JUMPSTART REGULATION CROWDFUNDING: WHAT IS WRONG AND HOW TO FIX IT

by
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In 2015, the Securities and Exchange Commission adopted Regulation Crowdfunding, which permitted small businesses and startups to raise capital from the general public online. Unfortunately, Regulation Crowdfunding failed its essential purpose to facilitate capital formation for small businesses and startups due to its high transaction costs and low offering limit. But it turns out that equity crowdfunding in other countries—especially in Great Britain—is highly successful, and in some cases, exceeds venture capital funding. In these countries, equity crowdfunding's transaction costs and disclosure requirements are much lower than, and issuers may raise more money than, offerings under Regulation Crowdfunding. Furthermore, the increase in equity crowdfunding investment in other countries did not lead to a disproportionate increase in securities fraud. The Securities and Exchange Commission may better fulfil the JOBS Act's policy goals by amending Regulation Crowdfunding to incorporate a de minimis exception for small businesses, and by raising its offering limit to adequately support startups.

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INTRODUCTION

In the summer of 2012, Palmer Luckey, the founder of Oculus Rift—a virtual reality headset developer—launched a crowdfunding campaign on Kickstarter—"the world's largest funding platform for creative projects"[1]—to fund its virtual reality headset development.[2] Kickstarter is an online funding platform that allows individuals to solicit funding for "creative projects" from a broad community of online donors.[3] The Oculus Rift campaign exceeded its goal of $250,000 in less than one day and went on to raise nearly $2.5 million from 9,522 contributors in less than

[1] *See Become an Active Member of the Kickstarter Community*, BACKERKIT (May 3, 2018), https://www.backerkit.com/blog/kickstarter-community.

[2] Leo Benedictus, *Why Oculus's $2Bn Sale to Facebook Sparks Fury from Kickstarter Funders*, THE GUARDIAN (Mar. 26, 2014), https://www.theguardian.com/technology/shortcuts/2014/mar/26/oculus-rift-facebook-fury-kickstarter-funders.

[3] *See Pressroom*, KICKSTARTER, https://www.kickstarter.com/press?ref=about_subnav (last visited Feb. 23, 2018).

one month.[4] Two years later, Facebook acquired Oculus Rift for $2 billion.[5]

Although Mr. Luckey did not disclose his compensation for the buyout, *Forbes* listed Mr. Luckey's net worth at $730M in 2016.[6] Unfortunately, none of Oculus Rift's Kickstarter contributors received a single penny from Facebook's purchase.[7] At the time, there was no mechanism for contributors to receive equity in exchange for their contribution to the project. In lieu of equity, contributors received rewards ranging from a T-shirt to a prototype virtual reality headset, depending on their contribution.[8] Had Oculus Rift's contributors received equity for their contribution, they would have received a 145x return on their investment in just two years.[9]

Due to the success of Oculus Rift, Pebble Watch, Fidget Cube, and other Kickstarter campaigns, national attention has shifted towards equity crowdfunding as an innovative and effective mechanism for small businesses and startups to raise capital.[10] In 2012, Congress passed the Jumpstart Our Business Startups Act ("JOBS Act"), which created a new exemption to the Securities Act of 1933 ("Securities Act") and constructed a framework for small businesses and startups to crowdfund securities online without having to register with the Securities and Exchange Commission (SEC).[11] Under the statute, small businesses and startups

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[4] *Oculus Rift: Step into the Game*, KICKSTARTER, https://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game (last visited Feb. 23, 2018); *see also* Richard Mitchell, *Oculus Rift: From $2.4 Million Kickstarter to $2 Billion Sale*, ENGADGET (Mar. 28, 2014), https://www.engadget.com/2014/03/28/oculus-rift-from-2-4-million-kickstarter-to-2-billion-sale/.

[5] *See* Mitchell, *supra* note 4.

[6] *See #22 Palmer Luckey*, FORBES (Dec. 12, 2016), https://www.forbes.com/profile/palmer-luckey/.

[7] *See* Benedictus, *supra* note 2.

[8] *See* Jillian Berman, *I Backed Oculus Rift on Kickstarter and All I Got Was This Lousy T-Shirt*, HUFFINGTON POST (Mar. 26, 2014), https://www.huffingtonpost.com/2014/03/26/oculus-rift-kickstarter_n_5034511.html.

[9] A $1,000 contribution equated to a 0.00482% equity stake in Oculus Rift. Facebook would have paid these "investors" $145,000 for their ownership stake, resulting in a 145 times return on their money in two years. *See* Greg Belote, *What if Oculus Crowdfunded for Equity? 145x Return.*, WEFUNDER BLOG (Mar. 26, 2014), https://wefunder.com/post/42-what-if-oculus-crowdfunded-for-equity.

[10] *See* Thomas Murphy, *Playing to a New Crowd: How Congress Could Break the Startup Status Quo by Raising the Cap on the JOBS Act's Crowdfunding Exemption*, 58 B.C. L. REV. 775, 776 (2017); *see also* Reza Dibadj, *Crowdfunding Delusions*, 12 HASTINGS BUS. L.J. 15, 16 (2015) ("Indeed, crowdfunding generates a buzz in the otherwise staid field of securities regulation.").

[11] *See* 15 U.S.C. § 77(a)(6) (2012); Patrick Archambault, *How the SEC's Crowdfunding Rules for Funding Portals Save the Two-Headed Snake: Drawing the Proper Balance Between Integrity and Cost,* 49 SUFFOLK U. L. REV. 61, 66 (2016) ("Crowdfunding law diverges from the long-settled laws for public offerings of securities.").

may issue up to $1 million in crowdfunding securities annually to the general public though an online intermediary.[12] The JOBS Act further created an express private remedy for investors to mitigate the risk of fraud due to crowdfunding's internet-based nature.[13]

The JOBS Act's primary purpose was to enhance innovation and economic growth in the United States by "deliver[ing] appropriate forms of capital and liquidity to entrepreneurs at each stage of their growth."[14] The JOBS Act included a mandate for the SEC to create a regulatory framework for equity crowdfunding, which the SEC subsequently finalized as Regulation Crowdfunding ("Regulation CF").[15] Since small businesses and startups are vital to the nation's economy and job creation, Congress also intended the JOBS Act to create new jobs.[16] Regulation CF's proponents were optimistic that equity crowdfunding would revolutionize business financing as well as democratize security investments by allowing the middle class to invest in early-stage businesses when equity is cheap.[17]

Unfortunately, the JOBS Act and Regulation CF failed to live up to the hype. Offerings under Regulation CF totaled approximately $40 million one year out, while offerings under Regulation D, the most popular SEC registration exemption, totaled over $1.3 trillion.[18] Small businesses

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[12] Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(6)(A) (2012); *see also* Murphy, *supra* note 10, at 776.

[13] Securities Act of 1933 § 4A(c)(1)(A), 15 U.S.C. § 77d-1(c)(1)(A) (2012).

[14] Thomas A. Martin, The JOBS Act of 2012: Balancing Fundamental Securities Law Principles with the Demands of the Crowd 3 (April 12, 2012) (unpublished J.D. thesis) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2040953).

[15] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), https://www.sec.gov/news/pressrelease/2015-249.html.

[16] *See* 158 CONG. REC. H1236 (daily ed. Mar. 7, 2012) (statement by Representative Bachus: "[The JOBS Act will] increase capital formation which spurs the growth in start-up companies, creates jobs, and encourages companies, small companies, to add jobs and to invest."); *id.* at H1237 (statement by Representative Hansarling: "So we in the Congress need to do whatever we can to enable the start-up companies, the job engines of America, to be able to access the equity markets. . . ."); *id.* at H1239 (statement by Representative Fincher: "It is no secret that our Nation has seen a decline in small business startups over the last few years, which means less jobs created for American workers.").

[17] *See* Chance Barnett, *Trends Show Crowdfunding to Surpass VC in 2016*, FORBES (June 9, 2015), https://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/3/#793c2b892ecd; *see also* Marcus Hollon, *Joining SeedInvest and the Equity Crowdfunding Revolution!*, LINKEDIN (Oct. 11, 2017), https://www.linkedin.com/pulse/joining-seedinvest-equity-crowdfunding-revolution-marcus-hollon/.

[18] *See* Catherine Yushina, *Regulation Crowdfunding: One Year in Force*, CROWDFUNDINSIDER (May 16, 2017), https://www.crowdfundinsider.com/2017/05/100442-regulation-crowdfunding-one-year-force/.

and startups overwhelmingly avoided using Regulation CF to secure their early-stage financing and generally turned to banks, venture capitalists, and angel investors.[19] Starting a new small business or startup is often very capital intensive. In their early stages, nearly all small businesses and startups face a "capital gap"—the difference between how much small businesses and startups require to develop, and the amount that investors are willing to invest in the company.[20] The small business capital gap usually ranges between $25,000 and $50,000, while the capital gap facing startups range from $1.5 million to $4 million.[21] Some scholars estimate the small business and startup shortfall to exceed $60 billion a year.[22] Regulation CF is unable to assist small businesses and startups in their early-stage capital formation because the substantial transaction costs associated with its disclosure requirements are too high for small businesses to utilize, and the $1.07 million offering cap is insufficient to cover the capital gap for most startups.[23]

However, other scholars insist that Regulation CF's high regulatory costs and disclosure requirements are necessary to deter fraud.[24] These scholars assert that without proper disclosure, unaccredited investors—people with less than $1 million net worth or with an annual income less than $200,000—would be unable to discern the investment risks, and would be unable to ascertain the merits of the investment.[25] Michael B. Dorff, Professor of Law at Southwestern Law School, goes so far as to claim that no amount of disclosure can adequately protect unaccredited investors, and advocates for making Regulation CF's disclosure requirements so draconian that no issuer would raise capital under Regulation CF.[26]

However, such opinions regarding crowdfunding fraud were based mostly on speculation and heavily underestimated unaccredited investor sophistication.[27] More recent studies indicate that absent fraud, many un-

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[19] *See* Murphy, *supra* note 10, at 786–87.

[20] Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Market: Recent Trends and Developments*, 6 J. PRIVATE EQUITY 7, 14 (2003).

[21] *See* Bill Payne, *The Funding Gap*, GUST BLOG (Dec. 6, 2011), http://blog.gust.com/the-funding-gap/.

[22] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 100 (2012).

[23] *See* Patricia H. Lee, *Access to Capital or Just More Blues? Issuer Decision-Making Post SEC Crowdfunding Regulation*, 18 TENN. J. BUS. L. 19, 21–22 (2016); Murphy, *supra* note 10, at 802–03.

[24] *See* Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 523 (2014).

[25] *Id.* at 502 n.83, 523.

[26] *See id.* at 523.

[27] *See* Barry James, *Research on Risk Shows Crowdfunding Has Significant Fraud Immunity: Here's Why*, CROWDFUND INSIDER (May 29, 2017), https://www.crowdfundinsider.com/2017/05/101121-research-risk-shows-crowdfunding-significant-

accredited investors make choices comparable to their accredited counterparts, and unaccredited investors tend to become more sophisticated over time.[28] Non-equity crowdfunding studies show that donors were highly selective regarding which projects they fund.[29] Of the successfully funded projects on Kickstarter, 1% of the projects accounted for 36% of the total amount raised, with 10% of the projects accounting for 63% of the total.[30] Similarly, according to a study conducted on Sellaband—a music-centered crowdfunding website—61% failed to obtain any funding at all, and less than 1% of bands raised more than 73% of the funding between 2006 and 2009.[31] Such studies indicate that unaccredited investors are more discerning than critics give them credit for and do not blindly invest in junk investments merely because they are available.

The SEC can spur innovation more effectively and better assist small business and startup capital formation by adopting two additional Regulation CF exemptions. The first proposed amendment ("Exemption A") creates a *de minimis*[32] exemption that will allow issuers to raise up to $50,000 through an online intermediary with reduced disclosure requirements, which is similar to what banks require for small business loans. The second proposed amendment ("Exemption B") will allow issuers to raise up to $5 million annually through an online intermediary but limits each investor to $1,000 per offering. Incorporating these exemptions will assist small businesses and startups with their early-stage capital formation needs while protecting unaccredited investors by limiting their investments and mandating the use of third-party intermediaries.

The SEC has the authority to incorporate these exemptions under section 3(b) and section 28 of the Securities Act.[33] Section 3(b) authorizes the SEC, without congressional approval, to create exemptions for offerings that do not exceed $5 million.[34] Section 28 authorizes the SEC to create new exemptions in excess of $5 million if the exemption is "neces-

fraud-immunity-heres/; *see also* INFO. FOR DEV. PROGRAM (*INFO*DEV)/THE WORLD BANK, CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 46 (2013), http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf; Anita Anand, *Is Crowdfunding Bad For Investors?*, 55 CAN. BUS. L.J. 215, 216–17 (2014).

[28] *See* THE WORLD BANK, *supra* note 27, at 46.

[29] *See* Ajay Agrawal et al., *Some Simple Economics of Crowdfunding*, 14 INNOVATION POL'Y & ECON. 63, 66 (2014); Rajkamal Iyer et al., *Screening Peers Softly: Inferring the Quality of Small Borrowers*, 62 MGMT. SCI. 1554, 1554 (2016) (finding that the non-expert lender eventually achieved 87% of the predictive power of an expert in the field.).

[30] Agrawal, *supra* note 29, at 66.

[31] *Id.*

[32] *De minimis* means "about minimal things."

[33] Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (2012); Securities Act of 1933 § 28, 15 U.S.C. § 77z-3 (2012).

[34] Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (2012).

sary or appropriate in the public interest, and is consistent with the protection of investors."[35] Permitting unaccredited investors access to equity crowdfunding to assist small business and startup capital formation is necessary to promote the compelling government interest in obtaining the societal "benefits that flow" from a diverse business environment.[36]

This Note asserts that the SEC should amend Regulation CF to include Exemption A and B under section 3(b) or section 28 of the Securities Act. Alternatively, this Note asserts that Congress should amend the JOBS Act directly to better meet the statute's policy goals. Part I provides an overview of crowdfunding. Part II examines the JOBS Act and Regulation CF. Part III discusses why the JOBS Act failed in its primary purpose to enhance innovation and economic growth by enhancing capital formation for small businesses and startups. Part IV proposes two amendments to Regulation CF to better serve the JOBS Act's primary policy goal. Part V illustrates that incorporating Exemptions A and B will not lead to a disproportionate level of fraud and abuse. Finally, Part VI explains that Exemptions A and B are necessary because the existing regulatory framework is inadequate to jumpstart small business and startup capital formation.

I. WHAT IS CROWDFUNDING?

Crowdfunding is the "practice of funding a project or venture by raising money from a large number of people who each contribute a relatively small amount, typically via the Internet."[37] Crowdfunding is an increasingly popular method of fundraising for the arts, video games, and early-stage tech companies.[38] Businesses such as Oculus Rift, Cards Against Humanity, Fidget Cube, and Pebble Watch all sought funding through crowdfunding.[39] According to Massolution's Crowdfunding Industry Report, the global crowdfunding industry raised an estimated $34.4 billion in 2015, and crowdfunding investment is projected to exceed $90 billion in 2020.[40]

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[35] Securities Act of 1933 § 28, 15 U.S.C. § 77z-3 (2012).

[36] The Supreme Court values diversity as a compelling government interest. *See* Regents of the University of California v. Bakke, 438 U.S. 265, 267 (1978) ("[T]he goal of achieving a diverse student body is sufficiently compelling . . . .").

[37] *Crowdfunding,* OXFORDDICTIONARIES.COM, https://en.oxforddictionaries.com/definition/crowdfunding (last visited Feb. 8, 2015).

[38] *See* Dorff, *supra* note 24, at 494.

[39] *See Most Successful Crowdfunding Campaigns*, CROWDFUNDINGBLOG.COM, https://crowdfundingblog.com/most-successful-crowdfunding-projects/ (last visited Mar. 23, 2018).

[40] The peer-to-peer lending model accounted for $25.1 billion, while the donation/reward model accounted for $5.5 billion. *Massolution Crowdfunding Industry 2015 Report*, CROWDEXPERT.COM (Jan. 12, 2016), http://crowdexpert.com/crowdfunding-industry-statistics/. Equity crowdfunding accounted for a mere $2.56

There are five basic crowdfunding models: the donation model, the pre-purchase model, the reward model, the lending model, and the equity model.[41] These models differ in the compensation investors receive for their contribution. Under the donation model, "investors" make charitable donations and receive no consideration for their contribution.[42] Under the pre-purchase and reward models, investors receive either a pre-purchased product, or a nominal gift such as a T-shirt.[43] Under the lending model—also known as "peer-to-peer lending"—investors loan money to the issuer and expect repayment of their loan, sometimes with interest.[44] Finally, under the equity model, investors receive an ownership interest in the company for their contribution.[45]

Under certain circumstances, individuals and groups raising money through crowdfunding may be offering investment securities, which are subject to SEC regulation. Section 2(a)(1) of the Securities Act expansively defines "securities" to include not only stocks and bonds, but to also include novel and unique instruments such as "investment contracts."[46] The Supreme Court in *SEC v. Howey* stated: "an investment contract [security] for the purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party . . . ."[47] Thus, under the *Howey* test, the first three crowdfunding models are not considered investment securities—since the "investors" are merely donating their funds or receiving consumable items in return. The equity model qualifies as a security because investors are seeking profits, and the lending model may be a security, depending on whether the lender charged interest.

II. WHAT ARE THE JOBS ACT AND REGULATION CF?

In April of 2012, President Obama signed the JOBS Act, which created a statutory exemption for "retail crowdfunding"—equity crowdfunding available to the general public. Subsequently, the SEC adopted Regulation CF to create a regulatory framework for equity crowdfunding under Title III of the JOBS Act.[48] Title III of the JOBS Act—also known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act ("CROWDFUND Act")—created an exemption to the Se-

billion in 2015. *Id.*

[41] Murphy, *supra* note 10, at 791–92.

[42] *See id.* at 792.

[43] *See id.* at 792–93.

[44] *See id.* at 793.

[45] *Id.*

[46] Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012).

[47] SEC v. Howey Co., 328 U.S. 293, 298–99 (1946).

[48] Archambault, *supra* note 11, at 70–71.

curities Act of 1933 to allow small businesses and startups to issue securities through an intermediary without registering with the SEC.[49] The purpose of the CROWDFUND Act was to "assist smaller companies with capital formation and to provide investors with additional protections."[50] The CROWDFUND Act included a mandate for the SEC to create a regulatory framework for equity crowdfunding, which the SEC subsequently finalized as Regulation CF.[51]

Regulation CF permits the general public to invest in small businesses and startups through online intermediaries, subject to some restrictions. Under Regulation CF, small businesses and startups can raise up to $1.07 million annually by offering equity in their company to investors through an online intermediary.[52] Investors with a net worth or annual income under $107,000 may invest the greater of $2,200 or 5% of their annual income per year.[53] Investors with both a net worth and an annual income exceeding $107,000 may invest up to 10% of the lesser of either their net worth or annual income, with a hard cap of $107,000 annually.[54] Further, Regulation CF restricts investors from, *inter alia*, reselling securities purchased through the exemption for a period of one year, except when investors sell the security back to the issuer or to an accredited investor.[55] Finally, offerings under Regulation CF are "covered" securities, meaning that offerings under the statute are not subject to state blue sky laws.[56]

To issue an offering under Regulation CF, the issuer must file a Form C with the SEC which requires the issuer to proffer extensive disclosures which include, *inter alia*:

- information about officers, directors, and owners of 20 percent or more of the issuer;
- a description of the issuer's business and the use of proceeds from the offering;

[49] *See* Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(6) (2012).

[50] Press Release, *supra* note 15.

[51] *See* Lee, *supra* note 23, at 23; Regulation Crowdfunding, 17 C.F.R. §§ 227.100–227.305 (2018).

[52] Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(1) (2018); *see also Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, U.S. SEC. & EXCH. COMM'N (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.
htm.

[53] Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(2)(2018).

[54] *Id.*

[55] Regulation Crowdfunding, 17 C.F.R. § 227.501(a)(2018); *see also Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, *supra* note 52.

[56] *See* 17 C.F.R. § 227.501(a).

- the price to the public of the securities or method for determining the price,
- the target offering amount and the deadline to reach the target offering amount,
- whether the issuer will accept investments in excess of the target offering amount;
- certain related-party transactions; and
- a discussion of the issuer's financial condition and financial statements.[57]

To deter fraud, the statute further requires issuers to proffer their financial statements and federal income tax returns for the preceding 12-month period before the issue, certified by its principal executive officer.[58] Issuers raising between $107,000 to $535,000 must have their financial statements reviewed by an independent public accountant.[59] Issuers raising more than $535,000 must have their financial statements au-audited by an independent public accountant unless the issuer is a first-time issuer. Finally, issuers must file annual reports with the SEC via Form C-AR.[60]

Ordinarily, section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") requires issuers with total assets more than $10 million and a class of securities held by either 2,000 persons or 500 unaccredited investors to register with the SEC.[61] Offerings under Regulation CF are particularly vulnerable to this registration requirement, as the very nature of crowdfunding is to obtain small investments from a broad donor base. Fortunately, Rule 12g-6 conditionally exempts Regulation CF offerings from section 12(g) registration as long as the issuer:

- is current in its ongoing annual reports required pursuant to Regulation Crowdfunding;
- has total assets as of the end of its last fiscal year of $25 million or less; and
- has engaged the services of a transfer agent registered with the SEC.[62]

[57] *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, *supra* note 52; Regulation Crowdfunding, 17 C.F.R. § 227.201 (2018); *see also* Crowdfunding, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

[58] 17 C.F.R. § 227.201(t); *see also Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, *supra* note 52.

[59] 17 C.F.R. § 227.201(t).

[60] 17 C.F.R. § 227.203(b).

[61] Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g) (2018); 17 C.F.R. § 240.12g-1 (2018).

[62] *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, *supra* note

In the event that the issuer's assets exceed $25 million at the end of its fiscal year, Rule 12g-6 provides a two-year grace period before the issuer is required to register its securities under § 12(g).[63] This conditional section 12(g) exemption protects small businesses and startups from prematurely becoming a reporting company before they are ready.

Regulation CF prohibits issuers from advertising directly to the general public and requires issuers to make their offerings through online intermediaries. These intermediaries must register as either a broker-dealer or as a funding portal with both the SEC and the Financial Industry Regulatory Authority, Inc. (FINRA).[64] Intermediaries are limited to connecting issuers to investors and are prohibited from proffering investment advice or from soliciting investors to purchase particular offerings.[65] Intermediaries act as "gatekeeper[s]," and play a critical role in protecting investors and deterring fraud under the JOBS Act.[66] Regulation CF requires intermediaries to:

- provide investors with education materials;
- take measures to reduce the risk of fraud;
- make available information about the issuer and the offering;
- provide communication channels to permit discussions about offerings on the platform; and
- facilitate the offer and sale of crowdfunded securities.[67]

To prevent conflicts of interest, intermediaries that are not registered brokers (i.e. funding portals) are prohibited from holding, possessing, or handling investor funds or securities and must use qualified third parties to hold the proceeds for the benefit of investors and issuers.[68]

Intermediaries must have "a reasonable basis for believing" that issuers are acting in compliance with § 4A(b) of the Securities Act.[69] This usually requires the intermediary to run a background check and an enforcement history on the issuer's principal officers, directors, and any persons holding more than 20% equity.[70] By making these disclosures publicly available, intermediaries reduce the risk of fraud by allowing po-

52; *see also* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.12g-6 (2018).

[63] 17 C.F.R. § 240.12g-6(b).

[64] *See* Regulation Crowdfunding, 17 C.F.R. § 227.300(a) (2018).

[65] *See* Regulation Crowdfunding, 17 C.F.R. § 227.300(b) (2018).

[66] *See* Archambault, *supra* note 11, at 78–79.

[67] *See* Regulation Crowdfunding, 17 C.F.R. §§ 227.300–227.305 (2018); Crowdfunding, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

[68] *See* 17 C.F.R. §§ 227.300, 227.303.

[69] Regulation Crowdfunding, 17 C.F.R. § 227.301(a) (2018).

[70] Regulation Crowdfunding, 17 C.F.R. § 227.201(b)-(c) (2018).

tential investors to personally examine any of the issuer's questionable claims. Since many prospective investors will have a limited ability to distinguish between valid and dubious financial disclosures, intermediaries add an extra layer of protection to prevent fraudulent offerings.

Since intermediaries participate in the greatest number of transactions, they will likely be the most sophisticated party in Regulation CF transactions, and therefore are best able to protect investors from fraud.[71] The internet-based nature of retail crowdfunding increases the risk of fraud when compared to face-to-face transactions. Regulation CF's increased liability for intermediaries attempts to mitigate that risk.[72] FINRA also oversees online intermediaries for failures to comply with Regulation CF and can shut down any intermediary that fails to comply with the statute.[73] Regulation CF adequately deters fraud by providing multiple layers of checks and balances that act as a barrier against fraud and abuse.

III. THE JOBS ACT FAILED TO MEET EXPECTATIONS?

The JOBS Act's purpose was to enhance innovation and economic growth in the United States by "deliver[ing] appropriate forms of capital and liquidity to entrepreneurs at each stage of their growth."[74] Scholars estimate that small businesses and startups face a capital gap in excess of $60 billion each year.[75] Many economists consider a robust and active entrepreneurial environment to be integral to a well-functioning and prosperous economy.[76] By authorizing investment opportunities hitherto available only to the wealthy, proponents claimed that crowdfunding investments would become the anti-establishment alternative to investing in Wall Street.[77] Although many scholars were initially optimistic that Title

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71 *See* Archambault, *supra* note 11, at 79.

72 *See* 17 C.F.R. § 227.301.

73 *See* Archambault, *supra* note 11, at 78.

74 *See* Martin, *supra* note 14, at 3 (alteration in original).

75 *See* Bradford, *supra* note 22, at 100.

76 *See, e.g.*, Ed Sappin, *7 Ways Entrepreneurs Drive Economic Development*, ENTREPRENEUR.COM (Oct. 20, 2016), https://www.entrepreneur.com/article/283616 ("[E]ntrepreneurs create businesses and new businesses create jobs, strengthen market competition and increase productivity."); *see also* Karen Mills, *SBA's Karen Mills: U.S. Economy Depends on Entrepreneurs, Needs Them Back in the Game*, WASH. POST (Apr. 29, 2013), https://www.washingtonpost.com/business/on-small-business/sbas-karen-mills-us-economy-depends-on-entrepreneurs-needs-them-back-in-the-game/2013/04/29/5a7bfd84-ad02-11e2-a8b9-2a63d75b5459_story.html?utm_term=.008fd9e31d6b ("Entrepreneurship is America's secret sauce. It's what built the greatest economy in the world and the strongest middle class.").

77 *See* Dan Miller, *E-Commerce Is to Borders As Crowdfunding Is to Wall Street*, FORBES (Mar. 16, 2015), https://www.forbes.com/sites/theyec/2015/03/16/e-commerce-is-to-borders-as-crowdfunding-is-to-wall-street/#15d57fe21f29. *See generally* John Armour & Luca Enriques, *The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts*, ECGI 2, 3 (2017), http://ssrn.com/abstract_id=3035247.

III of the JOBS Act would foster a new renaissance in start-up financing—by allowing general solicitation without SEC registration—the results did not live up to the hype.

Globally, the crowdfunding industry has doubled every year since 2012, reaching $32 billion in 2016, mainly under the peer-to-peer lending and the donation/reward models.[78] However, capital raised under Regulation CF was a modest $10 million from May 16, 2016 through January 15, 2017, which accounts for less than 1% of the capital raised under the other crowdfunding models.[79] The primary reason that small businesses and startups avoided Regulation CF was due to the substantial transaction costs associated with complying with its disclosure requirements, which were not required under the other crowdfunding models.[80]

A. The Primary Reasons for Regulation CF's Anemic Performance Are Its High Transaction Costs and Low Offering Limit

Under Section 5 of the Securities Act, all offers or sales of securities must be registered with the SEC or qualify for an exemption.[81] SEC registration is a long and expensive process, costing hundreds of thousands of dollars, and therefore is impractical for small businesses and startups.[82] Regulation CF is a qualified exemption to Section 5 registration, but the transaction costs are too high for most small businesses and startups to fully utilize. Under Regulation CF, issuers are subject to transaction costs totaling upwards of 21.5% and subject to ongoing reporting costs each year.[83] Unfortunately, many costs are fixed, making it especially burdensome for smaller offerings. Further, Regulation CF does little to foster innovation and diversity and fails to assist small businesses seeking relatively small amounts of capital through broad-based solicitation.[84]

While some may be tempted to explain Regulation CF's lackluster performance on its relative newness rather than on its high transaction costs, a comparison between Regulation CF and the U.K.'s booming retail crowdfunding market casts doubt on that assertion. The U.K. authorized retail crowdfunding in 2014—two years after Congress passed the

[78] The peer-to-peer lending model accounted for $25.1 billion, while the donation/reward model accounted for $5.5 billion. Equity crowdfunding accounted for a mere $2.56 billion in 2015. *See Massolution Crowdfunding Industry 2015 Report*, *supra* note 40.

[79] *See* STAFF OF THE DIV. OF ECON. & RISK ANALYSIS OF THE U.S. SEC. & EXCH. COMM'N, *supra* note 18, at 58.

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

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

[82] *See* Dorff, *supra* note 24, at 501.

[83] Armour & Enriques, *supra* note 77, at 26.

[84] *See* Murphy, *supra* note 10, at 786–90.

JOBS Act—and by 2015, the U.K.'s retail crowdfunding market reached £245 million ($343 million), which surpassed the £225 million ($315 million) invested by U.K. venture capitalists that same year.[85] By contrast, Regulation CF offerings totaled over $40 million one year out.[86] This comparison is even more remarkable since the U.K. economy ($2.622 trillion GDP) is almost eight times smaller than the U.S. economy ($19.391 trillion GDP).[87] This difference in performance is primarily due to the difference in retail crowdfunding transaction costs between the U.S. (15%–21.5%) and the U.K. (8%–10%).[88]

In lieu of creating a new regulatory scheme for retail crowdfunding, the U.K.'s Financial Conduct Authority (FCA) incorporated the scheme into its existing regulatory framework.[89] The FCA created a new type of "non-readily realisable securities" and authorized general solicitation through online intermediaries authorized by the FCA.[90] The main difference between U.K. and U.S. equity crowdfunding is that in the U.K. there is no limit to how much issuers can raise in an offering, and investors can invest up to 10% of their "investible assets" with no hard investment limit.[91] Further, the FCA requires much less disclosure than the SEC, with transaction costs averaging less than half that of Regulation CF.[92] Non-accounting-related disclosure requirements are similar to those of Regulation CF, such as disclosing the issuer's officers and principal shareholders, tax returns, and business plans.[93] Finally, although there is no limit to the amount issuers can raise, the FCA requires a prospectus for offerings which exceed £5 million ($6.89 million).[94]

The U.K.'s retail peer-to-peer lending industry is likewise booming, accounting for £1.490 billion ($2.086 billion) in 2015.[95] Unlike the U.S.,

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[85] *See* Armour & Enriques, *supra* note 77, at 10.

[86] Yushina, *supra* note 18.

[87] *See generally World Economic Outlook Database*, INT'L MONETARY FUND (Apr. 23, 2017), https://www.imf.org/external/pubs/ft/weo/2017/02/weodata/index.aspx; *see also GDP (Current US$)*, THE WORLD BANK, https://data.worldbank.org/indicator/ny.gdp.mktp.cd?view=map (last visited Oct. 11, 2018).

[88] *See* Armour & Enriques, *supra* note 77, at 26–27.

[89] *See* TIFFANY NG, LEG. COUNCIL SECRETARIAT, REGULATION OF CROWDFUNDING IN SELECTED PLACES 12 (2017), https://www.legco.gov.hk/research-publications/english/1617in17-regulation-of-crowdfunding-in-selected-places-20170721-e.pdf.

[90] *See* Armour & Enriques, *supra* note 77, at 23–24.

[91] *Id.*

[92] *Id.* at 26–27.

[93] *See Investee Terms*, CROWDCUBE.COM, https://www.crowdcube.com/pg/investee-terms-1503 (last visited Feb. 24, 2018).

[94] *See* Armour & Enriques, *supra* note 77, at 22.

[95] Brian Zhang et. al., *Pushing Boundaries: The 2015 UK Alternative Finance Industry Report*, UNIV. OF CAMBRIDGE 15 (2016), https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2015-uk-alternative-finance-industry-report.pdf.

the U.K. permits the general public to participate in peer-to-peer lending through online intermediaries.[96] Since the FCA considers peer-to-peer lending to be less risky than equity crowdfunding, it requires less disclosure and lower transaction costs to raise capital.[97] The maximum a small business can borrow through peer-to-peer lending in the U.K. is £25,000 ($35,000), and the disclosure requirements approximate what banks require for small business loans.[98] The online intermediary assesses the borrower's creditworthiness and is charged with displaying risks or warnings in an "easily understandable manner."[99] In the U.S., not only would this "*de minimis*" peer-to-peer lending be subject to Regulation CF's high transaction costs, but it may also be subject to other regulations concerning consumer credit, usury laws, privacy laws, and anti-money laundering laws.[100] Although the U.S. permits accredited peer-to-peer lending, retail peer-to-peer lending is not yet available.[101]

The success of the U.K.'s retail crowdfunding model has influenced many other countries to ease their retail crowdfunding regulatory and disclosure requirements.[102] For example, Australia increased its retail crowdfunding offering limit to AU$5 million ($3.84 million) and increased the amount unaccredited investors can invest to AU$10,000 ($7,769) per year.[103] Contrary to many critics' predictions, the U.K.'s increase in retail crowdfunding did not lead to a proportionate increase in securities fraud.[104] While some critics accuse equity crowdfunding proponents of "cherry-picking information," any published negative articles regarding retail crowdfunding did not have a "chilling effect" on investment. Thus, the U.K.'s equity crowdfunding boom supports the assertion that Regulation CF's high transaction costs, rather than its newness, are the primary reason for the U.S.'s anemic retail equity crowdfunding growth.

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96 *See* NG, *supra* note 89, at 8 n.26 ("[P]eer-to-peer lenders . . . may be subject to the Truth in Lending Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Electronic Fund Transfer Act, and Fair Debt Collection Practices Act . . . .").

97 *Id.* at 10–11.

98 *Id.* at 11.

99 *See id.*

100 *See id.* at 8.

101 Noah Buhayar, *Peer-to-Peer Lending*, BLOOMBERG (June 6, 2017), https://www.bloomberg.com/quicktake/peer-peer-lending.

102 *See* NG, *supra* note 89, at 3 (noting that in 2016 Singapore eased its equity crowdfunding requirements. Australia also amended its equity crowdfunding statute in 2017 requiring less stringent disclosure.).

103 *See id.* at 3 n.9.

104 *See* Anita Anand, *Equity Crowdfunding: More Benefits Than Costs*, THE CLS BLUE SKY BLOG (July 8, 2015), http://clsbluesky.law.columbia.edu/2015/07/08/equity-crowdfunding-more-benefits-than-costs/ ("According to a UK report, the established evidence shows that little fraud actually occurs in crowdfunded transactions.").

B. Regulation CF Fails Because the Cap is Too Low to Adequately Support Startups in Their Early-Stage Financing

Startups are distinguishable from traditional small businesses because startups focus on high-growth and innovation rather than producing a yearly return on investment.[105] Since many startups seek funding when they are not yet profitable, bank loans are difficult for them to obtain. Even if startups were able to secure bank financing, cash flow demands usually makes this financial strategy impractical.[106] Startups rely heavily on venture capitalists and angel investors for financing, and often have the goal of getting bought by a larger company or going public.[107]

Between 2007 and 2013, the average startup raised approximately $41 million before being acquired by a larger company or going public.[108] This amount dwarfs the $1.07 million that Regulation CF permits issuers to raise annually. "A capital gap exists when a startup requires cash to operate and grow, but is still too immature to generate interest from investors."[109] This capital gap, sometimes referred to as the "valley of death," generally affects businesses looking to raise up to $2 million.[110] Startups stuck in the valley of death are highly vulnerable to failure.[111]

Venture capitalists and angel investors are unable to adequately meet the needs of early-stage startups. Venture capitalists are sophisticated investors who take large equity stakes in startups, seeking to cash out as startups go public or are acquired by larger companies.[112] Venture capitalists often perform extensive due diligence before investing in a startup and often participate in the startup's management to increase the likelihood of its success.[113] However, obtaining venture capital is very rare, and venture capitalists typically only fund established startups with a clear

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105 *See* Murphy, *supra* note 10, at 781–82.

106 *See id.*

107 *See* Tim Berry, *What Startups Need to Know About Exit Strategies*, BPLANS, https://articles.bplans.com/what-startups-need-to-know-about-exit-strategies/ (last visited Apr. 15, 2018); Sramana Mitra, *Can Crowdfunding Solve the Startup Capital Gap?*, HARV. BUS. REV. ONLINE (July 24, 2013), https://hbr.org/2013/07/can-crowdfunding-solve-the-sta.

108 *See* Mark Lennon, *CrunchBase Reveals: The Average Successful Startup Raises $41M, Exits at $242.9M*, TECHCRUNCH (Dec. 14, 2013), https://techcrunch.com/2013/12/14/crunchbase-reveals-the-average-successful-startup-raises-41m-exits-at-242-9m/.

109 Murphy, *supra* note 10, at 786; Sohl, *supra* note 20, at 14.

110 *See* Murphy, *supra* note 10, at 787.

111 *Id.*

112 *See id.* at 783; *see also* George Deeb, *Comparing Equity, Debt, and Convertibles for Startup Financings*, FORBES (Mar. 19, 2014), https://www.forbes.com/sites/georgedeeb/2014/03/19/comparing-equity-vs-debt-vs-convertibles-for-startup-financings/#5eb36da069ff.

113 *See* Murphy, *supra* note 10, at 783–84.

path towards an exit.[114] According to the Small Business Administration, only 300 of the 600,000 new businesses that are started each year obtain venture financing.[115] Since venture capitalists focus primarily on "high-growth, high-return" investments with a proven track record, they accept less than 1% of the proposals they receive.[116] As a result, most startups struggle to acquire capital, and many potentially successful startups fail due to the inability to procure adequate funding.[117]

Angel investors are also unable to adequately meet the needs of early-stage startups. Angel investors are investors or groups of investors who invest their own money in the startup and usually take an active role in the business as a mentor or as a member of the board.[118] The typical angel investor has a master's degree, has over 14 years of experience as an entrepreneur, and invests at least 10% of his or her wealth in startups.[119] Unlike venture capitalists, angel investors usually possess specialized industry knowledge and generally make investments earlier in the startup's life cycle. However, angel investors alone are insufficient to fill the capital gap, as they are few and far between, and are geographically concentrated in population centers such as New York, San Francisco, and Seattle.[120] Further, since the total investment of angel investors was less than half of what venture capitalists invested in 2015, angel investment is not sufficient to adequately fill the capital gap for most startups.[121]

Many scholars contend that startups require between $2 million and $5 million to avoid the "valley of death."[122] Regulation CF fails to adequately assist startups with their capital formation because the $1.07 million offering cap is too low to meet their early-stage capital needs. Alt-

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[114] *See* Mitra, *supra* note 107.

[115] Dileep Rao, *Why 99.95% of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital*, FORBES (July 22, 2013), https://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time-seeking-venture-capital/#2dd8501346eb.

[116] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-00-190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 10 (2000).

[117] *See* Archambault, *supra* note 11, at 62.

[118] *See* COLIN M. MASON & RICHARD T. HARRISON, ANNUAL REPORT ON THE BUSINESS ANGEL MARKET IN THE UNITED KINGDOM: 2008/09, at 1 (2010), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32214/10-994-annual-report-business-angel-market-2008-2009.pdf.

[119] *See* MARIANNE HUDSON, ANGEL CAPITAL ASS'N, ANGEL INVESTMENT IN THE U.S. – TRENDS & BEST PRACTICES (2016), http://angelcapitalassociation.org/data/Documents/ACAatAEBAN09-26-16.pdf.

[120] *See* Murphy, *supra* note 10, at 787.

[121] *See* HUDSON, *supra* note 119, at 8 (venture capitalists invested $59.1 billion, while angel investors invested $24.6 billion).

[122] *See* Murphy, *supra* note 10, at 803; Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1445 (2008) (a capital gap exists for entrepreneurs raising up to $5 million).

hough some startups are successful with minimal financing and eventually exit successfully, the bulk of startups fail during this stage.

C. Regulation CF Fails Because the Transaction Costs Are Way Too High for Most Small Businesses to Utilize

People often speak of small businesses as being the "backbone of our society." This statement is not far from the truth. According to the Small Business Association, small businesses comprise of 99.7% of U.S. employer firms and 97.6% of firms exporting goods, and created 61.8% of net new private-sector jobs between 1993–2016.[123] Small businesses enhance independence, encourage innovation, and generate a broad variety of employment opportunities.[124]

A comparison between the Inc. 500 and the Forbes Fortune 500 highlights the power of small business job creation. The Inc. 500 is an annual list of the 500 fastest-growing private companies in the United States.[125] The Fortune 500, on the other hand, lists the largest companies by revenue in the United States.[126] Inc. 500 companies created 35,823 jobs from 2007–2010, while Fortune 500 companies eliminated 821,000 jobs during the same time frame—despite having "buoyant profits."[127] While the legislatures of the 20th century safely relied on big companies to create jobs in exchange for tax incentives, small businesses and startups have created two out of every three jobs since the turn of the century.[128]

The JOBS Act's legislative history illustrates that spurring small business growth was among the legislature's chief goals in enacting the JOBS Act. Representative Spencer Bachus stated that government regulations and capital formation "are two reasons that small companies are not hiring . . . . It's harder for these companies to get traditional bank financing. . . . [I]ncrease[d] capital formation . . . creates jobs, and encourages companies, small companies, to add jobs and to invest."[129] Other representatives echoed this sentiment with comments such as: "[i]t is time to cut away the redtape [sic]" and "[w]e should be doing everything we can,

[123] *See* U.S. SMALL BUS. ASS'N OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS ABOUT SMALL BUSINESS 1 (2017), https://www.sba.gov/sites/default/files/Whats-New-w-Small-Business-2017.pdf.

[124] *See* David M. Kirby, *Small Businesses Can Make a Big Impact on the Economy*, HUFFINGTON POST (Dec. 6, 2017), https://www.huffingtonpost.com/david-m-kirby/small-businesses-can-make_b_13127000.html.

[125] *See* Lee, *supra* note 23, at 29.

[126] *See Fortune 500*, FORTUNE, http://fortune.com/fortune500/ (last visited Feb. 23, 2018).

[127] *See* Lee, *supra* note 23, at 29.

[128] *See Three Ways to Reignite U.S. Job Creation*, FORTUNE (May 7, 2014), http://fortune.com/2014/05/07/three-ways-to-reignite-u-s-job-creation/.

[129] *See* 158 CONG. REC. H1236 (daily ed. Mar. 7, 2012).

everything within our power to create an environment that enables those small businesses to hire one more worker."[130] Helping small businesses was a top priority when Congress enacted the JOBS Act.

However, the JOBS Act has done little to jumpstart small business growth in the United States. The transaction costs associated with issuing *de minimis* offerings through Regulation CF are many magnitudes too high for most small businesses to utilize. According to the Ewing Marion Kauffman Foundation, the average cost of starting a new small business from scratch in 2009 was approximately $30,000.[131] According to the SEC, the transaction cost related to raising $30,000 under Regulation CF is approximately $5,000 and 75 hours of internal document preparation.[132] Including $2,100 third-party intermediary costs, Regulation CF's costs rise to $7,100 (nearly 24% of the offering). Adding probable annual reporting costs of $3,000 a year for three years, the total amounts to $16,100—over half the issue price!

To compare, a qualifying small business can apply for an SBA 7(a) small business bank loan for $30,000 at an APR of 8.25%.[133] On a three-year repayment schedule, the small business makes 36 monthly payments of $940.09, and pays a total of $3,843.24 interest.[134] Including origination fees, the total cost of a three-year loan amounts to just over $4,000 (13.3%), and the small business gets to keep all of its built-up equity during that time. Unfortunately, traditional bank loans are often unattainable for small businesses because most small businesses lack the collateral, credit, and operating history that most banks require to qualify for a business loan.[135] In addition, as community banks consolidate into larger banks, it is increasingly difficult for small businesses to qualify for loans, as larger banks prefer to make loans to more established companies due to the lower risk and the higher profitability of larger loans.[136]

Regulation CF does little to assist small businesses in their capital formation because its transaction costs are too high for most small busi-

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[130] *Id.* at H1237, H1241.

[131] *See* Caron Beesley, *How to Estimate the Cost of Starting a Business from Scratch*, MBDA.GOV (Nov. 25, 2011), https://www.mbda.gov/news/blog/2011/11/how-estimate-cost-starting-business-scratch.

[132] *See* Regulation Crowdfunding, 80 Fed. 71,387, 71,497–71,524 (Nov. 16, 2015).

[133] *See* Megan Hanna, *SBA – Current Interest Rates and How They Work*, FITSMALLBUSINESS (Aug. 1, 2018), https://fitsmallbusiness.com/sba-loan-rates/#SBARates;%20Business%20Loan%20And%20Interest%20Rate%20Calculator.

[134] *See* Jeff White, *SBA Loan Calculator: Payments, Rates & Qualifications*, FITSMALLBUSINESS (May 1, 2018), https://fitsmallbusiness.com/sba-loan-calculator/.

[135] *See* Meredith Wood, *Financing Your Business: Your Small Business Loan Application Checklist*, FUNDERA (Dec. 12, 2016), https://www.fundera.com/blog/your-small-business-loan-application.

[136] The number of community banks decreased from 14,000 in the 1980's to less than 7,000 in 2014. Evan Gulstrom, *Intrastate Crowdfunding in Alaska: Is There Security in Following the Crowd?*, 34 ALASKA L. REV. 293, 298 n.33 (2017).

nesses to utilize. Even if a small business issuer were successful in its $30,000 Regulation CF offering, the venture would have to be exceedingly profitable for investors to see a return on their investment. Thus, because of the transaction costs related to excess regulatory burdens, the JOBS Act fails in its policy to assist small business capital formation.

IV. PROPOSED AMENDMENTS

The SEC can better meet the JOBS Act's policy goals by adopting two additional crowdfunding exemptions. First, the SEC can add Exemption A, a *de minimis* Regulation CF exemption which would allow issuers to raise up to $50,000 through an online intermediary with relaxed reporting requirements and transaction costs. Exemption A is loosely based on the U.K.'s retail peer-to-peer lending model, which was successful in raising £1.23 billion ($1.722 billion) for small businesses in 2016.[137] Exemption A incorporates Regulation CF's investment limit of the greater of $2,200 or 5% of the investor's annual income.[138] Mandatory disclosures should be no greater than what banks require for small business loans and should include:

- business and personal credit scores;
- relevant business documents including, but not limited to: 1) personal and business tax returns, 2) income statement, 3) profit & loss statement, 4) bank statements, 5) payroll records, and 6) business organization documents;
- personal and business background statements;
- business plan; and
- financial statements.[139]

Adopting Exemption A would allow small businesses to raise capital quickly and efficiently—by using the power of the crowd—and would protect unaccredited investors by limiting investments.

Exemption B would allow issuers to raise $5 million a year through an online intermediary, but would limit each investor to a $1,000 investment per offering. Investors under Exemption B are still permitted to invest $2,200 or 5% of their annual income per year, but investors may not invest more than $1,000 in offerings exceeding $1 million.[140] Offerings under Exemption B must be accompanied by audited financial state-

[137] *See Value of Peer-to-Peer (P2P) Business and Consumer Lending in the United Kingdom (UK) from 2014 to 2016 (in Million GBP),* STATISTA, https://www.statista.com/statistics/370647/lending-value-p2p-alternative-market/; *see generally* Armour & Enriques, *supra* note 77.

[138] 17 C.F.R. § 227.100(a)(2).

[139] *See* Wood, *supra* note 135.

[140] 17 C.F.R. § 227.100(a)(2).

ments. Exemption B protects investors by limiting the amount of loss for each individual investor, while allowing startups to adequately finance their innovative early-stage businesses.

Under Exemption B, issuers will be permitted to "test the waters" by filing a partially complete Form C with the SEC. The partially complete Form C will include information ordinarily required in a Form C,[141] but audited financial statements will not be required until the issuer is ready to proceed with the offering. Issuers will be prohibited from accepting any investments until they register a complete Form C with the SEC, and intermediaries will be required to include a legend stating that the potential issuer is merely testing the waters and that no money or other consideration is being solicited.[142] Approximately 33% of Regulation CF offerings fail to meet their goal.[143] Testing the waters allows issuers to gauge public interest in their company before spending tens of thousands of dollars in compliance costs.

The SEC may adopt Exemptions A and B to assist small businesses in capital formation under section 3(b)(1) of the Securities Act.[144] Section 3(b)(1) authorizes the SEC to create exemptions for offerings that do not exceed $5 million on its own initiative.[145] Such "small issue" exemptions do not require that the exemptions be "necessary for the public interest" or "for the protection of investors."[146] Alternatively, the SEC may adopt Exemption B under section 28 of the Securities Act.[147] Section 28 allows the SEC to "exempt any person, security, or transaction . . . from any provision or provisions of this title . . . to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[148] Exemption B is appropriate in the public interest because retail crowdfunding with a $5 million offering limit promotes the compelling government interest in obtaining the societal benefits that flow from a diverse business environment.[149]

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[141] *See* 17 C.F.R. § 227.201.

[142] Issuers and intermediaries should be held to a standard similar to Rule 255. *See* General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.255 (2017).

[143] *2017 State of Regulation Crowdfunding Report*, CROWDFUND CAPITAL ADVISORS (Jan. 24, 2018), http://crowdfundcapitaladvisors.com/2017-state-regulation-crowdfunding-report/.

[144] Securities Act of 1933, § 3(b)(1), 15 U.S.C. § 77c(b)(1).

[145] *Id.*

[146] *Id.*

[147] Securities Act of 1933, § 28; 15 U.S.C. § 77z-3. Although the SEC can also adopt Exemption A under § 28, Exemption A is more properly adopted under § 3(b).

[148] *Id.*

[149] Lee, *supra* note 23, at 28.

A. Exemption B Promotes Diversity in Startups

Studies show that venture capitalists, angel investors, and banks disproportionately reject financing proposals from women and minorities.[150] Since successful startups require substantial amounts of capital, entrepreneurs denied traditional financing sources face a serious disadvantage.[151] Women make up approximately 11% of the decision-making positions in venture capital, and startups with female CEOs only received 2.7% of total venture financing.[152] Minorities are also underrepresented in traditional startup financing. Blacks and Latinos only make up 7% of venture capital employees, and non-white startups received only 13% of venture capital funding.[153]

Many Supreme Court cases consider enhancing diversity to be a compelling state interest.[154] Thus, enhancing capital formation to maintain a diverse business community is certainly appropriate in the public interest. Many scholars agree that the ability to effectively network with venture capitalists and angel investors is vital to capital formation.[155] Female and minority entrepreneurs are often unable to network with venture capitalists and angel investors due to geographical constraints, or because they did not graduate from elite universities or belong to certain social clubs. This creates a serious disadvantage for female and minority entrepreneurs, who are often unable to otherwise obtain financing.

Since crowdfunding "brings the power of social networking" into small business and startup capital formation, retail crowdfunding has the potential to mitigate this lack of diversity.[156] Many entrepreneurs have great business ideas—notwithstanding the lack of venture capital networks or prestigious university degrees—and providing a platform that allows them to pitch their ideas to millions of Americans helps mitigate venture capital's "good ol' boys club." Further, community groups can organize online to support entrepreneurs that have been excluded from

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[150] *See* Murphy, *supra* note 10, at 787; *see also* Anita Li, *The Black Entrepreneur Trying to End Startup Racism is Almost Out of Cash*, MASHABLE (July 21, 2014), https://mashable.com/2014/07/21/startup-racism (discussing how only 17% of minority firms with gross receipts under $500,000 were likely to receive financing); Valentina Zarya, *Female Founders Got 2% of Venture Capital Dollars in 2017*, FORTUNE (Jan. 31, 2018), http://fortune.com/2018/01/31/female-founders-venture-capital-2017/ ("All-women teams received just $1.9 billion out of the $85 billion total.").

[151] *See* Murphy, *supra* note 10, at 787.

[152] *See id.* at 788–89.

[153] *See id.* at 789–90.

[154] *See* Regents of the University of California v. Bakke, 438 U.S. 265, 267, 315 (1978) ("[T]he goal of achieving a diverse student body is sufficiently compelling . . . ."); *see generally* Grutter v. Bollinger, 539 U.S. 306 (2003); Texas v. Johnson, 491 U.S. 397 (1989).

[155] *See* Murphy, *supra* note 10, at 804.

[156] *Id.*

traditional startup financing through retail crowdfunding. Groups like the Female Entrepreneur Association and Code2040 can facilitate capital acquisition by minority startups by exposing the startup to potential investors within their social networks, or by direct investment.[157] Thus, since Exemption B fosters gender, racial, and geographic diversity, such exemption is appropriate in the public interest. Exemption B is "consistent with the protection of investors" because it limits investors to $1,000 for offerings above $1 million, which acts to balance the higher offering limit.

V. INCORPORATING EXEMPTIONS A AND B WILL NOT LEAD TO A DISPROPORTIONATE LEVEL OF FRAUD AND ABUSE

The chief arguments against amending Regulation CF to incorporate Exemptions A and B are that 1) incorporating Exemptions A and B's relaxed standards exposes unaccredited investors to an unreasonable level of risk; 2) third-party intermediaries are inadequate gatekeepers; 3) investing in early-stage small businesses and startups exposes unaccredited investors to an unreasonable level of risk; and 4) small businesses and startups will experience problems due to dealing with a large group of shareholders. The following sections assert that 1) absent fraud, studies show that unaccredited investors can adequately assess business risk; 2) studies indicate that retail crowdfunding does not lead to a disproportionate level of fraud; 3) third party intermediaries sufficiently protect unaccredited investors; 4) even though investing in early-stage startups is risky, investment limits and non-monetary consideration help to mitigate that risk; and 5) voting restrictions and restricted resale help mitigate the effects of dealing with large groups of shareholders.

A. *Absent Fraud, Studies Show that Unaccredited Investors Can Adequately Assess Business Risk*

Due to the passing of the JOBS Act, small businesses and startups are permitted to offer securities to the general public online without complying with SEC registration.[158] However, many scholars were wary that the internet-based nature of retail crowdfunding would lead to an unacceptable level of fraud.[159] Some scholars went so far as to label the JOBS Act as the "Boiler Room Legalization Act," alluding to high-pressure tel-

[157] *See* Luke Cooper, *5 Organizations Helping Minority Startup Founders Succeed*, ENTREPRENEUR (Oct. 24, 2016), https://www.entrepreneur.com/article/282529; Tomer Harel, *6 Helpful Organizations for Women Entrepreneurs in 2017*, ENGADGET (Nov. 30, 2016), https://www.engadget.com/2016/11/30/6-helpful-organizations-for-women-entrepreneurs-in-2017/.

[158] *See* 17 C.F.R. § 227.100(a)(1).

[159] Murphy, *supra* note 10, at 800.

emarketing firms who sold investments through cold calling.[160] These scholars insist that Regulation CF's high disclosure requirements—and subsequent transaction costs—are necessary to provide enough information for investors to adequately assess the risk of the offering.[161] Michael B. Dorff—Professor at Law at Southwestern Law School—claims that no amount of disclosure is sufficient to protect unaccredited investors, and "there *is* no way to rescue retail crowdfunding."[162] Professor Dorff illustrates that Regulation CF offerings are terrible investments since entrepreneurs only turn to retail crowdfunding after being rejected by the banks, angel investors, and venture capitalists.[163] Since many unaccredited investors are not apt to read any disclosures at all—due to the overwhelming amount of information proffered by issuers and intermediaries—no amount of disclosure is likely to dissuade these investors from making bad investments.[164]

Other scholars assert that any investor protection must be viewed in light of the high transactional costs to both issuers and intermediaries. Requiring too much disclosure will have a "chilling effect" on the issuers utilizing the exemption, and requiring too little disclosure undermines investor protection.[165] Achieving the right balance between costs and disclosure "would be a bonanza for middle-class investors, entrepreneurs,

[160] *See* 158 CONG. REC. S1766 (daily ed. Mar. 19, 2012) (Senator Harry Reid stated that the lack of anti-fraud provisions in the bill makes the public vulnerable to unscrupulous people who "made cold calls to try to elicit unwary investors into dubious schemes"); *see also* Rick Cohen, *Introducing the JOBS Act—or the "Boiler Room Legalization Act,"* NONPROFIT QUARTERLY (Mar. 16, 2012), https://nonprofitquarterly.org/2012/03/16/introducing-the-jobs-actor-the-boiler-room-legalization-act/ ("[P]rofessor John Coffee calls it the 'boiler room legalization act . . . .'").

[161] *See* Anand, *supra* note 27, at 223–224; Dibadj, *supra* note 10, at 31; *see also* Edan Burkett, A *Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS 63, 96–99 (2011) (explaining how the JOBS Act disclosure requirements prevent fraud); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and The Securities Laws – Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1763 (2012) ("In order to give proper deference to investor protection, any exemption applicable to crowdfunding should be conditioned on mandatory disclosures" similar to Regulation A offerings.).

[162] *See* Dorff, *supra* note 24, at 523.

[163] *Id.* at 496–97.

[164] *Id.* at 507; *see also* Andy Greenberg, *Who Reads the Fine Print Online? Less Than One Person in 1000*, FORBES (Apr. 8, 2010), https://www.forbes.com/sites/firewall/2010/04/08/who-reads-the-fine-print-online-less-than-one-person-in-1000/#574add127017 (elaborating on a study done with 50,000 users, where less than 1 in 10,000 click twice to see e-commerce terms. The people who read fine print "are so close to zero that they call into question whether those legal disclosures should even be considered a safeguard for consumers.").

[165] *See* Dorff, *supra* note 24, at 780; *see also* Archambault, *supra* note 11, at 64.

job seekers, and the economy."[166] Of the two viewpoints, this paper adopts the latter and asserts that third-party intermediaries adequately protect Regulation CF's investors.

Many studies concerning retail crowdfunding fraud were based on speculation and were overly pessimistic regarding unaccredited investor sophistication.[167] Absent fraud, many unaccredited investors are just as selective as their accredited counterparts.[168] Non-equity crowdfunding studies show that donors were highly selective in deciding which projects to fund. Of the successfully funded projects on Kickstarter, 1% of the projects accounted for 36% of the total amount raised, with 10% of the projects accounting for 63% of the total.[169] Similarly, according to a study conducted on Sellaband—a music-centered crowdfunding program—61% of bands failed to obtain any funding, and less than 1% raised more than 73% of the funding between 2006 and 2009.[170]

U.K. retail crowdfunding sites show similar results. According to Crowdcube.com—the U.K.'s largest equity crowdfunding intermediary—26% of issuers received more than 75% of the total funding between January 2016 and October 2016.[171] During that same time period, 63% of issuers failed to raise even a quarter of their target funding.[172] Such studies indicate that unaccredited investors are more discerning than scholars credit them for and simply will not invest in junk investments merely because they have access to these investments online.

The knowledge gap that once separated professionals from the general public has greatly diminished due to the Internet providing readily accessible information.[173] Studies indicate that many unaccredited crowdfunding investors become more sophisticated over time.[174] A study of unsophisticated lenders on Prosper.com indicated that many lenders moved from investing in low performing loans to higher performing loans within two years.[175] Another study examined a non-expert lender's ability to screen for loan creditworthiness online.[176] The study found that over time, the non-expert lender could predict a loan defaults with 45%

[166] *See* Dorff, *supra* note 24, at 496.

[167] *See* Anand, *supra* note 27, at 222.

[168] *See* Anand, *supra* note 27, at 222–24; Ethan Mollick, *Crowdfunding: Promise or Peril?*, WHARTON ENTREPRENEURSHIP BLOG (Apr. 1, 2013), http://beacon.wharton.upenn.edu/entrepreneurship/2013/04/crowdfunding-promise-or-peril.

[169] *See* Agrawal, *supra* note 29, at 66.

[170] *Id.*

[171] *See* Armour & Enriques, *supra* note 77, at 16.

[172] *Id.*

[173] *See* Bradford, *supra* note 22, at 114.

[174] *Id.*

[175] *Id.* at 114–15.

[176] Iyer et al., *supra* note 29, at 1554–55.

greater accuracy than the default rate determined by credit score.[177] These unsophisticated lenders eventually achieved 87% of the predictive power of an expert in the field.[178] These studies show that many unaccredited investors are more sophisticated than critics give them credit for, and longer term investors may be able to adequately assess business risk.

B. Studies Show that Equity Crowdfunding Does Not Lead to a Disproportionate Level of Securities Fraud

In an Initial Public Offering (IPO), unaccredited, unsophisticated investors are protected from fraud by the due diligence of underwriters and through the information provided by the prospectus.[179] Since crowdfunding investors do not have the benefits of underwriters or a prospectus, many scholars predicted that it was only a matter of time before federal courts were filled with securities fraud claims.[180] However, these scholars' concerns were mostly hypothetical rather than "borne out by available evidence."[181] According to The World Bank, a seven year crowdfunding report (2007–2014) showed "very little" to "no reported fraud."[182] The report noted that it found no cases of equity crowdfunding fraud in the U.K. and Australia, while only 4 out of 43,193 Kickstarter projects ended in fraud.[183]

The potential for crowdfunding fraud cannot be determined in a vacuum and must be examined in relation to other securities offerings. A study by Tracy Wang, Andrew Winton, and Xiaoyun Yu reviewed over 3,000 IPOs from 1995 to 2005 and found that 11.59% of the companies that went public "committed fraud at the IPO stage."[184] While the authors concede that the time period was unusually active for IPO fraud, the numbers are startling even at half that level.[185] Another study, by James Bohn and Stephen Choi, documented evidence of fraud in 3.5% of IPOs between 1975 and 1985.[186] Averaging the two shows 7.54% of IPOs resulting in fraud over a 20-year period.

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[177] *Id.*at 1555.

[178] *Id.* at 1565.

[179] *See* Anand, *supra* note 27, at 217.

[180] *See* Dorff, *supra* note 24, at 495; *see also* Dibadj, *supra* note 10, at 39.

[181] Anand, *supra* note 27 at 222.

[182] *See* THE WORLD BANK, *supra* note 27, at 46.

[183] *Id.*

[184] Tracy Yue Wang et al., *Corporate Fraud and Business Conditions: Evidence from IPOs*, 65 J. FIN. 2255, 2270 (2010).

[185] *Id.* at 2267.

[186] James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 944 (1996).

Comparable results of fraud are not found in crowdfunding. A study by Ethan Mollick—Associate Professor of Management at The Warton School of Business—found evidence of fraud in only 14 out of 381 Kickstarter projects (3.7%).[187] In another study, Mollick found that less than 4% of the projects funded "showed signs of fraud."[188] Mollick attributed the low level of crowdfunding fraud to the crowd's inquiry regarding the project in an open dialogue and the crowd's ability to "find[] projects with signals of quality[.]"[189] In short, Mollick asserts that underwriter protection is adequately replaced by crowd due diligence.[190]

C. *Third-Party Intermediaries' Self-Interest Sufficiently Protects Investors*

Section 4A(c) of the Securities Act protects investors by expressly imposing liability on issuers, including its officers, directors, and control persons, if:

> (A) [the issuer] by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of section 77d(6) of this title, makes an untrue statement of material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of the untruth or omission; and (B) [the issuer] does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.[191]

The statute provides Regulation CF investors a remedy "either at law or in equity . . . to recover the consideration paid for such security with interest" from an issuer engaged in fraudulent activity.[192] The SEC refused to exempt intermediaries from section 4(A)(c) liability stating "[s]uch a categorical exemption or exclusion could pose undue risks to investors by providing insufficient incentives for intermediaries to take steps to prevent" fraud.[193]

[187] *See* Mollick, *supra* note 168.

[188] *The Promise and Perils of Equity Crowdfunding,* KNOWLEDGE@WHARTON (Nov. 7, 2013), http://knowledge.wharton.upenn.edu/article/promise-perils-equity-crowdfunding/.

[189] *Id.*

[190] *See id.*; *see also* Armour & Enriques, *supra* note 77, at 43.

[191] Securities Act of 1933 § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2) (2018).

[192] Securities Act of 1933 § 4A(c)(1)(A), 15 U.S.C. § 77d-1(c)(1)(A) (2018).

[193] Regulation Crowdfunding, 80 Fed. Reg. 71,387, 71,478 (Nov. 16, 2015).

Regulation CF requires issuers to issue their offerings through online third-party intermediaries.[194] These intermediaries act as "gatekeepers" and play a critical role in deterring investor fraud and abuse. Intermediaries have the duty to have "a reasonable basis for believing" that issuers are acting in compliance with the applicable securities laws and that issuers are not engaging in fraudulent activities.[195] Although Regulation CF prohibits intermediaries from offering investment advice or making recommendations among issuers on their webpages, intermediaries "merit review" their offerings when they determines whether or not to allow the offering on its platform. For example, Wefunder—the most popular Regulation CF online platform—actively seeks out "high-quality companies" to issue offerings to its investors.[196]

Third-party intermediaries adequately protect unaccredited investors because it is in the intermediaries' long-term best interests to limit investor fraud and abuse and for the issuers of offerings to successfully be acquired by larger companies or go public. Intermediaries usually charge an equity fee in addition to a cash fee for each successful offering on their website. For example, Wefunder charges 5% of the total issue in cash and 2% of the total issue in equity.[197] If the business fails, then the intermediaries' equity in the failed company depreciates. Furthermore, intermediaries face serious risks that investors will stop investing on the intermediaries' platform altogether due to fraud or if too many issuers on the platform fail. This is a strong incentive for intermediaries to do their due diligence and actively screen and exclude companies that are fraudulent or likely to fail.

D. Even Though Investing in Early-Stage Startups Is Risky, Investment Limits, and Non-Monetary Considerations Help to Mitigate that Risk

Critics of Regulation CF point out that many crowdfunding investors will lose most of their principal by investing in early-stage small businesses and startups.[198] These critics make a good point. Early-stage small busi-

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[194] *See* Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(3).

[195] Regulation Crowdfunding, 17 C.F.R. § 227.301(a) (2018).

[196] *See Interview*, WEFUNDER, https://wefunder.com/wefunder (last visited Feb. 23, 2018) ("To us, high-quality means deserving businesses with legitimate founders who can grow profitable companies.").

[197] *See How is Wefunder Compensated?*, WEFUNDER, https://help.wefunder.com/#/why-wefunder/303756-how-does-wefunder-make-money (last visited Feb. 24, 2018).

[198] *See* Archambault, *supra* note 11, at 67–68 ("[T]he CROWDFUND Act invites unaccredited investors to make risky investments in highly speculative businesses with large chances of illiquidity."); Andrew A. Schwartz, *The Nonfinancial Returns of Crowdfunding*, 34 REV. BANKING & FIN. L. 565, 570 (2014); *see also* Dibadj, *supra* note 10, at 39 ("Crowdfunding also presents dramatic risks to investors [because] . . . investing in small emerging companies is risky—and most will fail.").

nesses and startups "pose a disproportionate risk of business failure."[199] Even sophisticated venture capitalists pick losers more often than winners among the small businesses and startups they invest in.[200] The small business and startup failure rate under Regulation CF is likely to be worse than at the accredited investor level, as issuers will only raise money under Regulation CF after they have exhausted traditional sources of income such as banks, angel investors, and venture capitalists.[201] As one critic aptly stated, "So what kinds of companies would ever want to use non-accredited investor crowdfunding? Desperate ones."[202]

However, unaccredited investors already invest substantial amounts of money to assist small business and startup capital formation through donation and reward crowdfunding. According to Statista—an online statistics portal—the donation and reward crowdfunding models in the U.S. in 2018 totaled approximately $1.4 billion.[203] These non-securities investments are no less risky than Regulation CF investments. People making pure donations to small businesses and startups "are guaranteed to 'lose' all of their money and receive nothing in return."[204] People investing in small businesses and startups under the reward model may receive nothing in return, or the reward may not be as valuable as anticipated.[205] C. Stephen Bradford—Professor of Law at the University of Nebraska-Lincoln College of Law—asserts that retail crowdfunding lessens the overall risk to investors from startups and small businesses, since "the possibility of interest or profit is better than no financial return at all."[206]

Although this is an apples-to-oranges comparison—since retail crowdfunding investors have an expectation of profits whereas donation/reward "investors" have no such expectation—the data indicates that many people have strong non-monetary motives to support small businesses and startups. Music fans may want to support the bands that they like, and tech people may want to support companies that make certain gadgets that would not otherwise be made. A patient may prefer to support certain medical devices, and still others may wish to support certain movie sequels. Many people invest in startups that appeal to them in non-monetary ways regardless of the risk. As long as these people are ful-

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[199] Bradford, *supra* note 22, at 108.

[200] *Id.* ("One-third of those companies end up in bankruptcy, while another third meet their expenses but are unable to go public or pay significant dividends.").

[201] *See* Gulstrom, *supra* note 136, at 295.

[202] Jim Saksa, *"Kickstarter, But with Stock,"* SLATE (June 23, 2014), http://www.slate.com/articles/business/moneybox/2014/06/sec_and_equity_crowdfunding_it_s_a_disaster_waiting_to_happen.html.

[203] *Crowdfunding*, STATISTA, https://www.statista.com/outlook/335/109/crowdfunding/united-states# (last visited May 5, 2018).

[204] *See* Bradford, *supra* note 22, at 116.

[205] *See id.*

[206] *Id.*

ly aware of the risk before investing, there is little reason to prohibit reasonable investment.

Regulation CF's investment limit helps ensure that even if investors lose their entire investment in a high-risk startup, the result will not be catastrophic. Regulation CF limits each investor's total annual investment to $2,200 or 5% of their annual income, which the SEC deemed is an acceptable loss for most households.[207] Exemption A adheres to Regulation CF's investment cap, while Exemption B further limits the investor's loss to $1,000 per offering. Although the risks associated with investing in early-stage small businesses and startups can never be completely eliminated, Exemptions A and B attempt to minimize investor losses without undermining small business and startup capital formation needs.

E. Voting Restrictions and Restricted Resale Help Mitigate the Effects of Dealing with a Large Group of Shareholders

Most small businesses and startups prefer to deal with as few investors as possible.[208] Getting shareholders to sign new shareholder agreements or trying to assemble enough shareholders to obtain a proper quorum is very difficult with 40 or more small shareholders.[209] Due to the nature of retail crowdfunding, small businesses and startups raising money under Regulation CF are likely to have hundreds of investors to take care of.[210] Fortunately, Regulation CF's restricted securities and investors lacking voting rights makes handling things much easier.

Most third-party intermediaries require voting and information rights to be proxied to the intermediary, which votes on behalf of the investors.[211] Further, most Regulation CF issuers don't include voting rights in their offering.[212] According to Wefunder, the largest Regulation CF intermediary:

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[207] Regulation Crowdfunding, 80 Fed. Reg. 71,387, 71,394 (Nov. 16, 2015) ("Nevertheless, we believe that the investment limits in the final rules appropriately take into consideration the need to give issuers access to capital while minimizing an investor's exposure to risk in a crowdfunding transaction.").

[208] *See* Mark Suster, *How Many Investors Are Too Many?*, BOTH SIDES (Feb. 22, 2011), https://bothsidesofthetable.com/how-many-investors-are-too-many-b0ae2ccc523e.

[209] *See* Jordan Dolgin, *Does Your Company Suffer from Too Many Shareholders? . . . Read On!*, DOLGIN PROFESSIONAL CORP., http://www.dpclaw.ca/blog/does-your-company-suffer-from-too-many-shareholders-read-on/ (last visited May 2, 2018).

[210] The average number of investors per Regulation CF was 222 people in 2017. *See 2017 State of Regulation Crowdfunding Report*, *supra* note 143.

[211] *See Do I Have Voting or Information Rights?*, WEFUNDER, https://help.wefunder.com/ (last visited May 3, 2018); *see also Frequently Asked Questions*, SEEDINVEST, https://www.seedinvest.com/faqs (last visited May 3, 2018).

[212] *Wefunder FAQ: Will My Investment Have Voting Rights?*, WEFUNDER, https://help.wefunder.com/ (last visited May 3, 2018).

> It's rare for an investment on Wefunder to offer voting rights directly to smaller investors because founders fear it can scare off venture capitalists who invest in later rounds. They are concerned with the hassle of collecting thousands of signatures to make any major decision. You should assume your investment does not include voting rights unless specified otherwise.[213]

Intermediaries generally want to hold on to the stock until the startup is acquired or has an IPO.[214]

Resale restrictions also protect the issuer from the headaches of having too many investors. Regulation CF restricts securities for one year unless they sell it back to the issuer, to an accredited investor, or to a family member.[215] This one-year restriction protects the issuer from investor backlash if things don't go entirely as planned. Although investor treatment and remedies under Regulation CF seem harsh, investors do not seem perturbed, as investment under Regulation CF continues to grow by double digits each year.[216]

VI. THE EXISTING REGULATORY FRAMEWORK IS INADEQUATE TO JUMPSTART STARTUP AND SMALL BUSINESS CAPITAL FORMATION

Under section 5 of the Securities Act, a securities offering must be registered with the SEC or must fall under an authorized exemption.[217] However, none of the existing registration exemptions can adequately create a robust crowdfunding environment that promotes small business and startup capital formation. Regulation D, Rule 506(c) offerings are inadequate to fill the capital gap because offerings are limited to "accredited investors," which excludes 92.6% of American households from investing under the exemption.[218] Rule 504 and Rule 147A offerings are also inadequate because they are subject to state blue sky laws and the reporting requirements of section 12(g) of the Exchange Act.[219] Thus,

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[213] *Id.*

[214] *See When Do We Decide to Sell Securities?*, WEFUNDER, https://help.wefunder.com/ (last visited May 3, 2018).

[215] Regulation Crowdfunding, 17 C.F.R. § 227.501 (2018); *see also Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, *supra* note 52.

[216] *See 2017 State of Regulation Crowdfunding Report*, *supra* note 143.

[217] *See* Securities Act of 1934 § 5, 15 U.S.C. § 77(e) (2018).

[218] As of 2010, only 7.4% of Americans are accredited based on their net worth. *See* Jeff Thomas, *Making Equity Crowdfunding Work for the Unaccredited Crowd*, 4 HARV. BUS. L. REV. ONLINE 62, 63 (2014), http://www.hblr.org/wp-content/uploads/2014/04/Thomas_Making-Crowdfunding-Work.pdf.

[219] Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g)(1) (2018); General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.144A (2017); General Rules and Regulations, Securities Exchange Act of 1933, 17

Exemptions A and B are necessary to create a robust crowdfunding environment that promotes small business and startup capital formation.

A. *Regulation D, Rules 504 and 506*

Title II of the JOBS Act added Regulation D, Rule 506(c), which allows general solicitation over the internet, provided that all of the investors are accredited[220] and their accredited status is verified.[221] Rule 506(c) imposes few investor protections and disclosure requirements because the SEC regards accredited investors as sophisticated enough to protect themselves from fraud and abuse.[222] Some scholars assert that crowdfunding offerings under Rule 506(c) alone can create a robust crowdfunding environment that promotes small businesses and startups capital formation.[223] These scholars claim that Rule 506(c)'s advantages are superior to Regulation CF's advantages, and only issuers offering subpar investments will attempt to raise capital through retail crowdfunding.[224]

Offerings under Rule 506(c) have many advantages. First, issuers can raise an unlimited amount and the rule does not limit how much an investor can invest.[225] Second, Rule 506(c) insulates issuers from liability for mere negligence, and investors generally must prove scienter to hold issuers liable.[226] Further, unlike Regulation CF—where many officers and directors may be liable—only the person who made the false or misleading statement is liable for offerings made under 506(c).[227] Finally, the issuer is not subject to any disclosure requirements as long as all of the offerings' investors are accredited.[228]

However, the primary reason why Rule 506(c) is inadequate to create a robust crowdfunding environment is because Rule 506(c) limits offerings only to accredited investors, which eliminates 92.6% of American households from investing in the offering.[229] While offerings under Rule

C.F.R. § 230.504 (2017).

[220] *See* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 230.506(c) (2017).

[221] *See id.*

[222] *See* Dorff, *supra* note 24, at 517.

[223] *Id.* (stating that issuers will avoid equity crowdfunding because of Rule 506(c)).

[224] *See id.* at 498; *see also* Nathaniel Popper, *Doubts Arise as Investors Flock to Crowdfunded Start-Ups*, N.Y. TIMES (Jan. 24, 2017), https://www.nytimes.com/2017/01/24/business/dealbook/crowdfunding-fraud-investing-startups.html.

[225] 17 C.F.R. § 230.506(c).

[226] *See* Dorff, *supra* note 24, at 518.

[227] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194–215 (1976) (10b-5 actions require scienter).

[228] *See* Dorff, *supra* note 24, at 518.

[229] As of 2010, only 7.4% of Americans are accredited based on their net worth. *See* Thomas, *supra* note 218, at 63.

506(c) raised nearly $70.6 billion over three years, it pales in comparison to the $2.186 trillion raised under Rule 506(b) over the same time period.[230] Studies show that small businesses and startups would have access to $300 billion if Americans were to invest just 1% of their investable income into retail crowdfunding.[231] According to Darian M. Ibrahim, "a true crowd-based approach requires opening up the process to more than accredited investors."[232] Rule 506(c)'s "accredited crowdfunding" merely bridges a geographical gap, connecting issuers with accredited investors across the country online. While bridging the geographical gap may help some finance some companies, it is insufficient to create a robust crowdfunding environment that promotes small business and startup capital formation.

A crowdfunding framework under Regulation D, Rule 504 ("Rule 504") also fails to adequately create a robust crowdfunding environment that promotes small business and startup capital formation. Rule 504 allows offerings up to $5 million annually, does not require the use of third-party intermediaries or mandatory disclosure documents, and unaccredited investors may invest in the offering.[233] However, Rule 504 offerings are not "covered" securities, and are thus subject to state blue sky laws.[234] Given the inherent interstate nature of crowdfunding and the internet, determining which state's crowdfunding laws apply and compliance with multiple state laws could be cost prohibitive for small businesses.[235]

Unlike Regulation CF, there is no section 12(g) exemption under Rule 504. This means that the Rule 504 issuer must register its offering with the SEC if the issuer has more than $10 million in total assets, and over 500 unaccredited investors.[236] Since average retail crowdfunding investment in 2017 was $1,107, Rule 504 issuers would likely not be able to raise more than $500,000 before being subject to section 12(g)'s registration requirements.[237] Most early-stage startups need approximately three

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[230] *See* STAFF OF THE DIV. OF ECON. & RISK ANALYSIS OF THE U.S. SEC. & EXCH. COMM'N, *supra* note 18, at 39–40.

[231] *See* Christian Borek, *Regulation A+: Navigating Equity-Based Crowdfunding Under Title IV of the JOBS Act*, 47 CUMB. L. REV. 143, 170 (2016).

[232] *See* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 571 (2016).

[233] *See* General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.504 (2017).

[234] General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.504(b)(1) (2017).

[235] *See* Dibadj, *supra* note 10, at 34.

[236] *See* Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g)(1) (2018).

[237] *See 2017 State of Regulation Crowdfunding Report*, *supra* note 143 (stating the total amount raised under Regulation CF in 2017 was $49.2 million, and the total number of investors was 44,433).

to eight times that amount to adequately fund the growth of their business.[238] Thus, while some small businesses and startups may utilize Rule 504 to raise capital through intra-state crowdfunding, Rule 504 is inadequate to create a robust crowdfunding environment that promotes small business and startup capital formation nationally.

B. Intrastate Crowdfunding Exemptions § 3(a)(11), Rule 147, and Rule 147A

Currently, thirty-three states have enacted intrastate crowdfunding exemptions, which allows small businesses and startups to raise capital from investors residing in the state.[239] Intrastate crowdfunding exemptions are exempted from federal registration under Section 3(a)(11), which states:

> Any security which is part of an issue offered and sold only to persons resident within a single State or Territory where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.[240]

Rule 147 provides a safe-harbor for section 3(a)(11), which deems that an issuer is "doing business within" a state or territory if the issuer "is incorporated or organized, and it has its principle place of business" within the state; and meets any one of the following "doing business" requirements:

- the issuer derived at least 80% of its consolidated gross revenues from the state;
- the issuer had 80% of its assets within the state;
- the issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales in connection with the operation of a business or services in the state; or
- a majority of the issuer's employees are based in the state.[241]

Rule 147 further requires that "offers and sales" may only be made "to persons resident within the state or territory of which the issuer is a resident," and restricts the resale of such securities for six months[242]

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[238] The capital gap of most startups is between $1.4 million and $4 million. *See* Payne, *supra* note 21.

[239] N. Am. Sec. Admin. Ass'n, NASSA Intrastate Crowdfunding Update: November 16, 2016, at 3 (2016), http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Intrastate-Crowdfunding-Update-111616.pdf.

[240] Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2018).

[241] General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R.§ 230.147(c) (2018).

[242] General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R.§ 230.147(d)–(e) (2018).

Generally, intrastate crowdfunding offerings are less expensive and require less disclosure than similar offerings under Regulation CF.[243] Transaction costs for many intrastate offerings are generally less than $5,000.[244] Many states limit their offering to $1 million annually,[245] but some states allow issuers to raise from $2 million to $5 million annually when their offering is accompanied by audited financials.[246] Many states do not even require the use of third-party intermediaries and allow issuers the flexibility to solicit offers directly through their social media, or company website.[247]

However, complying with Rule 147 is difficult as the SEC broadly interprets "offers," and requires that general solicitation "must be conducted in a manner consistent with the requirement that offers made in reliance on Section 3(a)(11) . . . be made only to persons resident within the state or territory."[248] The SEC advised intrastate issuers relying on Rule 147 not to use social media to promote their offering, given the likelihood of inadvertently exposing the offering to out of state residents.[249] Given the interconnectivity of the internet, it must have been very difficult for issuers to vigorously promote their offering intrastate, while simultaneously taking precautions to make sure no information leaks outside the state.[250]

To address this issue, the SEC created Rule 147A under its general rule-making authority in section 28 of the Securities Act.[251] Rule 147A became effective on April 20, 2017, and incorporates most of Rule 147 except that issuers relying on Rule 147A do not have to be incorporated in the state in which they are issuing securities, and issuers are not prohibited from general solicitation outside the state.[252] Although Rule 147A permits issuers to solicit offers across state lines, issuers may only sell to

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[243] *See* Michael Vignone, *Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Business*, 91 Chi.-Kent L. Rev. 803, 813 (2016).

[244] Transaction costs for offerings under Regulation CF range from $11,700 to $107,250. *See id.* at 813, 828–29.

[245] IND. CODE ANN. § 23-19-2-2 (West 2014); MICH. COMP. LAWS ANN. § 451.2202a (West 2013); MINN. STAT. ANN. §80A.461 (West 2015); WIS. STAT. ANN. §551.202(26) (West 2014).

[246] *See, e.g.*, A.R.S. § 44-1844 ($2.5 million limit with audited financials); §§ 815 ILCS 5/3 ($5 million limit with audited financials); WIS. STAT. ANN. § 551.202(26) ($2 million limit with audited financials).

[247] *See* Vignone, *supra* note 243, at 814.

[248] *See Compliance and Disclosure Interpretations: Securities Act Rules*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (last updated Nov. 6, 2017) (answer to question 141.03).

[249] *Id.* (answer to question 141.05).

[250] *See* Vignone, *supra* note 243, at 815.

[251] General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.147A (2018).

[252] *See id.*

in-state residents. Thus, Rule 147A allows intrastate issuers to raise capital through intrastate crowdfunding at their principle place of business and issuers no longer have to worry about news of their offer leaking across state lines.[253]

Unfortunately, offerings under Rule 147A are inadequate to create a robust crowdfunding environment that enhances startup capital formation. Currently, the majority of states that allow intrastate crowdfunding require compliance with either section 3(a)(11) or Rule 147.[254] Since Rule 147A was created under section 28 rather than § 3(a)(11), issuers relying on Rule 147A would be unable to participate in 24 of the 36 states that allow intrastate crowdfunding.[255]

Assuming that every state that allows intrastate crowdfunding eventually adopts Rule 147A, offerings are still limited to the issuers' principle place of business.[256] While startups with their principle place of business in population centers such as California, Texas, Florida, New York, and Illinois may find utility in intrastate crowdfunding, startups in less populous states such as Alaska, Montana, and Wyoming will find Rule 147A marginally helpful. Further, even if the startup gains broad intrastate support for their offering, the issuer may prematurely be subject to the Exchange Act's reporting requirements, because unlike Regulation CF, there is no intrastate crowdfunding exemption from section 12(g).[257] Thus Rule 147A is inadequate to create a robust crowdfunding environment that promotes startup capital formation.

CONCLUSION

Small businesses and startups are vital to the U.S. economy, yet many are unable to secure the capital they need to grow to maturity. The U.S. demand for small business and startup financing—which some estimate to exceed $13 trillion over the next decade—greatly exceeds the supply. Regulation CF failed to fill the small business and startup capital gap because of the high transaction costs related to complying with its disclosure requirements.

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[253] *See id.*; *see also* Vignone, *supra* note 243, at 815.

[254] *See* NASAA, INTRASTATE CROWDFUNDING LEGISLATION (Jan. 2, 2018), http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Crowdfunding-Index-1-2-2018.pdf.

[255] The thirteen states allow intrastate crowdfunding under Rule 147A are: Arizona, Arkansas, Colorado, Georgia, Illinois, Michigan, Minnesota, Nebraska, North Carolina, Oregon, Vermont, and Wisconsin. *Id.*

[256] General Rules and Regulations, Securities Exchange Act of 1933, 17 C.F.R. § 230.147A(c)(1) (2018).

[257] Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83, 494, 511–12 (Nov. 21, 2016) ("[W]e are not amending Rule 147 or including a provision in Rule 147A to exclude other types of issuers from[§ 12(g)].").

The SEC could better meet the JOBS Act's primary policy to assist small business and startups with capital formation by amending Regulation CF to include two additional exemptions. Exemption A creates a *de minimis* retail crowdfunding exemption which allows issuers to raise up to $50,000 with relaxed disclosure requirements. Exemption B creates a retail crowdfunding exemption which allows issuers to raise $5 million annually, but limits each investor to $1,000 per offering. Exemption A and B are modeled after U.K.'s crowdfunding model, which has experienced explosive growth, exceeding U.K. venture capital financing in just three years. Increased fraud did not accompany U.K.'s retail crowdfunding growth, undermining the claim that decreased disclosure would lead to an increase of fraud and abuse.

Retail crowdfunding is still evolving, and its infrastructure is still developing. Once efficient systems are in place to streamline the disclosure process and to reduce transaction costs, raising money through retail crowdfunding may one day be the norm, rather than the exception. Although the current framework allows for small businesses and startups to raise capital, and for some third-party intermediaries to be profitable, Regulation CF leaves much to be desired. By incorporating Exemptions A and B, the SEC grants small businesses and startups the ability to truly tap into the power of the crowd.