOSAIC, www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf [hereinafter, "Issa Letter"].
[430] Issa Letter, *supra* note 429, at 11.
[431] *Letter from Mary Schapiro to Darrell E. Issa*, SEC (April 6, 2011), *available at* www.sec.gov/news/press/schapiro-issa-letter-040611.pdf [hereinafter, "Schapiro Letter"].
[432] Schapiro Letter, *supra* note 431, at 1.

noted the Sustainable Economies Law Center proposal for a crowdfunding exemption,[433] said the SEC staff had been discussing crowdfunding,[434] and promised a staff review of "the impact of our regulations on capital formation for small businesses," specifically including "the regulatory questions posed by new capital raising strategies."[435]

Prior to President Obama's endorsement, this promise probably should not have caused undue optimism among crowdfunding's supporters. The SEC often pays lip service to the needs of small business, but it seldom acts on those concerns.[436] Its annual forum on small business has produced "repeated and strongly-worded recommendations from small business advocates to lessen the SEC's regulatory burdens on raising capital . . .[, but] with rare exception . . . [the SEC] has turned a deaf ear to the Forum's recommendations and concerns."[437] But President Obama's commitment makes a crowdfunding exemption much more likely. At the House subcommittee hearing, Meredith Cross, director of the SEC's Division of Corporation Finance, indicated that she expects the SEC to consider crowdfunding in the near future.[438]

G. The SEC's Exemptive Authority

The SEC clearly has the authority to exempt crowdfunding from the registration requirements of the Securities Act and to exempt crowdfunding web sites from registration as brokers or investment advisers.

Two separate provisions of the Securities Act would give the SEC the authority to exempt crowdfunding from the Act's registration requirements. Section 3(b) of the Securities Act[439] authorizes the SEC to exempt offerings of less than a specified dollar amount, currently $5 million.[440] To authorize a section 3(b) exemption, the SEC must find that "enforcement . . . with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[441] The SEC has used its section 3(b) authority rather extensively; Rules 504 and 505 of Regulation D are both section 3(b) exemptions,[442] as is Regulation A.[443]

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[433] Schapiro Letter, *supra* note 431, at 22 n. 77.
[434] *Id.*, at 22-23.
[435] *Id.*, at 24.
[436] *See* Cohn & Yadley, *supra* note 13, at 64 ("Despite SEC profession of interest in small business, there has been a great deal more smoke than fire.")
[437] *Id.*, at 3.
[438] Yin Wilczek, *SEC Under Pressure to Allow Crowdfunding; Agency to Consider Issue Soon, Official Says*, BNA Corporate Law Daily (Sept. 16, 2011).
[439] Securities Act § 3(b), 15 U.S.C. § 77c(b).
[440] The Sustainable Economies Law Center petition points to section 3(b) as a potential source of authority. *See Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration*, *supra* note 425, at 8-9. The Center also argued that its proposed exemption could be a safe harbor for section 4(2) of the Securities Act, *id.*, at 9, a doubtful proposition give how section 4(2) has been interpreted. *See* Section III.B.2.a, *supra*.
[441] *Id.*
[442] *See* Rules 504(a) and 505(a), 17 C.F.R. §§ 230.504(a), 230.505(a).
[443] *See* Rule 251, 17 C.F.R. § 230.251.

The SEC's authority under section 28 of the Securities Act is even broader; section 28 authorizes the SEC to exempt "any person, security, or transaction, or any class or classes of persons, securities, or transactions," from any provision of the Act or associated rules.[444] Unlike section 3(b), section 28 does not limit the dollar amount of exempted offerings. To use its section 28 exemptive authority, the SEC must find that "such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors."[445]

The SEC has similar authority to exempt brokers, regulated under the Exchange Act, and investment advisers, regulated under the Investment Advisers Act. Section 36(a) of the Exchange Act authorizes the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions" from any provisions of the Act.[446] To adopt such an exemption, the SEC would have to find that it "is necessary or appropriate in the public interest, and . . . consistent with the protection of investors."[447] Section 202(a)(11) of the Investment Advisers Act, which defines "investment adviser," authorizes the SEC to exclude "other persons not within the intent of the definition."[448] More broadly, section 206A of the Advisers Act authorizes the SEC to "conditionally or unconditionally exempt any person or transaction, or any class or classes of persons, or transactions," provided that the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this Act."[449]

VI. The Costs and Benefits of Crowdfunding

A crowdfunding exemption, like any securities law exemption, involves a complicated balancing of two sometimes conflicting goals—investor protection and capital formation.[450] The SEC has long seen its mission as "investor protection in the sense of remedying information asymmetries and rooting out fraud,"[451] but all of the SEC's foundational statutes require it to consider, "in addition to the protection of investors, whether . . . [the SEC's] . . . action will promote efficiency, competition, and capital

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[444] Securities Act § 28, 15 U.S.C. § 77z-3.
[445] *Id.*
[446] Exchange Act § 36(a), 15 U.S.C. §78mm(a) (2010). There is an exception to the SEC's authority involving government securities and government securities brokers. Exchange Act § 36(b), 15 U.S.C. §78mm(b) (2010). That exception would not apply to crowdfunding.
[447] Exchange Act § 36(a), 15 U.S.C. §78mm(a).
[448] Investment Advisers Act § 202(a)(11)(G), 15 U.S.C. §80b-2(a)(11)(G) (2010).
[449] Investment Advisers Act § 206A, 15 U.S.C. §80b-6a(2010).
[450] *See* generally C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L. J. 591 (1996) (discussing the costs and benefits of registration and the justifications for exemptions from the registration requirement).
[451] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: the SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. Ill. L. Rev. 975, 1005 (2006). *See also* Stephen Choi, *Regulating Investors, Not Issuers: A Market-Based Proposal*, 88 Cal. L. Rev. 279, 280 (2000) ("Securities regulation in the United States revolves around investor protection.")

formation."[452] Balancing those competing interests is the "fundamental challenge of securities regulation,"[453] and the SEC usually tilts the balance in favor of investor protection.[454]

A crowdfunding exemption would, without a doubt, benefit capital formation. Very small businesses, particularly startups, have an unmet need for capital. Securities crowdfunding would help fill that capital gap.

The investor-protection consequences of a crowdfunding exemption are less clear. Small business investments are inherently risky, posing not only greater risks of business failure, but also of fraud and overreaching by controlling entrepreneurs. A crowdfunding exemption would expose to those risks a general public that, on the whole, lacks the financial sophistication necessary to deal with them. The structure of crowdfunding might, to some extent, ameliorate those risks, but not completely. Crowdfunding investors would still face a significant risk of loss.

But some of that risk is inherent in business startups; someone is going to bear it, with or without a crowdfunding exemption. The only way to completely eliminate it is to bar all small business financing. And the crowdfunding exemption proposals are structured so that losses to any single investor would be relatively small and bearable. Moreover, the public is already contributing billions of dollars to non-securities crowdfunding, and those crowdfunding investments are subject to the same risks that would affect securities crowdfunding. A securities crowdfunding exemption would, therefore, not open investors to new risks, but merely allow entrepreneurs to offer a higher return to offset those risks. The net effect on investors could be positive.

A. Capital Formation: The Need for a Crowdfunding Exemption

Small businesses face a capital funding gap.[455] Some estimates indicate that the financial markets fall $60 billion short each year "in meeting the demand of small companies for early-stage private equity financing,"[456] and equity capital is "widely viewed as less accessible and more costly per dollar raised for small businesses compared with large

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[452] Securities Act § 2(b), 15 U.S.C. §77b(b) (2010); Securities Exchange Act § 3(f), 15 U.S.C. §78c(f) (2010); Investment Company Act § 2(c), 15 U.S.C. §80a-2(c) (2010); Investment Advisers Act § 203(c), 15 U.S.C. §80b- 2(c) (2010).

[453] Paredes, *supra* note 451, at 1005.

[454] *Id.*, at 1006. According to Paredes, now himself an SEC commissioner, securities regulators "have an exaggerated concern over fraud and investor losses and, at least by comparison, a dulled sensitivity to the costs of greater investor protection." *Id.*, at 1009. Recently, several of the SEC's rules have been overturned because of the Commission's failure to adequately consider the cost of the rules. *See* Business Roundtable v. SEC, -- F.3d --, 2011 WL 2936808 (D.C. Cir. July 22, 2011); American Equity Investment Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

[455] Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 59-64 (1998); Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (2008); Cable, *supra* note 255, at 108.

[456] Sjostrom, *supra* note 200, at 3; GAO Report, *supra* note 202, at 2.

businesses."[457] Funding is particularly difficult for businesses seeking to raise funds in the $100,000-$5 million range.[458] Entrepreneurs with promising projects go unfunded, costing the U.S. an unknown number of jobs and innovations.[459] Early-stage entrepreneurial activity in the United States is steadily declining and the U.S. has lost its lead over other innovation-driven economies.[460]

The small business financing problem has at least two causes. The first cause is informational inefficiency—a failure to match potential sources of capital with potential investment opportunities.[461] Even if money is available, it will go unused if the entrepreneur who needs money fails to connect with the investors who have it. Currently, and not surprisingly, the major sources of small business funding tend to be geographically restricted.[462] Crowdfunding allows an entrepreneur to publish her request for funding to the world, "mak[ing] it . . . easier to harness spare capital and route it to those who need it most."[463]

The second element of the capital gap is the unavailability of traditional sources of small business financing—bank lending, venture capitalists, and angel investors—to startups and other very small businesses. Entrepreneurs typically begin new ventures using personal funds, including savings, credit card debt, and second mortgages, and money from friends and family.[464] Some entrepreneurs might raise $100,000, or even $500,000, from those personal sources,[465] but the amount available from such sources is significantly less for other entrepreneurs. Many entrepreneurs with good ideas have little access to funds; innovative ideas are not limited to the upper and middle classes.

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[457] U.S. General Accounting Office, Report to the Chairman, Comm. on Small Business, U.S. Senate, Small Business Efforts to Facilitate Equity Capital Formation 3 (Sept. 2000). *See also* Fisch, *supra* note 455, at 63 (Small business funding "is often viewed as inadequate."); Sjostrom, *supra* note 202, at 586 (Financing options available to small companies "are generally viewed as inadequate.").

[458] Ibrahim, *supra* note 455, at 1417 (amounts above $100,000); GAO Report, *supra* note 202, at 12-13 ($250,000-$5 million); Cable, *supra* note 255, at 108 ($500,000-$5 million).

[459] Curtis J. Milhaupt, *The Small Firm Financing Problem: Private Information and Public Policy*, 2 J. SMALL & EMERGING BUS. L. 177, 178 (1998); Sjostrom, *supra* note 200, at 3.

[460] Abdul Ali, et al, *Global Entrepreneurship Monitor: 2009 National Entrepreneurial Assessment for the United States of America: 2009 Executive Report* 7 (2010), *available at* http://www.gemconsortium.org/files.aspx?Ca_ID=112 (click on GEM United States 2009 Executive Report link) [hereinafter "National Entrepreneurial Assessment"]. The amount of total early-stage entrepreneurial activity in the United States dropped from 10.6% in 2005 to 6.9% in 2009. *Id.*, at 7. Nascent entrepreneurial activity declined from 8.7% of the U.S. population in 2005 to 4.9% in 2009. *Id.*, at 33.

[461] Sjostrom, *supra* note 200, at 3-4.

[462] *See* GAO Report, *supra* note 202, at 493 (venture capitalists); SIMON C. PARKER, THE ECONOMICS OF ENTREPRENEURSHIP 249-250 (2009) (angel investors).

[463] Howe, *supra* note 2, at 248. A study of Dutch crowdfunding site Sellaband found that only 13.5% of successful crowdfunders' capital came from investors within 50 kilometers of the entrepreneur. Almost 40% of the amounts received came from investors more than 3,000 kilometers away. Ajay Agrawal, Christian Catalini, and Avi Goldfarb, *The Geography of* Crowdfunding Table 2a, 22 (Jan. 6, 2011), *available at* http://ssrn.com/abstract=1692661.

[464] National Entrepreneurial Assessment, *supra* note 460, at 8; Fisch, *supra* note 455, at 60; Sjostrom, *supra* note 200, at 5. *See also* PARKER, *supra* note 462, at 250 ("Families are the most commonly used source of business loans in the USA after banks and other financial institutions.")

[465] *See* Ibrahim, *supra* note 455, at 1417; Cable, *supra* note 255, at 108.

When those personal sources are exhausted, funding is difficult to find. Other common sources of business financing are not available to small start-ups. Bank loans are one possible source of capital, but most small startups do not have the collateral, the cash flow, or the operating history to qualify for bank loans.[466]

Venture capital funds are another possible source of funding,[467] but most venture capitalists focus on companies that have passed the initial start-up phase and are seeking to grow further.[468] Less than a quarter of venture capital investments are for early-stage funding.[469] Venture capital funding is also not available in the small amounts that new companies need,[470] and the problem is worsening as the average minimum amount invested by venture capital funds has increased.[471] A typical venture capital investment averages between $2 and $10 million.[472] Venture capitalists sometimes provide smaller amounts,[473] but high transaction costs usually make smaller investments impractical.[474] Venture capital investments also tend to focus on selected industries,[475] and on firms with a potential for rapid growth,[476] and venture capitalists are extremely selective, rejecting 99% of the business plans submitted to them.[477]

So-called "angel investors," wealthy individuals with substantial business and entrepreneurial experience,[478] are the other major possibility. Angel investors often invest on a smaller scale than venture capital firms,[479] and they are also more willing to invest in start-up companies.[480] A typical financing round for an angel investor ranges from $100,000 to $2 million.[481] Some angels may be willing to provide as little as $25,000,[482] but one source indicates that the minimum deal size for most angel investors in the

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[466] Fisch, *supra* note 455, at 60; Cable, *supra* note 255, 121; Sjostrom, *supra* note 200, at 5; George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L. Q. 1029, 1032 (1992).
[467] For a good, short introduction to the venture capital industry, *see* Cable, *supra* note 255, at 112-115.
[468] Fisch, *supra* note 455, at 62; Ibrahim, *supra* note 455, at 1416.
[469] GAO Report, *supra* note 202, at 21.
[470] *See* GAO Report, *supra* note 202, at 3; Ibrahim, *supra* note 455, at 1416; Cohn & Yadley, *supra* note 13, at 80-81.
[471] GAO Report, *supra* note 202, at 13. One source claims that the total amount of venture capital funding has also declined recently, from $106 billion in 2000, to $40 billion in 2001 and $30.5 billion in 2007. PARKER, *supra* note 462, at 238.
[472] Ibrahim, *supra* note 455, at 1416.
[473] *See* GAO Report, *supra* note 202, at 11 (amounts ranging from $250,000 to $5 million).
[474] Dent, *supra* note 466, at 1080.
[475] GAO Report, *supra* note 202, at 3.
[476] Fisch, *supra* note 455, at 62; GAO Report, *supra* note 202, at 10.
[477] GAO Report, *supra* note 202, at 20; Fisch, *supra* note 455, at 20.
[478] Sjostrom, *supra* note 200, at 5.
[479] Fisch, *supra* note 455, at 62; Cable, *supra* note 255, at 115.
[480] GAO Report, *supra* note 202, at 10; Ibrahim, *supra* note 455, at 1406. According to Amatucci and Sohl, the percentage of angel deals involving the seed and startup stages of business was 45% in 2004, 52% in 2003, and 50% in 2002. F. M. Amatucci & J. E. Sohl, *Business Angels: Investment Processes, Outcomes and Current Trends*, in A. ZACHARAKIS AND S. SPINELLI, JR., 2 ENTREPRENEURSHIP: THE ENGINE OF GROWTH 87, 88 (2007).
[481] Ibrahim, *supra* note 455, at 1418; Sjostrom, *supra* note 200, at 6. *See also* Amatucci & Sohl, *supra* note 480, at 88 (2007) (average angel investment of $470,000 in 2004)..
[482] GAO Report, *supra* note 202, at 10.

United States is about $1 million.[483] And angel investors, like venture capitalists, generally look for "high-growth, high-return investment opportunities,"[484] so many small companies would not qualify. Angel investors by themselves are not currently filling the small business funding gap.[485]

Crowdfunding makes new sources of capital available to small businesses.[486] It opens business investment to smaller investors who have not traditionally participated in private securities offerings. Those investors have less money to invest, so they would be willing to fund smaller business opportunities that the venture capitalists and angel investors would not touch. Crowdfunding also gives poorer entrepreneurs whose friends and family lack the wealth to provide seed capital somewhere else to turn.

But what about the other benefits that venture capitalists and angel investors provide to small business entrepreneurs? In addition to the capital they invest, venture capitalists and angel investors typically provide companies with managerial and monitoring services.[487] If those sources of funding "are replaced by dispersed passive public investors, the collateral monitoring and managing services are likely to be eliminated."[488] However, crowdfunding is not a substitute for venture capital or angel investing; it is aimed at entrepreneurs who do not have access to such funding. The entrepreneurs most likely to engage in crowdfunding would not, in any event, have access to the other services that venture capitalists and angel investors provide.

Crowdfunding is no panacea. It will not completely eliminate the capital gap. It will, however open investment to new sources of capital and provide a platform that allows investors with unused capital to connect with entrepreneurs who need it.

B. Investor Protection: The Effect of Crowdfunding on Investors

Crowdfunding sites make it possible for relatively unsophisticated members of the general public to invest in particularly risky ventures. Investor protection is, therefore, an important issue. Crowdfunding, properly structured, can ameliorate some, but not all, of the risk, but investments in small businesses, whether or not those investments are facilitated through crowdfunding, are inherently risky. Crowdfunding investors will often lose money.

However, at the margin, the cost to investors of a crowdfunding exemption is likely to be low. Investors are already contributing substantial amounts of money to unregulated crowdfunding offerings, although not for securities. Those crowdfunding investments are subject to the same risk of loss as crowdfunded securities, but do not offer the upside

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[483] PARKER, *supra* note 462, at 249.
[484] GAO Report, *supra* note 202, at 10.
[485] *See generally* Cable, *supra* note 255 (suggesting regulatory changes to enable more angel investing).
[486] *See* Heminway and Hoffman, *supra* note 144, at 45-46 (arguing that crowdfunding "enables entrepreneurs to more quickly and easily identify supporter investors who are willing and able to fund their businesses or projects").
[487] PARKER, *supra* note 462, at 239-240; Fisch, *supra* note 455, at 84; Ibrahim, *supra* note 455, at 1419; GAO Report, *supra* note 202, at 11.
[488] Fisch, *supra* note 455, at 86.

potential of a securities investment. Allowing crowdfunding entrepreneurs to sell securities would, therefore, be a net gain to investors, increasing the possibility of gains without any increase in the risk. Investors could actually be better off with a crowdfunding exemption.

1. The Risks of Small Business Investment

Investing in small businesses is very risky. Small business investments are illiquid, and small businesses, especially start-ups, are much more likely to fail than more established companies. Losses due to fraud and self-dealing are also much more likely.

Small businesses pose a disproportionate risk of fraud.[489] The abuses in the penny stock market in the 1980s "typify the securities fraud potential associated with direct marketing of microcap securities to individual investors."[490] The SEC's experience in the 1990s when it eased the requirements of the Rule 504 small offering exemption may be instructive. In New York, which has no state registration requirement, "Rule 504 was . . . used by nefarious promoters to distribute up to $1 million of securities in New York to a select favored group, followed promptly by boiler-room promotions that artificially drove up the secondary market price until such time as the initial purchasers could sell their shares at a handsome profit, leaving the gullible crop of new investors with suddenly deflated shares and irrecoverable losses."[491]

Even absent fraud, investors in small businesses must deal with potential agency costs and problems of opportunism that arise from uncertainty and information asymmetry.[492] Uncertainty is inherent in start-up businesses. At the time of investment, "virtually all of the important decisions bearing on the company's success remain to be made, and most of the significant uncertainties concerning the outcome of the company's efforts remain unresolved."[493] The entrepreneur will typically have a business plan laying out a strategy but, at the start-up phase, that plan is little more than a "best guess."[494] Major strategic decisions remain to be made[495] by a management whose quality is unknown to investors.[496] The entrepreneur's intentions and abilities are "not easily observable by an investor and difficult for an entrepreneur to communicate credibly."[497] In the case of high-technology companies, there may also be uncertainty about the technology itself, which the entrepreneur is almost certain to understand better than most investors.[498]

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[489] Fisch, *supra* note 455, at 58; Sjostrom, *supra* note 202, at 586.
[490] Fisch, *supra* note 455, at 82.
[491] SEC, Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 1999 WL 95490, at *2 (Feb. 25, 1999), ; Cohn & Yadley, *supra* note 13, at 71.
[492] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076-77 (2003); Ibrahim, *supra* note 455, at 1407; Cable, *supra* note 255, at 121-22 (2010).
[493] Gilson, *supra* note 492, at 1076-77.
[494] Cable, *supra* note 255, at 121-22.
[495] Cable, *supra* note 255, at 122.
[496] Gilson, *supra* note 492, at 1077.
[497] Cable, *supra* note 255, at 122. *See also* Gilson, *supra* note 492, at 1077.
[498] Gilson, *supra* note 492, at 1077.

In short, the entrepreneur holds all the cards. Investors have little information about what is to come and little control over what the entrepreneur does. This presents the opportunities for self-dealing, excessive compensation, misuse of corporate opportunities, and dilution of investors' interests with which all students of closely-held businesses are familiar.[499]

Sophisticated venture capital funds deal with these problems by negotiating control rights and negative covenants requiring investor approval for certain actions.[500] Staged financing complements these protections.[501] Entrepreneurs and investors "recognize that the company will need additional rounds of financing" requiring the cooperation of the venture capitalists.[502] The need to go back to investors for future funding constrains the entrepreneur.

Most crowdfunding investors will not have the sophistication to negotiate for control rights or protective covenants. Even if they were sophisticated enough to desire such protection, it's not clear how they would negotiate for it, or whether it would be worth their effort. The small amount invested by each crowdfunding investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiations.[503]

Even in the absence of fraud or self-dealing, many crowdfunded small businesses will fail. The small start-ups to whom crowdfunding appeals pose a disproportionate risk of business failure.[504] Approximately 80% of new businesses "either fail or no longer exist within five to seven years of formation."[505] Even the small businesses selected by sophisticated venture capital funds are predominantly failures: one-third of those companies end up in bankruptcy; another third meet their expenses but are unable to go public or pay significant dividends.[506]

Investors in start-ups also face a liquidity risk; there is no ready public resale market for their investments.[507] Crowdfunding sites will not provide such a trading market; if they do, they might have to register as exchanges or alternative trading systems.[508] Therefore,

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[499] *See* Dent, *supra* note 466, at 1052-1057.

[500] Gilson, *supra* note 492, at 1074; Ibrahim, *supra* note 455, at 1407; Dent, *supra* note 490, at 1035, 1044-61.

[501] Gilson, *supra* note 492, at 1074.

[502] Dent, *supra* note 466, at 1065.

[503] "From a general perspective, crowdfunding practices raise questions with respect to corporate governance and investor protection issues if most individuals only invest tiny amounts. Crowdfunders are most likely offered very little investor protection. This may lead to corporate governance issues, which in turn may turn into reputation concerns if some cases of fraud or bad governance are uncovered. Crowdfunders have very little scope to intervene to protect their interests as stakeholders. Moreover, the fact that their investment is small is likely to create a lack of incentive to intervene." Belleflamme, et al, *supra* note 12, at 26.

[504] Sjostrom, *supra* note 202, at 586; Fisch, *supra* note 455, at 58; FRIEDMAN, *supra* note 266, at 306.

[505] GAO Report, *supra* note 202, at 19.

[506] Dent, *supra* note 490, at 1034. Only about 10% of investments by venture capital funds actually meet their expected rate of return. GAO Report, *supra* note 202, at 19.

[507] Fisch, *supra* note 455, at 79; Cable, *supra* note 255, at 122; Dent, *supra* note 466, at 1045.

[508] Crowdfunding sites that facilitate resales would thereby be bringing together multiple buyers and sellers, increasing the likelihood that they would be exchanges. *See* Section IV.A, *supra*.

investors may have to wait quite a while to realize any return.[509] Crowdfunding sites often require repayment within a few years,[510] which limits the illiquidity problem, but may exacerbate the risk of failure. Entrepreneurs may be forced to repay investments before their business has developed sufficiently to do so. And, if start-ups take a while to become profitable, the short repayment periods may preclude much profit-sharing.

2. The Financial Sophistication of the Crowd

The risks associated with crowdfunding ventures would be a less significant concern if crowdfunding investors were sophisticated enough to protect themselves. But crowdfunding is open to the general public, and many members of "the crowd" are not that well-informed financially.[511] In one study, 35% of American adults gave themselves a C grade or below on their knowledge of personal finance; only 22% awarded themselves an A.[512] Self-assessment is probably not the best way to measure financial knowledge, but people's self-assessments are strongly correlated with their actual financial knowledge.[513]

Many Americans are not financially literate. In a 2005 on-line survey of 3,512 adults and 2,242 high school students, only 17% of the adults and 3% of the students scored an A on a 24-question financial literacy quiz.[514] Sixty-six percent of the adults and 91% of the

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[509] *See* Cable, *supra* note 255, at 122 (An investor in a start-up "can expect to wait more than five years for any return on the investment.")

[510] *See, e.g.*, Prosper Registration Statement, *supra* note 83, at 4 (three-year notes); Lending Club Registration Statement, *supra* note 83, at 3 (three-year notes); Lang, *supra* note 108 (maximum of five years).

[511] "Financial literacy surveys in many developed nations show that consumers are poorly informed about financial products and practices." Annamaria Lusardi & Olivia Mitchell, *Financial Literacy and Retirement Planning: New Evidence from the Rand American Life Panel* 43 (Oct. 2007), *available at:* http://ssrn.com/abstract=1095869. *See also* B. Douglas Bernheim, *Financial Illiteracy, Education, and Retirement Savings*, in Olivia S. Mitchell & Sylvester J. Schieber, eds., LIVING WITH DEFINED CONTRIBUTION PENSIONS: REMAKING RESPONSIBILITY FOR RETIREMENT 38, 42 (1998) ("Collectively, existing studies paint a rather bleak picture of Americans' economic and financial literacy.").

For specific survey results, *see National Foundation for Credit Counseling, The 2010 Consumer Financial Literacy Survey: Final Report* (April 2010) *available at* www.nfcc.org/.../FinancialLiteracy/.../2010ConsumerFinancialLiteracySurveyFinalReport.pdf; Applied Research & Consulting LLC, Financial Capability in the United States: Initial Report of Research Findings from the 2009 National Survey (Dec. 1, 2009); Annamaria Lusardi, *Financial Literacy: An Essential Tool for Informed Consumer Choice?* (June 2008), *available at* http://ssrn.com/abstract=1336389; Lusardi & Mitchell, *supra*; National Council on Economic Education, WHAT AMERICAN TEENS AND ADULTS KNOW ABOUT ECONOMICS (Apr. 26, 2005), *available at* http://www.councilforeconed.org/cel/WhatAmericansKnowAboutEconomics_042605-3.pdf; Marianne A. Hilgert, Jeanne M. Hogarth, and Sondra G. Beverly, Household Financial Management: The Connection Between Knowledge and Behavior, Federal Reserve Bulletin 309 (July 2003); Bernheim, *supra*.

[512] National Foundation for Credit Counseling, *supra* note 511, at 9 *But see* Applied Research & Consulting LLC, *supra* note 511, at 37 (Seventy percent of American adults rated their overall financial knowledge in the top 3 levels on a seven-point scale. Only 13% put themselves in the bottom 3 levels.)

[513] Bernheim, *supra* note 511, at 48.

[514] National Council on Economic Education, *supra* note 511, at 44.

students had grades of C or worse.[515] In a 2009 survey of American adults, respondents answered an average of 2.72 of 5 financial literacy questions correctly.[516] Forty-eight percent of those respondents did not understand that investing in a mutual fund generally provides a safer return than investing in a single stock.[517] Thirty-five percent missed a very simple question about compound interest.[518] Seventy-nine percent did not understand the relationship between interest rates and bond prices.[519] Another survey of Americans 50 or older asked questions about compound interest, the relation between investment return and inflation, and the value of diversification. Only one-third of the respondents were able to correctly answer all three questions.[520]

This financial ignorance extends beyond general principles of finance to more specific questions about economic facts. In a 2001 survey, only 52% of the respondents knew that mutual funds do not pay a guaranteed rate of return, only 33% knew that not all investment products purchased at a bank are federally insured, and only 56% knew that, over the long term, stocks offer the highest rate of return.[521] In a 1993 survey of adults aged 29-47, people's estimates of current economic conditions—including the Dow Jones average, the rates of unemployment and inflation, and the amount of federal debt—were considerably off the mark.[522]

Still, the numbers are not totally disheartening. A large percentage of American adults do get many basic financial literacy questions right.[523] And, in one recent survey, two-thirds

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[515] *Id.* There was a positive correlation between students' grade level and their scores, *id.*, at 48, indicating that the students were learning over time.

[516] Applied Research & Consulting LLC, *supra* note 511, at 41.

[517] *Id.*, at 40. *See also* National Council on Economic Education, *supra* note 511, at 42 (in another survey, only 44% of adults and 15% of high school students understood that diversification was a reason for preferring mutual funds to individual stocks).

[518] Applied Research & Consulting LLC, *supra* note 511, at 39. *See also* Lusardi & Mitchell, *supra* note 511, at 6,21 (In a survey of American adults, only 75.7% correctly answered a multiple-choice questions about compound interest); Bernheim, *supra* note 511, at 44 (In a 1993 survey of American adults aged 29-47, nearly one-third indicated that $1,000 left in the bank for 30 years with compound interest of 8% would earn less than $5,000. The correct answer was more than $10,000.)

[519] Applied Research & Consulting LLC, *supra* note 511, at 38. *See also* Lusardi & Mitchell, *supra* note 511, at 6, 20 (In a survey of American adults, only 36.7% could answer the same question.)

[520] *See* Lusardi, *supra* note 511, at 4-6. Here are the questions:

> 1) Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow: more than $102, exactly $102, less than $102?
>
> 2) Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy more than, exactly the same as, or less than today with the money in this account?
>
> 3) Do you think that the following statement is true or false? "Buying a single company stock usually provides a safer return than a stock mutual fund."

Id., at 5.

[521] *See* Hilgert, et al, *supra* note 511, at 313.

[522] Nearly two-thirds of the respondents could not guess the level of the Dow Jones average, and the median answer of those who did was almost 10% off. The median estimate of the level of the unemployment rate was 8%; at the time, it was 6.7%. The median estimate of the inflation rate was 4%; the actual rate was 2.8%. The median estimate of the federal debt was $3 trillion; it was actually $4.4 trillion at the time. Bernheim, *supra* note 511, at 44.

[523] *See* Lusardi & Mitchell, *supra* note 511, at 6, 21.

of the respondents correctly answered basic questions about the function of stock markets, mutual funds, diversification, and risk.[524] However, these respondents were relatively highly educated and wealthy, so the results probably "overstate the level of financial literacy in the general population."[525]

The precise numbers are irrelevant, however. It is clear that a significant portion of the American public lacks basic financial literacy. Since crowdfunding sites are usually open to the general public, at least some of the people investing in crowdfunding offerings will not have the basic financial knowledge required to understand the risks.

3. Crowdfunding and Small Business Investment Risk

Crowdfunding offers relatively risky investments to relatively unsophisticated investors. Crowdfunding has some features that might reduce the risk of loss, and a crowdfunding exemption could be structured to provide additional investor protection. But, no matter how an exemption is framed, many crowdfunding investors will lose money. The risks associated with crowdfunding cannot be eliminated.

Consider first the effect of crowdfunding on the risk of fraud. No matter how the exemption is structured, there will be fraud. "[N]o amount of exemption requirements will hinder the fraud artists from their endeavors."[526] But, of course, registration itself does not eliminate fraud. The question is whether Internet-based crowdfunding will encourage or inhibit fraud, and by how much.

Paul Spinrad, who proposed the first crowdfunding exemption, argues that, because of the small amounts involved and the open, public nature of crowdfunding, fraudsters would not find it appealing.[527] It is not clear if that is true. On the one hand, the Internet allows fraudulent offerings to be distributed widely at low cost.[528] Crowdfunding sites are an obvious target for fraudsters. On the other hand, fraud is "more detectable on the Internet,[529] especially when it must be mediated through an independent crowdfunding site. Moreover, the absence of personal, face-to-face interaction may make it more difficult to con investors.[530] The net effect is indeterminate. However, it is important to remember that a crowdfunding exemption would not legitimize fraud or protect fraudulent offerings from the securities statutes' antifraud rules. The SEC and private parties would still have the usual remedies for any fraud.

The crowdfunding structure does have some features that could help limit some of the risks of investing in small business ventures. First, crowdfunding, like venture capital,

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[524] *See* Lusardi, *supra* note 511, at 8-9, 26.
[525] Lusardi & Mitchell, *supra* note 511, at 5.
[526] Cohn & Yadley, *supra* note 13, at 72.
[527] Scott Shane, *Let the Crowd Buy Equity in Private Companies*, Bloomberg Businessweek, http://www.businessweek.com/smallbiz/content/may2011/sb2011052_710243.htm (May 3, 2011).
[528] Fisch, *supra* note 455, at 58.
[529] Fisch, *supra* note 455, at 81.
[530] *See* Fisch, *supra* note 455, at 78.

sometimes involves staged financing.[531] The need to come back for additional funds could temper entrepreneur behavior, especially if prior-round investors are able to publicly communicate on the crowdfunding site about any problems they have had. Second, investors could use crowdfunding discussion boards to point out problems with proposed ventures, to coax concessions from entrepreneurs prior to investing, and to monitor investments after they invest. Lenders on peer-to-peer lending sites "have shown a remarkable propensity to shoulder the burden of monitoring underlying debts. Web forums and message boards are replete with the adventures of P2P lender qua detective, ferreting out fraud that had been overlooked by the platform."[532]

Crowdfunding, under the right conditions, could benefit from what James Surowiecki calls "the wisdom of crowds,"[533] the notion 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."[534] The knowledge gap that once separated professionals from others has shrunk as information has become more readily accessible through the Internet.[535] And investment expertise does not necessarily translate into success; experts often make extraordinarily poor judgments.[536] The lesson of crowd-sourcing is that a diverse group of less expert decision-makers can often make better choices than those with expertise.[537] It is at least possible that crowdfunding investors will do a better job compared to venture capitalists and angel investors than their relative sophistication would predict.[538]

There may also be a learning effect.[539] Unsophisticated crowdfunding investors may become more sophisticated over time. A study of lenders on Prosper.com found that, over

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[531] *See, e.g.*, *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) (To continue fundraising after a campaign closes, just start a new campaign); *Creating a Project,* KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project (under heading "Starting a Project") (projects can be split into stages, but it is not recommended). *See also* Lawton & Marom, *supra* note 3, at 112 (with crowdfunding, the discrete rounds of financing are being replaced with the "rolling close," continuous funding).

[532] Verstein, *supra* note 14, at 11.

[533] *See* Surowiecki, *supra* note 125.

[534] *Id.*, at xiii.

[535] *See* Howe, *supra* note 2, at 39-40.

[536] *See* DAN GARDNER, FUTURE BABBLE: WHY EXPERT PREDICTIONS ARE NEXT TO WORTHLESS (2011). James Suroweicki quotes Wharton professor J. Scott Armstrong, who surveyed expert forecasts and analyses in a number of fields and concluded, "I could find no studies that showed an important advantage for expertise." Surowiecki, *supra* note 125, at 33.

[537] *See* Howe, *supra* note 2, at 131-145.

[538] That would not necessarily translate into higher investment returns. Venture capital funds and angel investors are highly selective, and venture capitalists especially tend to focus on larger, high-growth companies that are past the start-up phase. *See* text accompanying notes 467-477, *supra*. Crowdfunding sites appeal to entrepreneurs who cannot otherwise obtain funds—those, in other words, who could not attract funding from venture capitalists and angel investors. Even if crowdfunding investors are better at discriminating among available investments, they are picking from a different, more risky pool than venture capitalists and angel investors.

[539] *See* Seth Freedman & Ginger Zhe Jin, *Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence From Prosper.com* 3 (Nov. 2008), *available at* http://ssrn.com/abstract=1304138 (finding that "many Prosper lenders make mistakes in loan selection and therefore have a negative rate of return on their portfolios, but they learn vigorously and the learning speeds up over time.).

the two-year period studied, lenders moved from lower-performing loans to loans with a higher rate of return.[540] However, crowdfunding is still relatively young; until we have more experience, we should be cautious about predicting its success in protecting investors from risk.

The investors on crowdfunding sites, like other small-business investors, will undoubtedly suffer significant losses.[541] Fraudsters will use crowdfunding sites to deceive investors and take their money. Entrepreneurs will take advantage of their control to benefit themselves at the expense of outside investors. Unsophisticated investors will make ill-advised investments. But the proposed crowdfunding exemptions are structured so that none of those losses will be catastrophic to individual investors. Each of the proposed exemptions limits the maximum amount a single investor may contribute and therefore limits each person's possible loss.[542]

Finally, the relevant question is not whether there will be fraud or losses to investors if we exempt securities crowdfunding. The question is whether exempting securities crowdfunding will *increase* investor losses. Investors are already investing substantial amounts in non-securities crowdfunding; those investments are as risky as securities crowdfunding. People who make pure donations to entrepreneurs are guaranteed to "lose" all of their money and receive nothing in return. People who contribute to crowdfunding appeals in return for small rewards or to pre-purchase a product might never receive the promised reward and, even if they do, the reward or product may not be as valuable as they anticipated. People who make no-interest loans on Kiva may never get their money back.

The risk of fraud or self-dealing is the same in non-securities crowdfunding as in securities crowdfunding. The gain to the fraudster or the self-dealing entrepreneur depends on the amount invested, not on the type of return offered to investors. A $1,000 contribution provides the same opportunity for diversion whether it's for a non-interest loan on Kiva, a pre-purchase on Kickstarter, or a purchase of stock on a securities crowdfunding site. Security or not, the risk to the crowdfunding investor is the same.[543]

Securities crowdfunding does, however, increase the potential gains to investors. Instead of making a donation or settling for some reward, investors in crowdfunded securities can receive interest or a share of the entrepreneur's profits. As discussed earlier, there is a serious risk they will not receive the promised return, but even the possibility of interest or profit is better than no financial return at all. Since the downside is the same as the

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[540] Freedman & Jin, *supra* note 539, at 25.

[541] *See* Lawton & Marom, *supra* note 3, at 180 (Numerous losses will occur, either through fraud, or, more likely, business failure).

[542] *See* Section V, *infra.*

[543] This does not mean investors' total losses will stay the same if a crowdfunding exemption is adopted. If entrepreneurs are allowed to sell securities on crowdfunding sites, the promise of greater returns might attract more investors, increasing the total amount of money invested through crowdfunding. Even if the proportionate loss is the same, the total loss would be greater simply because more money would be invested.

status quo and the upside is superior, an exemption allowing securities crowdfunding could make investors better off.

VII. A Crowdfunding Exemption Proposal

A crowdfunding exemption could be beneficial, but it needs to be structured to minimize investor losses as much as possible without destroying its utility to entrepreneurs raising capital. However, investor protection and capital formation are, to some extent, incompatible goals. It is not possible to maximize both. Adding additional requirements to protect investors will in most cases impose an additional cost on small business issuers using the exemption.

In Subsection A, I discuss the limits an exemption should impose on crowdfunded offerings. In Subsection B, I discuss the requirements sites hosting those offerings should be required to meet. The locus of any regulation should be the crowdfunding sites, not the entrepreneurs making the offerings. The small companies and entrepreneurs most likely to engage in crowdfunding are poorly capitalized and legally unsophisticated. They do not have and cannot afford sophisticated securities counsel to guide them through a labyrinth of complex regulation. The cost of counsel could easily exceed the value of the offering. Too much complexity at the entrepreneurial level will produce a host of unintended violations and destroy the exemption's utility.

Crowdfunding sites, on the other hand, are repeat players. They can spread any regulatory costs over a large number of offerings. They are more heavily capitalized than the entrepreneurs using their sites, and can afford securities counsel. Crowdfunding sites are also much more visible to the SEC for regulatory enforcement purposes. Any conditions needed to protect investors should be imposed at the site level.

Conditions may be imposed on the offerings or on the companies making the offerings, but those restrictions must be enforceable at the site level, with the crowdfunding sites acting as gatekeepers to enforce the restrictions. A restriction on the dollar amount of crowdfunding offerings, for example, is something that a crowdfunding site can easily monitor and enforce, since the money flows through the site. But anything that turns on what the entrepreneur is doing off-site is not as easily monitored. For example, if the available amount is affected by fundraising the entrepreneur does off-site, there is no effective way for the site to enforce the limit.

A. Restrictions on the Offering

The dollar amount of offerings qualifying for the crowdfunding exemption should be limited, as should the amount that any single investor may invest. It is not clear what the exact amounts of those limits should be; there is no magic number. I propose an annual offering limit of $250,000 to $500,000, with an annual limit on individual contributions equal to the greater of $500 or five percent of the investor's annual income. Integration and aggregation concepts should not be applied to the offering limit. A limit on the size of companies eligible to engage in crowdfunding offerings is not necessary but, if the SEC believes such a limit is appropriate, limiting the exemption to non-reporting

companies would do little damage. Finally, crowdfunding should be exempted only if it occurs on a crowdfunding site that meets the requirements specified in subsection B.

1. Offering Amount

An absolute, unconditional exemption of smaller offerings from Securities Act registration requirements makes sense.[544] The cost to register a relatively small offering exceeds any benefit that registration could provide.[545] This is true even if fraud is more likely in smaller offerings; although the likelihood of fraud affects the dollar amount below which offerings should be exempted, it does not affect the case for such an exemption.[546] Economies of scale make registration inefficient for smaller offerings, even if registration creates a net benefit for larger offerings.[547]

Consider, for example, an attempt to raise $20,000. The maximum amount investors could lose in that offering is $20,000. Even if registration could reduce the probability of any loss to zero, the maximum possible benefit of registration would only be $20,000. The cost to register an offering is clearly more than $20,000, so it would cost more to register this offering than to let investors bear the risks of an unregistered offering.

The case for exempting a $20,000 offering is obvious, but the exact level at which registration ceases to be cost-effective is less clear. And, if the exemption is not absolute—if it includes additional requirements designed to protect investors—a higher limit makes sense.[548] The proposed limits in the various crowdfunding exemption proposals range from $100,000 to $5 million.[549] Heminway and Hoffman propose a limit in the $100,000 to $250,000 range and Pope proposes a limit of $250,000.[550] There is no magic number. Given the cost of registering an offering,[551] the case for exempting offerings of less than $250,000 to $500,000 is solid. A plausible case can be made for exempting much larger offerings, particularly with a strong limit on the amount of each

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[544] For a more detailed discussion of this point, *see* C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. LAW 1 (2001). The argument for such a Securities Act exemption is just a specific case of the more general economic argument for small business exemptions. *See* C. Steven Bradford, *Does Size Matter? An Economic Analysis of Small Business Exemptions from Regulation*, 8 J. SMALL & EMERGING BUS. LAW 1 (2004).

[545] *See* Bradford, *Securities Regulation and Small Business*, *supra* note 544, at 29-33.

[546] Assume, for example, that the average loss in smaller offerings for all reasons, including fraud, is 60% of the amount invested. Make the heroic assumption that registration would prevent all those losses. If the total cost of registering a $100,000 offering is $70,000, it still makes sense to exempt such offerings. In the absence of registration, the average loss will be $60,000, but registration imposes an even greater cost, $70,000. Society is better off exempting such offerings. *See* Bradford, *Securities Regulation and Small Business*, *supra* note 544, at 39-47 (calculating the optimal exemption amount, given various assumptions about fixed costs, the proportion of losses, and the proportion of losses prevented by registration).

[547] *See* Bradford, *Securities Regulation and Small Business*, *supra* note 544, at 24-27. *See* generally Bradford, *Does Size Matter?*, *supra* note 544, at 5-15.

[548] *See* Bradford, *supra* note 450, at 618-622 (explaining the efficiency of intermediate, conditional exemptions).

[549] *See* Section V, *supra*.

[550] *See* Heminway & Hoffman, *supra* note 144, at 60; Pope, *supra* note 100, at 124.

[551] *See* Section III.B.1, *supra*.

person's investment. But an exemption limit above $500,000 requires stronger assumptions about the cost of registration, the risk of loss, and how much registration reduces that risk.[552]

2. Aggregation/Integration

Any proposal for a Securities Act exemption must deal with the frustrating problem of integration—whether two offerings that are ostensibly separate should be treated as part of the same offering, with the possible resulting loss of the exemption.[553] The integration doctrine was developed by the SEC "to prevent issuers from artificially dividing a single, non-exempt offering into two or more parts in an attempt to obtain an exemption for one or more of the parts."[554] Unfortunately, the integration doctrine is an uncertain, confusing mess.[555] Scholars have proposed its elimination[556] or substantial modification;[557] the SEC itself has created several safe harbors that protect against application of the doctrine.[558]

Even if two offerings are not integrated, the related concept of aggregation can be problematic. The aggregation provisions in Regulation A and Rules 504 and 505 of Regulation D reduce the maximum amounts available under those exemptions by the amount of certain other offerings.[559] The $1 million limit in Rule 504 would, for example, be reduced if the issuer had completed a Regulation A offering in the prior twelve months.[560]

The dollar limit of any crowdfunding exemption should be applied on an aggregate basis to all crowdfunding in that year by the same issuer. If the limit is $500,000, the total an entrepreneur raises through crowdfunding should not exceed $500,000 in a year, even if the entrepreneur conducts several, separate rounds of fundraising. Securities sold in non-crowdfunded offerings should not count against the exemption's limit. This is consistent with the SEC's approach in Regulation A. Rule 251(b) limits the offering amount in

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[552] For a set of hypothetical calculations, *see* Bradford, *Securities Regulation and Small Business*, *supra* note 544, at 47.

[553] For a general introduction to integration, *see* Bradford, *supra* note 450, at 649-657.

[554] *Id.*, at 649. *See also* Barry B. Deaktor, Integration of Securities Offerings, 31 U. FL. L. REV. 465, 473 (1979).

[555] *See* Bradford, *supra* note 450, at 651-652.

[556] *See* Rutheford B. Campbell, *The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933*, 89 KY. L. J. 289 (2001-02).

[557] *See* C. Steven Bradford, *Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions*, 49 EMORY L.J. 437 (2000).

[558] *See* Bradford, *supra* note 450, at 652-657.

[559] *See* Securities Act Rules 251(b), 17 C.F.R. §230.251(b) (2007); 504(b)(2), 17 C.F.R. §230.504(b)(2) (2007); 505(b)(2)(i), 17 C.F.R. §230.505(b)(2)(i) (2007). *See generally* Bradford, *supra* note 450, at 657-658.

[560] The available aggregate offering amount is reduced by "the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under . . .[Rule 504] . . . in reliance on any exemption under section 3(b)." Rule 504(b)(2), 17 C.F.R. §230.504(b)(2) (2007). Regulation A is a section 3(b) exemption. *See* Rule 251, 17 C.F.R. §230.251 (2007) .

Regulation A offerings to no more than $5 million in any 12-month period; only offerings pursuant to Regulation A are counted against that limit.[561]

Concepts of integration and aggregation should not be applied beyond that. Small business entrepreneurs seeking to raise money through crowdfunding cannot afford the legal expertise needed to apply the integration doctrine. They can count how much money they receive through crowdfunding, but they are not in a position to consider the effect of other fundraising efforts on the availability of crowdfunding—whether, for example, the private solicitation of money from Aunt Agnes will count against the crowdfunding limit.[562] They also cannot anticipate their future capital needs[563] and the possible retroactive application of integration to destroy their crowdfunding exemption. Integration concepts would just be a trap for unsophisticated, unwary entrepreneurs.

Integrating or aggregating non-crowdfunded offerings is also inconsistent with the idea of crowdfunding sites as gatekeepers. Crowdfunding sites can monitor how much each entrepreneur raises through crowdfunding since the money passes through their portal. They cannot easily ascertain how much entrepreneurs have raised through other, outside sources.

3. Individual Investment Cap

All of the crowdfunding exemption proposals limit not only the total amount of the offering, but also the amount that each investor may invest. A per-investor limit is sensible. Small business offerings are very risky and losses are likely. [564] A properly set cap on the amount each person may invest eliminates the possibility of catastrophic loss and limits losses to what each investor can bear. As with the offering amount, there is no magic number; I propose that each investor be able to invest annually no more than the greater of $500 or two percent of his annual income.

a. The Individual Cap Related to Existing Exemptions

None of the current exemptions limit the amount an individual investor may invest. Many of the exemptions cap the total dollar amount of an offering,[565] but, as long as the total offering amount does not exceed the cap, it does not matter how much any single investor

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[561] Rule 251(b), 17 C.F.R. §230.251(b) (2007). Other exemptions with dollar limits use a similar 12-month period, although the amounts charged against those limits include other specified offerings. *See* Rules 504(b)(2), 17 C.F.R. §230.504(b)(2) (2007); 505(b)(2)(i), 17 C.F.R. §230.505(b)(2)(i) (2007).

[562] Consider the following example from the Wall Street Journal: Bronson Chang raised $54,000 on ProFounder from family members, friends, and customers. He then sought another $60,000 through a "public raise" on ProFounder. Emily Maltby, *Tapping the Crowd for Funds*, WALL STREET JOURNAL (Dec. 8, 2010), http://online.wsj.com/article/SB10001424052748703493504576007463796977774.html. It is likely Chang never even considered whether his subsequent offering negatively affected the status of his earlier Rule 504 "private raise."

[563] *See* Cohn & Yadley, *supra* note 13, at 50 (Small companies' capital needs "are often sporadic and immediate.").

[564] *See* Section VI.B.1, *supra*.

[565] *See* Rule 251(b), 17 C.F.R. § 230.251(b) ($5 million); Rule 504(b)(2), 17 C.F.R. § 230.504(b)(2) ($1 million); Rule 505(b)(2)(i), 17 C.F.R. § 230.505(b)(2)(i) ($5 million).

purchases. The exemption would be available even if a single investor purchased the entire offering.

However, some of the existing exemptions do consider an investor's ability to bear losses in a less direct way. Both Rule 506 of Regulation D and section 4(5) of the Securities Act restrict the purchasers to whom sales may be made. Section 4(5) of the Securities Act is limits sales to accredited investors"[566] and Rule 506 limits sales to purchasers who either are accredited investors or who have "such knowledge and experience in financial and business matters that . . . [they are] . . . capable of evaluating the merits and risks of the prospective investment."[567]

Rule 506 is a safe harbor for section 4(2) of the Securities Act and the sophistication requirement is consistent with the Supreme Court's analysis of the section 4(2) exemption in the *Ralston Purina* case. *Ralston Purina* indicated that the availability of the section 4(2) exemption turns on whether the class of offerees "needs the protection of the Act" or are "able to fend for themselves."[568] But, under Rule 506, sales may be made even to unsophisticated investors, as long as they are accredited.[569]

Some of the categories of accredited investors are individuals or institutions who would ordinarily be sophisticated.[570] In those cases, accredited status is merely a more objective proxy for sophistication. But other parts of the accredited investor definition focus solely on an investor's wealth or income. Any individual whose net worth, either alone or with a spouse, exceeds $1 million is accredited,[571] as are corporations, partnerships, and certain other entities with total assets in excess of $5 million.[572] An individual is also an accredited investor if she has had an income of $200,000, or a joint income with her spouse of $300,000, over the two previous years, provided she reasonably expects to reach the same income in the year of the offering.[573]

Many people who are accredited investors solely because of wealth or income are unsophisticated investors.[574] Consider, for example, the high school dropout who wins

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[566] Securities Act § 4(5), 15 U.S.C. §77d(5) (2010).

[567] Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii). Even if a non-accredited investor does not meet the sophistication requirement, the exemption is still available if the investor is represented by someone who meets the requirement or if the issuer reasonably believes that the purchaser meets the sophistication requirement. *Id.*

[568] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). *See also* 1 HAZEN, *supra* note 44, at 565.

[569] Moreover, the information requirements that would otherwise apply in a Rule 506 offering do not apply to sales to accredited investors. *See* Rule 502(b), 17 C.F.R. § 230.502(b).

[570] The definition includes, for example, registered securities brokers or dealers, registered investment companies, banks, and insurance companies. *See* Rules 215(a), 501(a)(1), 17 C.F.R. §§ 230.215(a), 230.501(a)(1) (2007). Directors and executive officers of the issuer, who would ordinarily have access to information about the issuer, are also accredited investors. Rules 215(d), 501(a)(4), 17 C.F.R. §§ 230.215(d), 230.501(a)(4) (2007).

[571] Rules 215(e), 501(a)(5), 17 C.F.R. §§ 230.215(e), 230.501(a)(5) (2007).

[572] *See* Rules 215(c), 501(a)(3), 17 C.F.R. §§ 230.215(c), 230.230.501(a)(3) (2007)..

[573] Rules 215(f), 501(a)(6), 17 C.F.R. §§ 230.215(f), 230.501(a)(6) (2007).

[574] *See* Choi, *supra* note 451, at 311 (the definition of accredited investor includes "financial neophytes"); Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984) ("Experience indicates

$10 million in a lottery.[575] He would be an accredited investor, even though nothing he has done to accumulate his wealth shows that he is capable of evaluating the merits and risks of investing in the offering.

The SEC's reason for including such wealthy, but unsophisticated, investors is unclear. One possibility is that wealth and income are just extraordinarily imperfect proxies for sophistication, [576] but the more plausible reason is that wealthy investors can afford to lose the money.[577]

If that is the rationale, the existing exemptions do not fit it well. Neither section 4(5) nor Rule 506 limit the amount any single investor may invest in the offering.[578] Thus, an individual with a net worth of only $1 million could invest all of his wealth in a single risky offering, and a total loss on that one investment would leave the investor penniless. And an investor whose accredited status is based solely on net income could actually be insolvent at the time of purchase.[579] The crowdfunding exemption proposals focus directly on the investor's ability to bear the loss in a much more coherent way.

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that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment."); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 Okla. L. Rev. 291, 299 (1994) (such investors are "easy prey for securities sales personnel").

[575] This example is derived from a problem in JAMES D. COX, ROBERT W. HILLMAN, & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 270-271 (6th ed. 2009). *See also* Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASHINGTON U. L. REV. 733, 754 (2009).

[576] *See* Friedman, *supra* note 574, at 301; C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1124 (1988) ("the SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naïve, do not need the protection of the . . . registration provisions"); Note, *Unsophisticated Wealth, supra* note 575, at 747 (the SEC's goal in Regulation D was to use wealth as a proxy for whether an investor is capable of fending for himself); Warren, *supra* note 574, at 381 (the SEC presumes that these investors can fend for themselves) Marvin R. Mohney, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121, 165 (1982) ("the SEC has equated wealth with sophistication and with access to information"); *See also* Susan E. Satkowski, *Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Businesses*, 23 WM. & MARY L. REV. 73, 81 (1981) (Rule 242, the predecessor to Regulation D, attempted to dispense subjective criteria of sophistication and access to information with more "definitive and objective standards").

[577] *See* Friedman, *supra* note 574, at 299-300 (the basis for making wealthy but unsophisticated investors accredited is "the ground that they can afford to lose money"). Edward Fletcher also seems to believe that this basis underlies the accredited investor categories. He asks, "should the law presume that wealthy investors, *who can bear investment risks*, are sophisticated investors, and treat them as such, no matter how financially naive they may be?" Fletcher, *supra* note 576, at 1123 (emphasis added).

[578] This has not always been the case. When Regulation D was adopted, an investor was accredited if he purchased at least $150,000 of the securities being offered and the purchase price did not exceed 20% of the purchaser's net worth. *See* SEC, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (Mar. 8, 1982). *See also* Warren, *supra* note 574, 369; Mohney, *supra* note 576, at 135. Presumably this 20% floor "assures . . . [investors] . . . are able to bear the risk of the investment." Mohney, *supra* note 576, at 136.

[579] *See* Warren, *supra* note 574, at 382.

b. How to Structure the Cap

Unfortunately, the crowdfunding exemption proposals leave many questions unanswered. Should the limit be applied on a per-offering basis or applied cumulatively across all of a person's crowdfunding investments? Should it be an annual limit or a cap on the total amount of all outstanding crowdfunding investments? Should the limit be a uniform dollar amount or a percentage of each person's wealth or income? And, most importantly, what should the limit be? The proposals range from $100 to $10,000 per person, and some of the proposals add an alternative cap based on the investor's income.[580] I propose to limit each investor's annual crowdfunding investments to the greater of $500 or two percent of the investor's annual income.

Consider first whether the investment limit should be the same amount for all investors or should vary depending on the investor's financial circumstances. A fixed limit of, for example, $500 per person is simple and easy to apply. But a uniform limit, unless it is very small, does not necessarily limit all investors to an amount they can afford to lose. Many investors have very little savings or uncommitted income.[581] A loss of even $500 could be catastrophic to those investors.

A limit tailored to the particular investor's wealth or income would better fit the policy rationale. An individual investor might, for example, be limited to investing no more than five percent of his net worth or annual income. But this type of limit would make the exemption more costly and difficult to administer; either the crowdfunding site or the issuer would have to determine the investor's income or net worth before allowing the investor to invest.[582] And, since crowdfunding depends on small contributions from a large number of investors, the number of such income and wealth determinations could be prohibitive.

There are two ways to incorporate an income- or wealth-based limit without unduly increasing administrative costs. One possibility, adopted by H.R. 2930, is to allow the issuer (and, presumably, the crowdfunding site as well) to rely on the investor's self-certification of income.[583] The site or the issuer would still have to collect and track

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[580] *See* Section V, *supra*.

[581] A 2010 survey found that 30% of all adults had no savings (excluding retirement savings). National Foundation for Credit Counseling, *supra* note 511, at 5. *See also* Hilgert, et al, *supra* note 511, at 310 (earlier survey finding that 80% of the respondents had a savings account). Another survey found that fewer than half of American adults had an emergency fund that would cover expenses for three months. Applied Research & Consulting LLC, *supra* note 511, at 16. Forty-nine percent of those respondents found it difficult merely to pay all of their bills each month. Applied Research & Consulting LLC, *supra* note 511, at 15. *But see* Hilgert, et al, *supra* note 511, at 310 (July 2003) (finding that 63% of the respondents had *some* emergency fund and that 49% of the respondents set aside money out of each paycheck).

[582] Both the Small Business & Entrepreneurship Council petition and the White House proposal phrase the individual investor limit alternatively: either $10,000 or 10% of the investor's income. *See* Sections V.B and V.D, *supra*. Neither proposal indicates how the limit will be applied if an investment is within one of those limits but not the other. In H.R. 2930, the limit is the *lesser* of $10,000 or 10 percent of the investor's annual income. *See* Section V.E, *supra*.

[583] H.R. 2930 provides that "an issuer may rely on certification provided by investors." H.R. 2930 (Sept. 14, 2011). It is unclear what would happen under this proposal if the issuer knows or reasonably should

income figures for each investor, but no verification would be required. Once the investor stated an income, the site's work would be complete. However, a self-certified income standard is essentially the same as no standard at all. Investors who want to invest more would quickly learn to exaggerate their income.

The second, preferable option is to state the limit per investor in the alternative—the *greater* of a specified dollar amount or a percentage of the person's income. Under such a standard, crowdfunding sites would not be required to check or verify anyone's income. Since the limit is the greater of the two, sites could simply limit investments to the specified dollar amount.[584] An income determination would be required on a case-by-case basis only if the site chose to allow a particular investor to contribute more than that dollar limit. It would, therefore, be left to the site whether to incur the additional costs of determining an investor's income.[585]

Both the dollar amount and the income percentage should be low enough that most people could afford to lose that amount. Neither theory nor empirical analysis can specify the precise amount, but an investment limit of around $500 per person seems reasonable.[586] This amount is more than some investors could afford to lose, but, at some point, potential investors must be trusted to decide for themselves what they can afford. The $10,000 individual limit in some of the proposals seems excessive; it is doubtful whether most investors could afford an annual loss of that magnitude.[587]

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know that the investor's self-certification is false. What if, for instance, the investor states one income, then changes it when he wants to invest more money?

[584] If, as in some of the other exemption proposals, the limit is the *lesser* of the two alternatives, crowdfunding sites would still have to determine each investor's income in order to know which of the two numbers is smaller.

[585] If a site does choose to use the income-based limit, it should only have to establish a reasonable belief that the investor qualifies. The easiest way to do this would be to obtain the first two pages of the investor's federal tax return.

[586] *See* Heminway & Hoffman, *supra* note 144, at 60 (proposing an individual limit of $100 to $250 per offering); Shane, *supra* note 527 (allowing people to invest only $100 "doesn't seem to impose a significant risk of financial loss on individuals").

The limit could be applied individually or on a household basis. An individual limit would be easier to administer because neither the site nor the issuer would have to determine who belongs to the same family or household. But risk is typically borne by a household as a whole; if one family member loses money, the entire family suffers. The dollar limit should be adjusted to account for the individual versus family choice. If the limit is applied on an individual basis, the limit can be slightly less; if it is applied on a household basis, it can be slightly more.

My colleague Steve Willborn suggests a mandatory diversification requirement—requiring investors to spread the maximum in smaller amounts across several different offerings. He points out that this could reduce some of the company-specific risk, and thus reduce the expected loss. However, the question is not what the average, expected loss will be, but how much of a loss the investor can bear. Diversification would not eliminate the risk of a complete loss, so the question is still the maximum amount an investor can afford to lose. Moreover, a diversification requirement would increase the cost of using the exemption in two ways. Enforcing the diversification requirement would increase the administrative cost. And a diversification requirement would reduce the average investment amount, and thus increase the number of purchasers, in each offering, increasing the cost of making an offering under the exemption.

[587] Pope proposes a limit of $1,000 per investor, arguing that "many consumers already spend [that much] on items such as laptop computers and tablets, designer footwear and high-definition televisions." Pope,

The alternative limit in most of the proposals is ten percent of the investor's annual income.[588] Again, there is no magic number. How much an investor can afford to lose depends on a number of factors other than annual income. An investor whose wealth is tied up in illiquid assets and who has little free income can afford to lose very little of her income. But ten percent seems too high for most people; a more cautious cap of two percent makes more sense, at least until we have some experience with the exemption. Thus, investors should be able to invest no more than the greater of $500 or two percent of their annual income.[589]

Whatever the limit, it should be applied to all of an individual's crowdfunding investments in any given year, not on a per-offering basis. Otherwise, an investor could quickly invest more than he could afford to lose by investing the maximum amount in a large number of offerings—$500 in offering A, $500 in offering B, $500 in offering C, and so on. An investment limit fits the policy argument only if it is applied on a cumulative basis.[590]

Only crowdfunding investments should be considered in applying this annual cap. Other investments, even other securities investments, should not count. People have numerous other investments with various levels of financial risk—mutual funds, houses, cars, friends' businesses. All of a person's assets and liabilities are relevant in assessing the risk that a particular investment adds to the person's portfolio, but the SEC has to draw a line somewhere. The SEC is not a general risk protection agency, and going outside the crowdfunding exemption to calculate the limit would make the exemption unworkable.[591]

The limit should also be an annual one. An investor who invests $500 in 2012 should be free to invest another $500 in 2013, even if she still holds the 2012 investment. The amount of the cap obviously should be lower for an annual limit than it would be for a cumulative limit, but an annual limit is much easier to administer. A cumulative cap would have to account for withdrawals of money, dividends, and bankruptcies, and could pose difficult computational issues.[592]

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supra note 100, at 124. That may be true of some people, but $1,000 would be a catastrophic loss to some investors, particularly when considered on an annual basis.

[588] *See* Section V, *supra*.

[589] Heminway and Hoffman suggest limiting the cap to investors who are not accredited or sophisticated, and allowing accredited and sophisticated investors to invest without any limit. *See* Heminway & Hoffman, *supra* note 144, at 63. Issuers can already offer securities to accredited and sophisticated investors using Rule 506 of Regulation D. My proposal would preclude integration of any Rule 506 offerings with offerings pursuant to the crowdfunding exemption. *See* Section VII.A.2, *infra*. Therefore, the only thing that would preclude simultaneous, side-by-side Rule 506 and crowdfunding exemption offerings on the same web site is Regulation D's general solicitation restriction. *See* text accompanying notes 225-227, *supra*. I would prefer that the SEC eliminate the general solicitation restrictions for all Rule 506 offerings rather than carve out an exception in the crowdfunding exemption for sales to accredited and sophisticated investors.

[590] *But see* Heminway & Hoffman, *supra* note 144, at 60 (proposing a limit of $100 or $250 "in a single offering or over a specified period").

[591] *See also* Section VII.A.2, *supra* (rejecting integration and aggregation concepts).

[592] If, for example, an investor loses his entire $500 investment, is he forever barred from again investing in crowdfunding? He has, after all, lost the total amount we determined he could afford to lose. We might

4. Should There Be Company Size Limits?

The proposed crowdfunding exemption is designed to help very small businesses raise capital. Should larger businesses therefore be excluded from using it? The SEC already limits the use of the Regulation A and Rule 504 exemptions to non-reporting companies,[593] and Heminway and Hoffman suggest that any crowdfunding exemption should be similarly limited.[594] The justification for small offering exemptions depends on the size of the offering, not on the size of the company making the offering,[595] so such restrictions are theoretically unnecessary. But such a limit would be relatively easy to administer and would have no dramatic effect on the use of crowdfunding.[596]

Larger businesses are unlikely to use the exemption even if they are allowed to. Most large businesses are unlikely to seek external funding for such small amounts, particularly given the cost of raising money through investments of $500 or less. Big companies usually have enough cash to meet such small funding requirements internally. Apple Computer, for instance, had $11.2 billion in cash and cash equivalents at the end of its 2010 fiscal year.[597] The Buckle, Inc., a much smaller company, reported over $116 million in cash and cash equivalents at the end of its most recent fiscal year.[598] These companies are not going to be using a crowdfunding exemption.

Larger non-reporting companies have another reason to avoid the crowdfunding exemption. Companies in the U.S. with more than $10 million in total assets and a class of equity security held of record by 500 or more people must register with the SEC under the Exchange Act.[599] Selling equity to a large number of investors in small amounts would increase the number of equity holders and could trigger Exchange Act reporting requirements.

B. Restrictions on Crowdfunding Sites

Offerings that fall within the limitations discussed above should be exempted only if they are sold through crowdfunding sites that meet certain standards designed to protect investors. Crowdfunding sites should be open to the general public and should provide publicly accessible communications portals that allow potential investors to communicate

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want to bar him on the theory that he is a bad investor, but given the high percentage of start-up failures, a total loss does not necessarily reflect negatively on that person's capabilities as an investor.

[593] *See* Rules 251(a)(2), 17 C.F.R. §230.251(a)(2) (2007); 504(a)(2), 17 C.F.R. §230.504(a)(2) (2007).

[594] *See* Heminway & Hoffman, *supra* note 144, at 60. They also propose to exclude foreign issuers and investment companies. *Id.*

[595] *See* text accompanying notes 544-547, *supra*.

[596] If, however, the rule's exception is expressed in terms of a company's total or net assets, crowdfunding sites would have to review documentation from each issuer to verify that it does not exceed the cap, and the cost of administering the restriction would be higher.

[597] Apple Inc., Form 10-K for the fiscal year ended Sept. 25, 2010, p. 47, *available at* http://www.sec.gov/Archives/edgar/data/320193/000119312510238044/d10k.htm#tx37397_2.

[598] The Buckle, Inc., Form 10-K for the fiscal year ended Jan. 29, 2011, p. 31, *available at* http://www.sec.gov/Archives/edgar/data/885245/000115752311001807/a6663779.htm#statements.

[599] *See* Exchange Act § 12(g)(1)(B), 15 U.S.C. §78l(g)(1)(B) (2010) (requiring the registration of companies with more than $1 million in total assets and 500 or more record holders of a class of equity security); Rule 12g-1 (raising the asset amount to $10 million).

about each offering. Investors should be allowed to invest on those sites only after viewing a brief investor education video or quiz. Entrepreneurs posting on those sites should be required to specify a funding goal and should be allowed to close an offering only if that goal is reached. Until then, investors should be free to withdraw their commitments. Crowdfunding sites should not be allowed to recommend or rate investment opportunities, or to advise investors about those opportunities, unless they are willing to register as brokers or investment advisers. Neither the crowdfunding sites nor their employees should be able to invest in any of the offerings that appear on the site.

Crowdfunding sites that meet these standards and notify the SEC that they are engaged in crowdfunding should not be required to register as brokers or investment advisers unless they also engage in other activities that would make them such.

1. Open Sites; Open Communication

Crowdfunding sites that want to take advantage of the proposed exemption should be open to the general public and should be required to provide some means, such as an electronic bulletin board, that allows investors to communicate freely and openly about each offering. These requirements will allow crowdfunding sites to take advantage of "the wisdom of crowds" that is the foundation of all crowd-sourcing, including crowdfunding.[600]

An open platform will help prevent fraud by allowing investors with particular knowledge about an offering or the issuer to communicate it to other investors. Investors who are aware of a particular entrepreneur's shady business background can communicate that knowledge to others. Investors with local knowledge of facts inconsistent with the entrepreneur's claims can inform others. For example, if the entrepreneur falsely claims to own a facility in North Platte, Nebraska, people in North Platte can expose the fraud.

In addition to preventing fraud, open communication will lead to better informed investors. Investors with knowledge of the particular industry or type of product can share that knowledge with other potential investors. Investors who are also potential customers can explain why the proposed product or service will or will not succeed, and can suggest modifications of the product or service. Investors with business or accounting expertise can point out problems in the entrepreneur's business plan or projections. Investors with legal expertise can point out regulatory issues the entrepreneur has not considered. Not only would these communications better inform investors, they might help the entrepreneur refine his business plan.

Openness like this can also lead to better monitoring after an investment is made. From a purely economic standpoint, it makes little sense for someone who has invested a couple of hundred dollars to devote a substantial amount of time and effort to monitoring. But

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[600] *See* James Surowiecki, *supra* note 125, at 230 (Peer monitoring is a fundamental part of the virtual world); Schwienbacher & Larralde, *supra* note 16, at 12 (Although crowdfunders might not have any special knowledge about the industry in which they are investment, as a crowd, they can be more efficient than a few equity investors alone). *See also* Freedman & Jin, *supra* note 551, at 2.

the social aspects of crowdfunding and other crowdsourcing applications lead people to contribute inordinate amounts of time and effort to the enterprise.[601] An open platform allows these monitors to share their findings with other investors.

Open communication is not an unmitigated positive. It could also lead to group-think. Deliberative discussion "is the enemy of collective intelligence because it reduces diversity."[602] James Surowiecki, famous for promoting "the wisdom of crowds," notes that group judgment is most likely to be accurate if each person's opinion is not determined by the opinions of those around them.[603] According to Surowiecki, "The more influence a group's members exert on each other, and the more personal contact they have with each other, the less likely it is that the group's decisions will be wise ones."[604] If people can see what others have done before they act, they tend to follow the actions of others, creating an "information cascade problem.[605]

There is also a risk that these open forums will be the target of spammers or advertisements, or that users will pose fraudulent comments. Crowdfunding sites should not be liable for the content of the comments and should be free to remove irrelevant or fraudulent material.

2. Investor Education

Many of the investors on crowdfunding sites will be unsophisticated.[606] The presence of so many unsophisticated investors offers a rare investor-education opportunity. Each crowdfunding investor, before he or she is given access to any offerings, should be required to complete a brief investor education video or quiz prepared by the SEC.[607]

I am not suggesting that the SEC require a full course of investor education or that the SEC certify whether investors are qualified to invest.[608] Such requirements would unduly burden crowdfunding and chill its development. I am suggesting a brief film or quiz with feedback that would take no more than five or ten minutes to complete. Such a short presentation would not make crowdfunding investors sophisticated, but it would allow the SEC to warn them of the potential pitfalls and risks associated with small business investments.

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[601] "In many cases, the financial return seems to be of secondary concern for those who provide funds. This suggests that crowdfunders care about social reputation and/or enjoy private benefits from participating in the success of the initiative." Belleflamme, et al, *supra* note 12, at 26.

[602] Howe, *supra* note 2, at 175.

[603] Surowiecki, *supra* note 125, at 10.

[604] *Id.*, at 42.

[605] *Id.*, at 63-64.

[606] *See* Section VI.B.2, *supra*.

[607] *See The SBE Council Proposal*, SEC, *available at* http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf (proposing that investors be required to take an online test prior to investing).

[608] Others have suggested certification of investors. *See* Choi, *supra* note 451, at 310-311 (proposing that investors be licensed); Note, *Unsophisticated Wealth*, *supra* note 575, at 759-762 (2009) (proposing that investors be licensed). *See also* Jeffrey J. Hass, *supra* note 200, at 112 (arguing that unseasoned issuers should have to make a suitability determination before selling securities to unsophisticated retail investors).

The mechanics would be relatively simple. When investors first register with the crowdfunding site, they could be linked to the SEC material, and returned to the crowdfunding site when the educational video or quiz is completed.[609] There is no easy way to guarantee that investors actually pay attention (or, in the case of a video, even watch it), but this requirement would at least give unsophisticated investors an *opportunity* to learn something. Those who choose not to utilize this opportunity have only themselves to blame.

Heminway and Hoffman propose to accomplish the same objective in a slightly different way—by requiring each crowdfunding web site to include cautionary language and certain other limited disclosures.[610] This is a plausible alternative, but my proposal has two advantages. First, it allows a disinterested party, the SEC to control the disclosure and the context in which it is presented. Second, as anyone who has dealt with the detailed scroll-down licenses on the Internet can attest, cautionary language and mandatory disclosures tend to be ignored. Investors could be forced to engage with a non-graded quiz, even if they breeze through it.

3. Funding Goals and Withdrawal Rights

Entrepreneurs should be required to include a funding goal in their on-line proposals and should not be allowed to close offerings unless and until investors have pledged at least that amount. Until then, investors should be free to change their minds and withdraw their pledges.

These requirements allow the social networking aspect of crowdfunding to work fully. Investors can communicate with each other while the offering is open and withdraw their bids if they conclude, based on the information shared, that the offering is not a suitable investment. The all-or-nothing condition also protects the most optimistic and foolhardy investors from their own improvidence. Unless the entrepreneur can convince other, more rational, investors to participate, the foolhardy are not at risk.[611]

The all-or-nothing condition also forces the entrepreneur to carefully consider her financing needs before posting her proposal. Since overreaching could cause the offering to fail, the entrepreneur has an incentive to request only the minimum amount needed to

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[609] Crowdfunding sites would not be required to present the SEC material to investors or to endorse the SEC educational materials as their own, only to limit access to investors who have viewed such material. Therefore, any claim that the exemption compels speech in violation of the First Amendment seems weak. *See generally* ERWIN CHERERINSKY, CONSTITUTIONAL LAW: PRINCIPLESA ND POLICIES 1001-1002 (4th ed. 2011) (discussing the compelled speech issue under the First Amendment); RONALD ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE 63-64 (4th ed. 2008) (same).

[610] *See* Heminway & Hoffman, *supra* note 144, at 65.

[611] This all-or-nothing restriction "imposes a market discipline. . . You can see whether an artist or organizer can get sufficient attention to a project." Tina Rosenberg, *On the Web, a Revolution in Giving*, OPINIONATOR, NEW YORK TIMES (Mar. 31, 2011), http://opinionator.blogs.nytimes.com/2011/03/31/on-the-web-a-revolution-in-giving/ (quoting Ethan Zuckerman, senior researcher at Harvard's Berkman Center for Internet and Society).

fund the project. This will lead to more careful budgeting before the funding request is posted.

Some of the existing crowdfunding sites already impose all-or-nothing requirements like this,[612] and requirements of this type are common in other areas of securities regulation. Some securities offerings include minimum sales conditions.[613] Closing an offering when that minimum is not met constitutes securities fraud.[614] And, since no contract of sale is allowed before a registration statement is effective,[615] investors who express interest before that time are free to change their minds and withdraw their offers. Similarly, shareholders whose shares are subject to a tender offer are free to withdraw their tenders at any time prior to closing of the offer.[616] Crowdfunding investors should receive similar protection.

4. No Investment Advice or Recommendations

One of the key determinants of whether a person is a broker or an investment adviser is whether he or she offers recommendations or investment advice to investors.[617] Unless crowdfunding sites are willing to register as brokers or investment advisers, they should not recommend or rate the offerings that appear on the sites and should not advise investors about the merits or risks of those offerings. Without this restriction, a crowdfunding exemption could become a way to circumvent the regulation applicable to ordinary brokers and investment advisers. If crowdfunding sites do more than act as a neutral intermediary, they should have to face the regulatory consequences. Similarly, if crowdfunding sites set up a secondary trading market for crowdfunded securities, the crowdfunding exemption should not free them from having to register as exchanges or alternative trading systems if such registration would otherwise be required.

5. Prohibition on Conflicts of Interests

Crowdfunding sites and their employees should not be allowed to invest in the offerings on their sites, or to have any financial interest in the companies posting offerings on the

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[612] *See, e.g., Kickstarter Basics*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter%20basics#AlloFund (last visited Aug. 23, 2011); *ProFounder Terms and Conditions for Services*, PROFOUNDER, https://www.profounder.com/legal/terms_and_conditions (last visited Jan. 27, 2011) ("If the aggregate value of pledges that Company receives in its Raise does not meet Company's Raise Goal within the time period allotted, ProFounder will no longer continue to support the making or collection of pledges for that particular Raise, pledges will not be converted to Investments and funds distributed to Company, and no money will change hands on the Website."). *But see Frequently Asked Questions*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Aug. 23, 2011) (under "Creating a Campaign" tab) ("If you don't meet your funding goal, you still keep the money you raise with your campaign.")

[613] *See* Regulation S-K, Item 501(a)(8)(ii), Example B, 17 C.F.R. §229.501(a)(8)(ii) (2011) (requiring that any such conditions be disclosed on the front cover of the registration statement).

[614] Rule 10b-9(a)(2), 17 U.S.C. §240.10b-9(a)(2)(2007). *See also* In the Matter of Richard H. Morrow, Exchange Act Release No. 40392 (Sept. 2, 1998) (violation to sell securities after the deadline set in the offering document for raising the required minimum amount).

[615] *See* Securities Act § 5(a)(1), 15 U.S.C. §77e(a)(1) (2010).

[616] Rule 14d-7, 17 U.S.C. §240.14d-7 (2007).

[617] *See* Section IV.B.2.c(1), *supra*.

site. Some of the SEC no-action letters regarding matching services condition relief on the non-participation of the site and its employees in any of the posted offerings.[618] Although typically unstated by the SEC staff, the concern is obvious: participation in the advertised offerings gives the site and its employees a financial interest in favoring or promoting particular offerings.[619] If recommendations and other investment advice are prohibited, the potential dangers of such conflicts are reduced. Nevertheless, a conflict-of-interest prohibition would eliminate any remaining incentives to manipulate the system to promote or favor particular offerings. Such a condition would also prevent an issuer from setting up a sham site to promote the issuer's own securities. And, necessary or not, a conflict-of-interest prohibition like this could enhance the public reputation of crowdfunding sites.[620] Such restrictions seem relatively harmless; the cost to the site of imposing such a policy would be small.[621]

6. Notification to the SEC

Crowdfunding sites that meet these requirements should not have to register as brokers, investment advisers, or exchanges, and no other special registration should be required. However, sites should have to notify the SEC that they are acting as crowdfunding sites pursuant to the exemption. The SEC, understandably, will want to monitor how the crowdfunding exemption is being used and whether sites are in compliance; it can do that only if it knows where crowdfunding is occurring. A simple notice containing the site's name and URL should be sufficient. Since the sites will be open to the public, including the SEC, that is all the SEC will need for monitoring purposes.

This notice should not trigger any other regulatory requirements. The more the SEC requires from these sites, the greater the cost that will be passed along to entrepreneurs doing crowdfunding, and the less effective the crowdfunding exemption will be.

C. Other Possible Requirements

1. Non-Profit Versus Profit Status

Crowdfunding sites should not be required to have non-profit status. The SEC no-action letters applying the definitions of broker and investment adviser to Internet matching sites have often focused on the provider's non-profit status.[622] A for-profit provider obviously has a stronger incentive to push investors and entrepreneurs to complete the proposed

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[618] *See, e.g.*, Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Atlanta Economic Development Corp., SEC No-Action Letter, 1987 WL 107835 (Feb. 17, 1987).

[619] The receipt of transaction-based compensation already gives crowdfunding sites a financial incentive to promote all of the offerings collectively. The concern here is the incentive to promote particular offerings in which the site's operators have invested or plan to invest.

[620] Of course, if that is the case, individual sites have a competitive incentive to impose and promote such policies, whether or not the SEC requires them.

[621] The site should not be liable if an employee, without its knowledge or complicity, invests in one of the site's offerings—for example, through a false identity. If the crowdfunding site has a conflict-of-interest policy, informs its employees of its policy, and makes a good faith effort to enforce the policy, it should qualify for the exemption.

[622] *See* Section IV.B.2.e and text accompanying note 362, *supra*.

transactions, even if those transactions are not in investors' best interests.[623] This is especially true when, as in the case of many existing crowdfunding sites, the site operator's compensation depends on completion of the transaction.

But that profit motivation also gives companies incentives to establish crowdfunding sites in the first place and to develop and improve those sites.[624] With the exception of Kiva, and that is admittedly a big exception, for-profit sites have driven business-related crowdfunding. Limiting crowdfunding to non-profits would seriously restrict its development. Some of the proposed restrictions on crowdfunding sites, such as the prohibition of investment advice and the conflicts-of-interest bar, should temper some of the less positive effects of the profit motive. Reputational constraints will also moderate a site's interest in pushing investors into inappropriate investments; a site that develops a reputation for losing investments will suffer a loss of customers as investors move to more reputable sites.[625]

2. Registration/Standardized Disclosure

Some of the crowdfunding exemption proposals call for crowdfunding offerings to be registered with the SEC and to make standardized disclosure available to investors. The Small Business and Entrepreneurship Council proposal would require some sort of standard disclosure, such as a modified SCOR form.[626] The Startup Exemption proposal would require standardized disclosure and monthly reports to be filed with the SEC.[627] Heminway and Hoffman suggest that "issuers (both crowdfunding ventures and their promoters, including Web site operators) . . . file with the SEC (a) brief issuer registration and (b) a brief offering notice."[628] They envision "a stripped down version of either the Form D required by offerings under Regulation D or the Small Company Offering Registration form" used by the states.[629] They also suggest standardized disclosures on the sites themselves about

> the crowdfunding Web site, the crowdfunded ventures, the interests being offered, the way in which the offering is being conducted, the ongoing role of the crowdfunding Web site after investments are made, and any follow-on ministerial services (delivery of investor funds to the crowdfunded venture, monitoring of the crowdfunded venture's operations and financial data, collection and distribution

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[623] *See* Verstein, *supra* note 14, at 14 (peer-to-peer lending platforms "have an incentive to encourage lending, but suffer little if the lending is imprudent.)

[624] *See* Olivia L. Walker, *The Future of Microlending in the United States: A Shift from Charity to Profits?* 6 OHIO ST. BUS. L. J. 383, 393-395 (2011) (arguing that, for microlending to succeed in the United States, it needs to be transformed into a for-profit industry).

[625] *See* Verstein, *supra* note 14, at 14 (Peer-to-peer lending platforms "have long-term incentives to cultivate impressive returns to gain customers.")

[626] *See* The SBE Council Proposal, SEC, *available at* http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf.

[627] *See* Exemption Framework ¶ 7, Startup Exemption, http://www.startupexemption.com/?page_id=92#axzz1T9YWT6vM.

[628] Heminway & Hoffman, *supra* note 144, at 60.

[629] *Id.*, at 66.

of profit-sharing or revenue-sharing amounts to investors, etc.) that will be rendered.[630]

Mandatory disclosure requirements will clearly increase the cost of crowdfunding.[631] Any filing or standardized disclosure requirement, no matter how minimal, will increase the need for entrepreneurs to engage attorneys, and the increased cost will drive away small, marginal entrepreneurs. Crowdfunding site operators might help entrepreneurs complete the required disclosure, but that does not eliminate the cost, and such advice increases the likelihood that the site operator will be treated as a broker or investment adviser.[632]

The proponents of registration and mandatory disclosure are missing one of the important facets of the argument for small business exemptions. For offerings below a certain size, the cost of *any* regulatory requirements—even a minimal disclosure requirement—exceeds the benefit. For those small offerings, an *unconditional* exemption makes sense.[633] No matter how attractive registration and standardized disclosure might seem in the abstract, they make no economic sense for the very small offerings that crowdfunding facilitates.

Standardization, although it allows easier comparisons among investment opportunities and therefore has some value to investors,[634] is a bad idea for another reason. Crowdfunding is still in its earliest stage of development. Standardization of what appears on crowdfunding sites could discourage experimentation and freeze its development. Instead of forcing all crowdfunding sites into a federally mandated standard disclosure model, we should allow them to search for the format that investors find most useful.

3. Restrictions on Resale

Heminway and Hoffman propose that the resale of crowdfunded securities be restricted.[635] They point out that investors who buy in a resale market may not have direct access to the information available on the crowdfunding site itself, so resales are more conducive to fraud.

I do not believe that such restrictions on resale are necessary or desirable. The existing crowdfunding sites do not maintain trading markets, and they cannot easily establish such markets without registering as exchanges or alternative trading systems.[636] If crowdfunding platforms do establish their own trading platforms, information about the

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[630] Id., at 68.

[631] Heminway and Hoffman concede that "[t]he major disadvantage of this type of disclosure requirement is its cost." *Id.*, at 68.

[632] *See* Sections IV.B.2.c(1) and IV.C.4, *supra*.

[633] I explain this point in much greater detail elsewhere. *See* Bradford, *Securities Regulation and Small Business*, *supra* note 544, at 29-33; Bradford, *supra* note 450, at 614-622.

[634] *See* Heminway & Hoffman, *supra* note149, at 52-53.

[635] *See* Heminway & Hoffman, *supra* note 144, at 63-64.

[636] *See* Section IV.A, *supra*.

entrepreneur and the offering is available on-site. And, given the small amounts invested, active trading markets are unlikely to develop outside the crowdfunding site.[637]

Resale restrictions are likely to serve only as a trap for the unwary. They would expose unsophisticated investors, who are unlikely to understand or even be aware of such restrictions, to liability whenever they sell their crowdfunded securities to Uncle Ernie or Aunt Emma. And, if those restrictions have any teeth, resales could cause issuers to lose their exemptions because of actions effectively beyond their control.[638] Given the limited danger, resale restrictions are undesirable.

D. Preemption of State Law

Securities regulation in the United States is a polycentric combination of federal and state regulation. Issuers offering securities must deal not only with the registration requirements of the federal Securities Act, but also with the registration requirements in all of the states in which they are offering the securities. Congress has preempted state registration requirements for the offering of certain securities,[639] but the securities sold by small issuers on crowdfunding sites do not fall within the preempted categories. Even if the SEC adopts a crowdfunding exemption, the states would remain free to regulate crowdfunding.[640]

State securities laws also require the registration of brokers and other agents engaged in securities activities.[641] Exempting crowdfunding sites from federal regulation as brokers or investment advisers would not protect them from similar state regulation. The Exchange Act limits the power of states to regulate brokers and their associated persons,[642] but crowdfunding sites would *not* be brokers under the proposed crowdfunding exemption. The states would be free to construe the term "broker" more broadly than under federal law. The SEC probably could effectively preclude state regulation of crowdfunding sites as investment advisers. The Advisers Act provides that states may not require the registration, licensing or qualification of advisers excepted

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[637] The notes offered by Prosper and Lending Club are traded on a platform maintained by FOLIOfn, a registered broker-dealer. *See* Prosper Registration Statement, *supra* note 83, at 11; Lending Club Registration Statement, *supra* note 83, at 11. It is not clear how actively those notes are traded.

[638] Heminway and Hoffman recognize this issue. They note that "any regulatory solution should address the manner in which investor violations of any resale prohibition impact the issuer's exemption. Heminway & Hoffman, *supra* note 144, at 64 n. 298.

[639] *See* Securities Act § 18, 15 U.S.C. §77r (2010).

[640] "Even when the issuer is able to qualify for exemption from the . . . Securities Act, there is no guarantee, other than Rule 506, that the offering will be exempt from state securities regulation." Cohn & Yadley, *supra* note 13, at 13. A crowdfunding site could avoid the application of a *particular* state's securities law by not selling in that state. Most states have adopted an exemption for Internet offerings when (1) the offer specifically indicates it is not being offered to the residents of that state; no offer is specifically directed to anyone in that state; and no securities are sold in that state. *See* Sjostrom, *supra* note 200, at 30.

[641] *See generally* 12A LONG, *supra* note 150, at 8-3 to 8-10.

[642] Securities Exchange Act § 15(i), 15 U.S.C. §77o(i)

from the federal definition in section 202(a)(11) of the Advisers Act,[643] and one of the exceptions in 202(a)(11) is for advisers designated by the SEC.[644]

The states could develop coordinated exemptions that would also free crowdfunded offerings from state regulatory requirements. This would not be unprecedented. Many states, for example, have adopted a Uniform Limited Offering Exemption (ULOE) that coordinates with Rule 505 of Regulation D.[645] But the states have been unwilling to extend the ULOE to Rule 504,[646] and it is unlikely they will extend it to any other exemption for offerings to unaccredited, unsophisticated investors.[647]

Because of state securities law, a federal crowdfunding exemption would not by itself allow entrepreneurs to avoid the cost of regulation; unless state law was preempted, a federal exemption would merely shift the cost to another level in our federal system. Absent corresponding state exemptions, a federal exemption would therefore accomplish little.[648] Compliance with state regulation alone is "prohibitively costly if companies are seeking to raise only small amounts of money."[649] Therefore, states should be preempted from requiring the registration of offerings that comply with the proposed crowdfunding exemption.[650]

The most effective way to preempt state law is through congressional action.[651] Congress could simply add crowdfunded securities to the existing list of preempted offerings.[652] This is precisely what H.R. 2930 proposes to do. But Congress often moves glacially, and

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[643] Investment Advisers Act § 203A(b)(1)(B), 15 U.S.C. §80b-3a(b)(1)(B) (2010)

[644] Investment Advisers Act § 202(a)(11)(H), 15 U.S.C. §80b-2(a)(11)(H) (2010)

[645] There are actually two versions of the Uniform Limited Offering Exemption. *See* Uniform Limited Offering Exemption (adopted Sept. 21, 1983, with amendments adopted April 29, 1989), in 12B LONG, *supra* note 150, at App. C; Uniform Limited Offering Exemption, in *id.*, Appendix C-1. For a general discussion of the ULOE, *see* 12 LONG, *supra* note 150, at §§ 7:85-7:107.

[646] Only four states have exemptions for offerings under Rule 504, and at no time has there been any serious effort to coordinate the ULOE with Rule 504. 12 LONG, *supra* note 150, at 7-199.

[647] Most states have adopted a uniform private offering exemption that exempts offerings to no more than a few people in the state. *See* 12 LONG, *supra* note 150, at 7-45. That exemption is unlikely to work for most crowdfunded offerings. It focuses on the number of offerees in the state, not the number of purchasers, effectively precluding publicly advertised offerings. *Id.*, at 7-45-7-46. Some states have altered their versions of the exemption to focus on the number of purchasers, but even some of those states still put an outside limit on the number of offerees. *Id.*, at 7-50. Other states read a sophistication requirement into the exemption, which would preclude public offerings. *Id.*, at 7-49.

[648] Rutheford Campbell argues that requiring federally exempted small business offerings to comply with state registration requirements is inconsistent with the SEC's reckoning of the appropriate balance between investor protection and capital formation and imposes an "unwarranted drag on capital formation." Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 208 (1997). More recently, Campbell has called for the complete preemption of all state registration requirements. *See* Rutheford B Campbell, Jr., Federalism Gone Amuck: The Case for Reallocating Governmental Authority Over the Capital Formation Activities of Businesses (Sept. 28, 2011), available at http://ssrn.com/abstract=1934825.

[649] Shane, *supra* note 527.

[650] Others agree that any crowdfunding exemption should preempt state law. *See* Heminway & Hoffman, *supra* note 144, at 69; Pope, *supra* note 100, at 127.

[651] *See* Cohn & Yadley, *supra* note 13, at 82 (calling for Congressional action to preempt state registration requirements for all federally exempted offerings except the intrastate exemption).

[652] *See* Securities Act § 18, 15 U.S.C. §77r (2010).

the most recent congressional action, the Dodd-Frank Act,[653] was in the direction of more securities regulation, not less. Moreover, it is unclear "whether small business advocates have the political strength to overcome what is likely to be strong state opposition."[654]

The other possibility is intriguing, but probably even less likely. Section 18(b)(3) of the Securities Act preempts state securities requirements "with respect to the offer or sale . . . [of securities] . . . to qualified purchasers, as defined by the Commission by rule."[655] The statute itself does not define "qualified purchaser;" it says the SEC "may define the term . . . differently with respect to different categories of securities, consistent with the public interest and the protection of investors."[656] The SEC could define the term qualified purchaser to include everyone who purchases in a federally exempted crowdfunding offering, thereby exempting crowdfunding offerings from state registration requirements.[657] This would not solve the "broker" or "investment adviser" issues under state law, but it would exempt the offerings themselves from registration.

However, it is reasonably clear that, when Congress added this provision to the Securities Act, in the National Securities Market Improvement Act of 1996, it intended "qualified purchaser" to encompass only "sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary."[658] Rutheford Campbell argues that this legislative history should not limit the SEC,[659] but the SEC proposal to implement section 18(b)(3), still not adopted, equates the term qualified purchaser with the term "accredited investor" in Regulation D.[660] Most crowdfunding investors are not accredited investors, so the SEC is unlikely to include them within the definition of "qualified purchaser" for purposes of preemption.

VIII. Conclusion

The SEC should adopt an exemption to facilitate crowdfunded securities offerings. That exemption should include the basic features outlined above. Issuers should be able to raise a maximum of $250,000-500,000 each year without registration or other

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[653] Dodd-Frank Wall Street Reform and Consumer Protection Act, LAW Pub. L. 111-203

[654] Cohn & Yadley, *supra* note 13, at 60.

[655] Securities Act § 18(b)(3), 15 U.S.C. §77r(b)(2) (2010)

[656] Securities Act § 18(b)(3), 15 U.S.C. §77r(b)(2) (2010).

[657] Others have made similar suggestions. Shortly after these preemption provisions were added by the National Securities Markets Improvement Act of 1996, Rutheford B Campbell proposed that the SEC define "qualified purchaser" to include all purchasers in offerings pursuant to the Rules 504, 505, 147, and Regulation A exemptions. Campbell, *supra* note 648, at 207. *See also* Sjostrom, *supra* note 202, at 587-588 (noting this as a possible solution to the problem state regulation poses to Internet offerings).

[658] H.R. Rep. No. 622, 104th Cong., 2d. Sess. 31 (1996). *See also* S. Rep. No. 293, 104th Cong., 2d Sess. 15 (1996).

[659] Campbell, *supra* note 648, at 207-208. Campbell notes that the statute itself contains no such restriction and states that the legislative history is "so disjointed and confusing as to be essentially worthless." *Id.*, at 208. Section 18 requires the SEC to define the term "consistent with the public interest." Securities Act § 18(b)(3). Professor Campbell also points out that, in considering what is in the public interest, the SEC must consider not only investor protection, but also "whether the action will promote efficiency, competition, and capital formation." *Id.*, at 207.

[660] *See* Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Securities Act Release No. 33-80441 (Dec. 19, 2001).

information requirements, provided that each investor invests annually no more than the greater of $500 or two percent of the investor's annual income. Those crowdfunded offerings should include a funding goal and should not close until that goal is met. Until then, investors should be free to withdraw from the offering. The exemption should also require that the offering be made on a crowdfunding site that

- notifies the SEC it is facilitating crowdfunding offerings under the exemption
- is open to the general public;
- provides a communication portal that allows investors to communicate about each offering;
- requires investors to fulfill a simple education requirement before investing;
- does not invest, and does not allow its employees to invest, in the site's offerings; and
- does not offer investment advice.

Crowdfunding is no panacea. None of the requirements I propose will guarantee that investors receive their expected returns. None of these requirements will protect investors from the losses often incurred by investors in small businesses. None of these requirements will prevent fraud. That is not the point of the proposed crowdfunding exemption.

Instead, the proposed crowdfunding exemption is an attempt to promote small business capital formation by exempting offerings where the cost of registration clearly exceeds any possible benefits. The proposed exemption allows smaller, unsophisticated investors to act as capitalists, to learn by doing, while protecting those investors from catastrophic losses they cannot bear. And, finally, the proposed exemption attempts to bring securities regulation into the modern world of social networking and the Internet, to reconcile the regulatory requirements of 1933 with the realities of 2011.