Hastings Business Law Journal

Volume 12
Number 1 *Fall 2015*

Article 2

Fall 2015

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Recommended Citation

Reza Dibadj, *Crowdfunding Delusions*, 12 Hastings Bus. L.J. 15 (2015).
Available at: https://repository.uchastings.edu/hastings_business_law_journal/vol12/iss1/2

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Crowdfunding Delusions

*Reza Dibadj**

I. INTRODUCTION

The idea behind crowdfunding is, in principle, an attractive one. Individuals band together via the Internet in support of a common cause—a political candidate, disaster relief, and the like.[1] Business has not been immune to the phenomenon, with the enticing idea that small investors can pool together funds so that a company could produce a good or service.[2] At first glance, the idea is intellectually appealing since it aspires to democratize funding beyond accredited investors.[3] Think, for example of Pebble Technologies' Bluetooth-enabled watches: Using the crowdfunding platform Kickstarter, the company was able to crowdfund many times its initial objective.[4]

* Professor of Law, University of San Francisco. I thank the editors of the *Hastings Business Law Journal* for giving me the opportunity to present the ideas in this essay at the *Journal's* Symposium on "Regulating the Disruption Economy" on March 20, 2015, in San Francisco, California.

1. 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, 1736 (2012) ("Crowdfunding is the fundraising analog to crowdsourcing, which refers to mass collaboration efforts through large numbers of people, generally using social media or the Internet."); Migliozzi & Flatow, Securities Act Release No. 9216, WL 2246317 (June 8, 2011) ("Crowdsourcing is the use of social media and the Internet to organize a large group of individuals to achieve a common goal. . . ."); *see also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed At Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) ("Crowdfunding includes a variety of business financing models that use the Internet.").

2. *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 [hereinafter Bradford, *Crowdfunding*] ("Crowdfunding is, as its name indicates, funding from the crowd—raising small amounts of money from a large number of investors."). Various flavors of crowdfunding have been explored in the literature. *See id.* at 14–15 ("One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.").

3. *See infra* notes 80–81 and accompanying text (discussing Regulation D).

4. *See, e.g.*, *Pebble Time Kickstarter Project Raised $20.3 Million*, CNN MONEY, (Mar. 25, 2015, 11:16 PM), http://money.cnn.com/2015/03/27/technology/pebble-time-most-funded-kick

Indeed, crowdfunding generates a buzz in the otherwise staid field of securities regulation.[5]

Beyond all the hype, however, there is a curious incongruity. On the one hand, there exist apparently successful crowdfunding sites such as Kickstarter and IndieGoGo[6]; on the other hand, more than three years after the Jumpstart Our Business Act ("JOBS Act") mandated an equity crowdfunding exception, we are still waiting for final regulations from the Securities and Exchange Commission ("SEC").[7]

This essay begins by exploring this irony in Part I, arguing that existing crowdfunding sites carefully manage around a fundamental ambiguity in the securities laws—a surprisingly fuzzy definition of what a "security" is.

Part II shifts to understanding the existing regulatory framework: both the federal crowdfunding statute and proposed rules, as well as other existing alternatives issuers might consider. It starts by analyzing the contribution of the JOBS Act, the new section 4(a)(6) of the Securities Act of 1933 ("1933 Act"), and the SEC's October 2013 585-page proposed rules. While well intentioned, it concludes that this legal framework is ultimately unworkable, largely due to the very high transaction costs imposed. As such, to the extent the final rules are imminent, my prediction is that they will have little impact on actual fundraising practices. Second, Part II surveys other potential alternatives to place crowdsourced securities—sections 4(a)(2) and 4(a)(5), Regulation D, and Regulation A/A+, and even new state crowdfunding exemptions—but ultimately argues that none are attractive. As such, it is far more likely that crowdfunding sites will continue to operate as they currently do, rather than subject themselves to any new crowdfunding rules or seek alternative exemptions.

starter [hereinafter *Pebble Time Kickstarter*].

5. *See, e.g.*, Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 477 (2014) [hereinafter Heminway, *Public/Private*] ("In less than ten years, this fusion of social media and traditional corporate finance—a mode of corporate finance through which firms raise investment capital by reaching out over the Internet to a broad, undifferentiated mass of potential investors—grew from a creative impulse to a movement that catalyzed federal legislative action.").

6. *See infra* notes 28–31 and accompanying text.

7. *See infra* notes 34–53 and accompanying text.

Finally, Part III explores the implications of this pessimistic prediction along two dimensions. First, it argues that, for all of its advantages, crowdfunding presents fundamental negatives that cannot be regulated away. As such, we must face a stark choice: either prophylactically ban the activity, or allow it with few restrictions. To think that we can craft a balanced regulatory framework for crowdfunding is delusional.

Regardless of the direction securities law and policy gravitates towards, however, perhaps most important is to ponder crucial themes that the crowdfunding saga raises in a microcosm. Some are more obvious; for example, how to fund small businesses, the relative institutional roles of Congress and the SEC, the effectiveness of disclosure, and the role of intermediaries. Others are more subtle, such as bending the public/private distinction, uncoupling value-added services from capital, and whether the wisdom or madness of crowds is consistent with the efficient market hypothesis. Regardless, the real value of the contemporary crowdfunding saga may be to alert us to these challenging realities.

II. CROWDFUNDING WITHOUT RULES?

Section 5 of the Securities Act mandates that any security issued must either be registered or that the issuer must find a registration exemption.[8] Given that an exemption for equity crowdfunding does not yet exist, then how do crowdfunding sites exist?[9]

One possibility would be to argue that the issuer is a nonprofit or other charitable organization and thus, the security is exempt from registration under section 3(a)(4) of the 1933 Act.[10] Assuming the

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

9. *See, e.g.*, Bradford, *supra* note 2, at 6 ("[C]rowdfunding does not mesh well with federal securities regulation. Entrepreneurs seeking debt or equity financing through crowdfunding will often be selling securities, and securities offerings must be registered under the Securities Act of 1933 . . . unless an exemption is available."); Heminway & Hoffman, *supra* note 1, at 882 ("We became interested in this venture finance model because it has huge appeal in a number of obvious respects, yet we could not understand how some of the crowdfunding websites and crowdfunded ventures (especially those offering profit-sharing interests to funders) were complying with federal securities laws.").

10. The Act exempts "[a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit." Securities Exchange Act of 1934 § 12(g)(2)(D), 15 U.S.C. § 78l(g)(2)(D).

business is for-profit, however, this relatively narrow exemption would not be available—and even if it were exempt from registration, it would still be subject to the liability and antifraud provisions of the securities acts as a "security."[11]

As such, the basic manner in which crowdfunding sites might escape securities regulation would be to argue that what they are offering is not a "security."[12] This argument is only possible given a fundamental ambiguity in the federal securities laws.[13]

A. DEFINITION UNDER FEDERAL COMMON LAW

The question of what constitutes a "security" is deceptively difficult.[14] One of the supervening ironies of securities regulation is that we have an entire area of law devoted to regulating "securities," yet we still do not have a clear definition of what these are. To be sure, the 1933 Act does define the term,[15] but those familiar with the

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Having a profit motive would disallow the exemption. *Compare* SEC v. Children's Hosp., 214 F. Supp. 883 (D. Ariz. 1963) (exemption unavailable), *with* Deutsche Bank Microcredit Dev. Fund, SEC No-Action Letter, WL 1355511 (Apr. 8, 2011) (exemption available).

11. Notably sections 12(a)(2) and 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934.

12. *See also* Hazen, *supra* note 1, at 1737 ("*Unlike raising money for charities or other nonprofit ventures*, a business seeking investors through crowdfunding implicates the securities laws which provide investor protection by requiring disclosure and, in many instances, registration of securities offered to the public.") (emphasis added).

13. *See* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREP. BUS. L. J. 335, 356 (2012) [hereinafter Heminway, *What Is a Security*] ("The advent of crowdfunding has put significant pressure on the regulation of securities under the 1933 Act and the 1934 Act, in general, and the definition of a security, in particular.").

14. *See id.* at 353 ("The concept of a security—the subject (and an object) or securities regulation—is significantly more complex than it appears.").

15. Securities Act of 1933, subsection 2(a)(1) states that:

> The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim

securities laws recognize that the definition is too broad to be workable.

As such, the most relevant definition of "security" emerges from a United States Supreme Court case, *SEC v. Howey*,[16] which focuses on the term "investment contract"[17] and famously states: "an investment contract 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 third party."[18] The three components of the *Howey* test, then, focus on: (i) investment vs. consumption, (ii) common enterprise, and (iii) profits from the efforts of others.[19] There is rich case law exploring these factors.[20]

B. Testing the Definition

How do crowdfunding efforts stack up against this definition?[21] It is critical to note that if the crowdfunded instruments—whether equity or debt—offer the prospect of a financial return on investment, they would very likely be deemed securities.[22]

> certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012). This is rather broad definition, which is further muddied by the prefatory clause "unless the context otherwise requires." Securities Act of 1933 § 2(a), 15 U.S.C. § 77b(a) (2012).

16. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); *see also* Reves v. Ernst & Young, 494 U.S. 56 (1990) (notes); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (closely held corporations). *Howey*, however, remains by far the most significant articulation, and the most relevant for interests sold via crowdfunding sites.

17. The term appears as a separate category in section 2(a)(1) of the 1933 Act, but *Howey* has been used more generally to define the word "security." *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1)(2012).

18. *Howey*, 328 U.S. at 298–99.

19. The word "solely" has effectively been de-emphasized in subsequent Supreme Court opinions. *See, e.g.*, United Hous. Found. v. Forman, 421 U.S. 837, 852 n.16 (1975).

20. *See, e.g.*, SEC v. Edwards, 540 U.S. 389 (2004); Marine Bank v. Weaver, 455 U.S. 551 (1982).

21. For detailed application of *Howey* to crowdfunding, *see* Heminway & Hoffman, *supra* note 1, at 885–906.

22. *See* Bradford, *Crowdfunding, supra* note 2, at 31 ("Crowdfunding sites organized on the lending model probably are offering securities if the lender is promised interest. Crowdfunding sites organized on the equity model are usually offering securities.").

After all, the offering would be an "investment" and there would be the expectation of "profits" under *Howey*.[23] Consider, for example the SEC's cease-and-desist orders against BuyaBeerCompany.com,[24] a putative campaign to purchase the Pabst Brewing Company, as well as Prosper Marketplace, which was offering crowdfunded debt instruments.[25] Other crowdfunding sites offering instruments which would arguably meet the *Howey* definition, such as ProFounder and 33Needs, are now defunct.[26]

But what about today's popular crowdfunding sites such as Kickstarter and IndieGoGo?[27] Each site very carefully avoids the *Howey* definition by sidestepping "investment" and "profit." For instance, note how careful Kickstarter is on its website:

> What do backers get in return?
>
> Backers that support a project on Kickstarter get an inside look at the creative process, and help that project come to life. They also get to choose from a variety of unique rewards offered by the project creator. Rewards vary from project to project, but often include a copy of what is being produced (CD, DVD, book, etc.) or an experience unique to the project.

23. *See supra* note 17 and accompanying text. *See also* Heminway & Hoffman, *supra* note 1, at 895 ("[I]t is difficult to fathom how a financing plan or program that involves the exchange of funds for profit-sharing interests in a third-party's venture over the Internet would not qualify as a contract, transaction, or scheme under the Howey test.").

24. *See* Migliozzi & Flatow, *supra* note 1.

25. *See* Prosper Marketplace, Inc., Securities Act Release No. 8984, 94 SEC Docket 1913 (Nov. 24, 2008), ("The loan notes issued by Prosper pursuant to this platform are securities and Prosper . . . violated Sections 5(a) and (c) of the Securities Act, which prohibit the offer or sale of securities without an effective registration statement or a valid exemption from registration.").

26. *Cf.* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 865 (2014) [hereinafter Heminway, *Investment Crowdfunding*] ("Legally, entrepreneurs could not offer or sell a profit-sharing or revenue-sharing interest in the project or business for which they sought funding unless the offering was registered under the Securities Act of 1933 . . ."); *id.* at 877 ("Histories of the crowdfunding movement and investment crowdfunding are related in varying degrees of detail and with varying areas of emphasis. Many, if not most, of these histories, however, ignore the reality that various crowdfunding websites have been offering and selling investment interests that are securities without registering those offerings under the 1933 Act.").

27. *See, e.g.*, Bradford, *Crowdfunding*, *supra* note 2, at 16 ("Kickstarter and IndieGoGo are the leading reward/pre-purchase crowdfunding sites.").

> *Project creators keep 100% ownership of their work, and Kickstarter cannot be used to offer equity, financial returns, or to solicit loans.*[28]

IndieGoGo is even more direct:

> Can I offer my contributors shares in my venture or a return on their investment?
>
> *Campaign owners are not allowed to offer any form of "security" (as such term is defined in the Securities Act of 1933).* This means that campaign owners are not allowed to offer perks such as notes, stocks, treasury stocks, security futures, security-based swaps, bonds or debentures. For a comprehensive list, please take a look at the Securities Act of 1933 on the SEC website.[29]

It goes without saying that these sites are precisely avoiding the *Howey* definition—notably, that this is not a for-profit "investment," but rather it is consumption. Backers receive, for example, a Pebble watch, but not any shares in the company making the watch.[30]

The fact that sites like BuyaBeerCompany.com and ProFounder lost enforcement actions and Kickstarter and IndieGoGo operate seemingly without regulatory interference does not, of course, settle the matter. At a conceptual level, one could be forgiven for wondering whether a Supreme Court case from 1946 should be the arbiter of taste in crowdfunding. More practically, it leaves the question of mixed motivation unanswered. As one expert observes:

> Crowdfunding interests in the form of investment contracts are especially difficult to categorize since the range of terms they embody is particularly fluid.

28. *Kickstarter Basics*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter+basics?ref=footer (last visited Oct. 31, 2015) (emphasis added).

29. *Prohibited Perks*, INDIEGOGO, https://support.indiegogo.com/hc/en-us/articles/204255166 (last visited Oct. 31, 2015) (emphasis added). I leave aside here the question of how realistic it would be for someone contributing on IndieGoGo to decipher the 1933 Act.

30. *See Pebble Time Kickstarter*, *supra* note 4. *See also* Heminway & Hoffman, *supra* note 1, at 896 ("Many crowdfunding websites raise funds to support the production of goods and services by artists and others, and these crowdfunded ventures often reward funders with free or discounted products or services created or sold by the funded business."); Hazen, *supra* note 1, at 1739 ("If a crowdfunding effort seeks donations without any express or implied possibility of a return to the donor, there is no offering of securities, and thus, the securities laws are not implicated.").

> Investors may have mixed motives in purchasing them. While they have an expectation of "profits" generated by from a common enterprise and the efforts of others, they also may acquire these financial and related interests with the clear understanding that they will have no governance rights over the enterprise and will never recoup the full value of their investment through current returns, repayment or resale.[31]

As such, Congress and the SEC have stepped into the game as part of the JOBS Act to try to provide a coherent regulatory framework. Unfortunately, as Part II discusses, the statute and proposed regulations, by trying to be too many things to too many people, ultimately do not succeed.

III. OVERLY AMBITIOUS REGULATIONS, POOR ALTERNATIVES

Against the backdrop of existing crowdfunding, in 2012 Congress added section 4(a)(6) to the 1933 Act, and in October 2013 the SEC promulgated proposed rules for crowdfunding.[32] First, I provide an overview of the new statute and proposed rules. Next, I conclude that the current regulatory framework is overly ambitious in its attempt both to foster crowdfunding, as well as to deter fraud. To be sure, there are ambiguities—both in terms of the statute's language and attendant liability—but the fatal flaw of the current statutory and regulatory framework is the imposition of very high transaction costs.

A. CROWDFUND ACT AND PROPOSED RULES

1. Legal Framework

As part of the 2012 JOBS Act, the United States Congress passed Title III of the JOBS Act, "The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" ("CROWDFUND Act"), now included in section 4(a)(6) of the 1933

31. Heminway, *What Is a Security*, *supra* note 13, at 368.
32. As of September 2015, we are still awaiting final rules from the SEC.

Act.[33] Likely concerned with the SEC's failure to implement exceptions in the past,[34] the guidance is unusually specific. Section 4(a)(6) specifies that the issuer cannot raise more than one million dollars during a twelve-month period.[35] It bifurcates investors into two categories: those whose annual income or net worth is less than $100,000 and those whose annual income or net worth is at or above that amount.[36] The aggregate amount sold to the former during any twelve-month period cannot exceed the greater of $2,000 or five percent of the purchaser's annual income or net worth; by contrast, the amount sold to the latter cannot exceed ten percent of annual income or net worth not to exceed $100,000.[37] It also specifies that the transaction must be conducted via a registered broker-dealer or funding portal.[38]

Significantly, section 4A(b)(1) imposes disclosure requirements on issuers; notably, offerings above $500,000 require audited financials, offerings between $100,000 and $500,000 must be reviewed by an independent public accountant, and offerings below $100,000 require disclosure of the issuer's latest tax return and financial statements certified by an officer.[39] Section 4A(b)(4) in turn requires ongoing disclosure to investors at least annually.[40] Finally, while these crowdfunded securities would be "covered" securities exempt from state blue sky laws,[41] there would be a one-year holding period during which they could not be resold.[42]

33. *See* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195 (2012) (providing detailed description and analysis of statute) [hereinafter Bradford, *Unfulfilled*].

34. *See infra* notes 152–155 and accompanying text.

35. Securities Act of 1933 § 4(a)(6)(A), 15 U.S.C. § 77d(a)(6)(A) (2012).

36. *Id.*

37. *Id.*

38. *Id.*

39. Securities Act of 1933 § 4A(b)(1)(D), 15 U.S.C. § 77d-1(b)(1)(D) (2012).

40. Securities Act of 1933 § 4A(b)(4), 15 U.S.C. § 77d-1(b)(4) (2012).

41. Securities Act of 1933 § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C) (2012).

42. Securities Act of 1933 § 4A(e)(1), 15 U.S.C. §77d-1(e)(1) (2012). There are exceptions to the 1-year rule, notably for transfers to accredited investors and family members. *Id.*

In its 585-page proposed rules,[43] the SEC ended up largely repeating section 4(a)(6).[44] The rules did, however, try to achieve three things: they tried to (i) clarify some ambiguities and nuances in section 4(a)(6), (ii) suggest an approach to fairly esoteric concepts such as integration and 1934 Act triggers, and most importantly, and (iii) expand upon disclosure requirements and estimated costs.

The SEC clarified that if both the investor's income and net worth are less than $100,000, then the $2,000 or five percent (whichever is greater) applies,[45] and that the issuer may rely on the intermediary to assess these limits.[46] It also specified that issuers must use a single intermediary[47] who, in turn, must register with the SEC as a broker or funding portal, as well as join FINRA.[48]

It also noted that section (4)(a)(6) offerings are not to be integrated with other offerings, thereby isolating the one million dollar cap only to 4(a)(6) offerings,[49] and that crowdfunded securities are exempt from the 2,000 holder limit which would otherwise trigger full reporting obligations under section 12(g) of the Securities and Exchange Act of 1934 ("1934 Act").[50]

Perhaps most importantly, it expanded on disclosure requirements and estimated costs. The issuer must have some sort of a business plan and file a new Form C with both financial and non-financial disclosures.[51] The proposed rules, of course, are subject to change—as frustrated commentators have noted, however, the final rules have not yet been released.[52]

43. Crowdfunding, Exchange Act Release Nos. 9470; 70741, WL 5770346 (Oct. 23, 2013) [hereinafter SEC Release No. 9470]; *see also* Press Release, SEC, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677.

44. *See, e.g.*, Brian Korn, *SEC Proposes Crowdfunding Rules*, FORBES (Oct. 23, 2013, 2:41 PM), http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/ ("[T]oday's proposed rules are a virtual reprint of the parameters outlined in the JOBS Act.").

45. SEC Release No. 9470, *supra* note 43, at 10.

46. *Id.*

47. *Id.*

48. *Id.* at 128.

49. *Id.* at 16.

50. *Id.* at 275.

51. *Id.* at 43.

52. *See, e.g.*, Kendall Almerico, *SEC Delays Equity Crowdfunding Piece of JOBS Act for Another Year*, FORBES (Dec. 14, 2014), http://www.entrepreneur.com/article/240558; Kevin Harrington, *Will JOBS Act Equity Crowdfunding Ever Happen?*, FORBES (Feb. 3, 2015, 2:42

2. Critiques

There are numerous critiques of the exemption. Most focus on the ambiguities and poor drafting—both in terms of what the rule mandates, as well as uncertain implications for liability. While I discuss these criticisms first, my contention is that the fatal flaw in the legal framework is the imposition of very high transaction costs—notably on issuers, but also on intermediaries. Put simply, the exemption is too expensive to be meaningful.

a. Ambiguities and Poor Policy Choices

The foundational statute, section 4(a)(6), is far from a paragon of clarity, and one could endlessly debate the policy choices that have been made around investment limits, requirements for intermediaries, and the like. As one might expect, there have been numerous criticisms of the exemption. One scholar, who has written about the "ambiguities, internal inconsistencies, and outright drafting errors"[53] in the statute, laments:

> The new crowdfunding exemption is disappointing. It is poorly drafted, leaving many ambiguities and inconsistencies for the SEC or the courts to resolve. Its mandatory disclosure requirements are too complicated and expensive for the small offerings it is designed to facilitate. Its individual investment limits are too high, exposing investors to more risk than many of them can afford. Its regulation of crowdfunding intermediaries is haphazard, unnecessarily disadvantaging non-broker intermediaries, but failing to include a crucial investor protection provision. Its failure to include a "substantial compliance" provision to protect innocent and immaterial violations, coupled with its complicated regulatory requirements, makes inadvertent violations likely. . . . Because of these and a number of other

PM) http://www.forbes.com/sites/kevinharrington/2015/02/03/will-jobs-act-equity-crowdfunding-ever-happen/ ("Almost three years [after the JOBS Act] the SEC still has not published the final rules, and JOBS Act equity crowdfunding remains on hold. How is this possible?").

53. Bradford, *Unfulfilled*, *supra* note 33, at 215.

> problems, the promise of crowdfunded securities offerings remains unfulfilled. The new exemption is not the regulatory panacea crowdfunding supporters hoped for, and it is unlikely to spawn a crowdfunding revolution.[54]

Another expert summarizes the legislation as "an overwhelming mishmash of regulatory requirements."[55]

Crucially, liability is also far from clear. More specifically, section 4A(c) states that "[a]n action brought under this paragraph shall be subject to the provisions of Section 12(b) and Section 13, *as if the liability were created under Section 12(a)(2)*."[56] Leaving aside for the moment the interpretative ambiguities in section 12(a)(2),[57] one wonders why the statute says "as if"? Perhaps the phrase has no significance, or perhaps it is meant to address the oddity of using section 12(a)(2) to police crowdfunding: the US Supreme Court has held that section 12(a)(2) applies only to public offerings such as initial public offerings (IPOs),[58] yet crowdfunding is not such a registered public offering. And this is not even to mention that the liability of the funding portals remains poorly defined[59]—an aspect that could emerge as important as unsuccessful issuers become bankrupt and judgment-proof, while plaintiffs look for redress.

My point is not to pile onto these criticisms. While I am in no way defending the drafting, it does not bother me as much because it is fairly typical of securities statutes and regulations. Overall, the securities laws are riddled with ambiguities and interpretative puzzles, not to mention very debatable policy choices—yet somehow as

54. Bradford, *Unfulfilled*, *supra* note 33, at 198.

55. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1437 (2012).

56. Securities Exchange Act of 1934 § 4A(c)(1), 15 U.S.C. § 77d(a)(6)(C) (2012).

57. *See*, *e.g.*, Gustafson v. Alloyd Co., 513 U.S. 561, 567 (1995). Section 12(a) seems to impose a negligence standard. The statutory language says that any person who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable . . . to the person purchasing such security from him . . . ." Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(2) (2000).

58. *See* Gustafson, 513 U.S. at 566.

59. *See generally* C. Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others*, 83 U. CIN. L. REV. 371 (2014).

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My own view, moreover, is that in the end it will simply be the high costs of complying with the crowdfunding framework that will be its ultimate undoing.

b. Exorbitant Cost

My basic objective when trying to get a rough sense of cost is to understand how the cost of using the crowdfunding exemption would compare to that of going public, where the underwriting fee is typically seven percent, but one needs to add additional costs for a rough estimate of about ten percent, already quite high.[60] Fortunately, coming up with a rough estimate turned out to be relatively straightforward. First, I took data from the SEC's Proposed Rules,[61] which appears in three bands of offering sizes: less than $100,000, $100,000-$500,000, and greater than $500,000. I then tried to characterize a cost as initial or ongoing (or both), then simply added up each type of cost and calculated it as a percentage of the mid-point of each offering band; namely, $50,000, $250,000, and $750,000. The results are summarized below:

60. *See, e.g.*, Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1105–31 (2000).

61. *See* SEC Release No. 9470, *supra* note 43, at 358–59.

	Initial	*Ongoing*	*Offerings of $100,000 or less*	*Offerings of more than $100,000, but not more than $500,000*	*Offerings of more than $500,000*
Compensation to the intermediary	x		$2,500- $7,500	$15,00 - $45,000	$37,500 - $112,500
Costs per issuer for obtaining EDGAR access codes on Form ID	x		$60	$60	$60
Costs per issuer for preparation and filing of Form C for each offering	x		$6,000	$6,000	$6,000
Costs per issuer for preparation and filing of the progress updates on Form C-U	x		$400	$400	$400
Costs per issuer for preparation and filing of annual report on Form C-AR		x	$4,000	$4,000	$4,000
Costs for annual review or audit of financial statements per issuer	x	x	Not required	$14,350	$28,700
Costs per issuer for preparation and filing of Form C-TR to terminate reporting			$600	$600	$600

Initial costs	$8,960-13,960	$35,210-65,210	$72,060-147,060
Ongoing costs	$4,000	$18,350	$32,700
Average offering[62]	$50,000	$300,000	$750,000
Initial costs %	18-28%	12-22%	10-20%
Ongoing costs %	8%	6%	5%

The results are, to put it mildly, discouraging: depending on the size of the offering and the estimate range, anywhere from ten to twenty-eight percent in initial costs alone—with the smaller offerings estimated to be significantly more expensive on a percentage basis. One could be forgiven for wondering whether an entrepreneur would be willing to bear these substantial transaction costs—consider, for example, a small offering where almost three dollars of every ten dollars raised would be going to intermediaries and compliance. As one observer laments:

> Can this new regulatory-laden exemption be useful to small entrepreneurs? It is difficult to imagine that for offerings under $250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities. The mandated use of intermediaries, the significant role that intermediaries are expected to play, and the mandated disclosures all point to an impracticable exemption for relatively small offerings.[63]

Beyond the issuers themselves, there are also estimated costs to serve as an intermediary, which I summarize below, directly from the SEC's Proposed Rules:[64]

62. I assume the midpoint, as the SEC does. *See* Proposed Rules, *supra* note 61, at 358 n.918.

63. Cohn, *supra* note 55, at 13; *see also* Korn, *supra* note 44 ("To produce an offering disclosure document, enlist a funding portal, run background checks and file an annual report year after year might well cost upwards of $100,000.").

64. SEC Release No. 33-9470, *supra* note 43, at 385–86; *see also* Heminway, *Investment Crowdfunding*, *supra* note 26, at 883 ("Potential intermediaries also face significant costs, including the cost of registration.").

	Initial Cost	Ongoing Cost
Intermediaries that register as brokers	$770,000	$220,000
Intermediaries that register as funding portals	$417,000	$90,000
Intermediaries already registered as brokers	$295,000	$70,000

To the extent they are accurate, these costs are arguably less troubling since the intermediary would be a repeat player who could presumably spread these costs across many offerings. One arguably concerning aspect of the cost structure, however, would be that it would seem to encourage existing broker-dealers to register as funding portals—something which would presumably discourage new entrants into the funding portal business.

Of course, all of these are just estimates taken from proposed SEC rules.[65] But one might surmise that the statute will fail "in its primary purpose to assist entrepreneurs and others seeking to raise small amounts of capital through broad-based solicitation."[66] Put simply, "[w]hy and how does the crowdfunding exemption come up short in achieving its objectives? In one word, the answer is: *costs*."[67]

As one observer sums up:

> The proposed rules are extremely impractical because of the restrictions and procedural hurdles a crowdfunding issuer, investor and funding portal will have to endure to raise capital. *Compared to other forms of crowdfunding and capital raising, equity crowdfunding to the public has the worst "bang for your buck" in all of corporate finance*.[68]

65. Heminway, *Investment Crowdfunding*, *supra* note 26, at 884 ("Although the SEC has estimated the compliance costs attendant to each aspect of its rulemaking under the CROWDFUND Act, the actual costs and realizable benefits of the crowdfunding exemption, as implemented through the SEC's rulemaking, will depend on the number and nature of the issuers, investors, and intermediaries that participate in investment crowdfunding—which are unknown at the present time.").

66. Cohn, *supra* note 55, at 1; *see also id.* at 6 ("Promoters seeking to raise small amounts from small investors are now subject to such a wide range of disclosure and regulatory requirements that it is hard to imagine typical crowdfunding promotions being carried out under such conditions.").

67. Heminway, *Investment Crowdfunding*, *supra* note 26, at 880.

68. Korn, *supra* note 44, at 2 (emphasis added).

It would simply be too expensive for issuers to use the exemption to raise money, and it goes without saying that entrepreneurs are well-attuned to costs.[69] To be fair, one should grant that the transaction costs are imposed in an attempt to minimize the risk of fraud, especially given the SEC's historical focus on "micro-cap" fraud.[70] Notwithstanding this noble intention, however, there are at least two problems. The first is whether the mechanisms set in place—notably the expectations of funding portals to review information with investors, answer questions, make sure investors have not exceeded the 12-month aggregate investment limits, avoid conflicts of interest, and the like[71]—are realistic. Yet even assuming that these mechanisms will operate perfectly, there remains the question of whether the transaction costs outweigh the investor-protection benefits in the sense that the former are so high that the exemption is, ab initio, a non-starter.[72]

The supervening irony in all of this, of course, is how the regulatory framework increases transaction costs for a funding mechanism fundamentally created because of a technology that reduces transaction costs—the Internet.

B. POOR ALTERNATIVES

Given these limitations, are there other possible exemptions under which crowdfunding might flourish? The short answer is no, but in order to arrive at this conclusion an overview of other possibilities is in order.[73] In a nutshell, the statutory exemptions are too vague as to be practical, and neither Regulation D nor Regulation

69. *See, e.g.*, Sherwood Neiss, *It might cost you $39K to crowdfund $100K under the SEC's new rules*, VENTUREBEAT (Jan. 2, 2014, 2:14 PM), http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/.

70. *See* Bradford, *Crowdfunding*, *supra* note 2, at 105 and accompanying text.

71. *See, e.g.*, Securities Act of 1933 § 4A(a), 15 U.S.C. § 77d-1(a) (2015).

72. *See also* Cohn, supra note 55, at 11 ("During the rush to promote legislation to aid small companies, did anyone point out to Congressional members or staff that the requirement to certify financial statements by the CEO is not required for any other federal or state registration exemption, that financial statements are not required for Rule 504 small business exemption for offerings up to $1 million, and that audited financial statements are expensive and rarely available for small businesses?").

73. Needless to say, this section does not approach a comprehensive overview of offering exemptions under the 1933 Act.

A fit the bill. For their part, new state crowdfunding exemptions, while superficially attractive, are unlikely to become significant.

To begin, one might consider two statutory exemptions, sections 4(a)(2) and 4(a)(5) of the 1933 Act. Section 4(a)(2), which simply states that "the provisions of section 5 shall not apply to transactions by an issuer not involving a public offering,"[74] is problematic for two reasons: first and more generally, its meaning is still quite fuzzy nearly a century after drafting;[75] second and more specifically, it remains unclear whether crowdfunding is "public" or "private."[76] Section 4(a)(5), permitting offerings to one or more accredited investors,[77] is similarly of marginal use: crowdfunding involves the general public, not accredited investors,[78] and this statutory exemption has effectively been superseded by Regulation D.

One should quite naturally ask about Regulation D, the most important set of exemptions in the securities laws. Regulation D is comprised of three distinct exemptions: Rules 504, 505, and 506. First and foremost, Regulation D does not allow solicitation and advertising[79]—a limitation that makes it unattractive for crowdfunding.[80] There are two limited exceptions to this ban, but neither would really help with crowdfunding.[81]

74. Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d-1(a)(2) (2015).

75. *See generally* SEC v. Ralston Purina Corp., 346 U.S. 119 (1953).

76. *See infra* notes 167-71.

77. Section 4(a)(5) of the 1933 Act exempts from registration "transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b)(1) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe." Securities Act of 1933 § 4(a)(5), 15 U.S.C. § 77d(a)(5) (2015).

78. Accredited investor defined in 15 U.S.C. § 77b(15)(ii) (2015), which essentially defers the definition to the SEC. *See infra* note 81.

79. *See* 17 C.F.R. § 230.502(c) (2015).

80. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 918 ("The most serious obstacle to using Regulation D to exempt crowdfunded offerings from registration is its overall prohibition of general solicitation and advertising.").

81. The first is that solicitation and advertising are allowed if all the purchasers are accredited investors, and their accredited status is verified. *See* 17 C.F.R. § 230.506(c) (2015). As discussed below, however, accredited investors would not be the target audience in a crowdfunding context. *See infra* notes 83–85 and accompanying text. The second is that solicitation and advertising are allowed under 17 C.F.R. § 230.504(b)(1) (2015)—usually this applies if the offering is limited to states that provide for a registration and disclosure document, or to states that limit sales to accredited investors. As discussed below, however, section

Rule 506, which permits offerings of unlimited size,[82] would really not be applicable because it can be used only with sophisticated[83] or accredited[84] investors—neither of which presumably fits crowdfunding.[85] Rule 505, allowing offerings up to five million dollars,[86] also applies to accredited investors—there is an exception for up to thirty-five nonaccredited (and unsophisticated) investors,[87] but this threshold is significantly too low for crowdfunding.

The situation with Rule 504, which allows offerings up to one million dollars,[88] is significantly more nuanced. On the one hand, it looks very attractive: It does not require either initial or ongoing disclosure, does not require funding portals, and can be sold to an unlimited number of unaccredited and unsophisticated investors.[89] The problem with Rule 504, however, stems from that fact that its offerings are not "covered" securities, and are thus subject to the state blue sky laws—given the inherently interstate nature of crowdfunding with the Internet,[90] this restriction becomes very problematic. In the words of one scholar:

> Assuring compliance with Rule 504 for a crowdfunded venture is not straightforward. It may be difficult to determine the states in which crowdfunding interests

230.504 is of limited use given the interstate nature of crowdfunding. *See infra* notes 89–91.

82. *See* 17 C.F.R. § 230.506 (2015).

83. The definition of sophisticated is notoriously vague in the securities laws. *See, e.g.*, C. Edward Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081 (1988).

84. *See* 17 C.F.R. § 230.501(a) (2015). The most significant is subsection 230.501(a)(5), which includes natural persons whose net worth (excluding primary residence) exceeds $1 million, or whose income over the past two years exceeds $200,000 (or $300,000 if married, filing jointly).

85. *See, e.g.*, Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. (forthcoming 2016), *available at* http://ssrn.com/abstract=2539786 ("a true crowd-based approach requires opening up the process to more than accredited investors").

86. *See* 17 C.F.R. § 230.505 (2015).

87. *See* 17 C.F.R. §§ 230.505(b)(2)(ii), (e)(iv) (2015).

88. *See* 17 C.F.R. § 230.504 (2015).

89. *See, e.g.,* Cohn, *supra* note 55, at 13–14 ("Rule 504, [codified in 17 C.F.R. § 230.504], for example, also a federal registration exemption for offerings up to $1 million, does not require a disclosure document, does not require the use of an intermediary, does not require any investor qualification regarding education or understanding of risks, and does not require annual and other reports to the SEC and investors.").

90. *See infra* note 121 and accompanying text.

> are offered and sold, and assuming that the applicable state laws meet the proper threshold level of investor protection, the cost of complying with multiple state laws could be high, if not prohibitive.[91]

As such, while Rule 504 cannot be categorically excluded, it presents significant challenges; indeed, if it were a viable option, then presumably there would have been less lobbying for a new and distinct crowdfunding exemption.

Regulation A/A+ is even less attractive. Section 3(b)(1) has for decades granted the SEC exemptive authority for offerings under five million dollars.[92] The SEC used this authority to promulgate Regulation A.[93] At first glance, Regulation A might appear attractive to crowdfunding because it allows solicitation and advertising.[94] Unfortunately, though, Regulation A is problematic for two principal reasons. First, it is not a "covered" security and hence would also be subject to the state blue sky laws and all the attendant problems this would present for issuers.[95] Second, and perhaps more significantly, it requires disclosure in the form of a "mini-registration" statement,[96] whose cost and difficulty is generally considered to be a central factor in Regulation A's general lack of success.[97] Overall, "the expense of producing the offering circular, in addition to the costs associated with state securities law compliance, makes this exemption too costly for many crowdfunded ventures."[98]

91. Heminway & Hoffman, *supra* note 1, at 919–20.

92. *See* 28 U.S.C. § 77c(b)(1) (2015).

93. *See* 17 C.F.R. §§ 230.251–.263 (2015).

94. *See* 17 C.F.R. §§ 230.254–.255 (2015).

95. *See, e.g.*, Hazen, *supra* note 1, at 1762 ("Regulation A, which, at least in theory, could be used for crowdfunding, does not preclude state law from mandating its own registration and disclosure.").

96. *See* 17 C.F.R. § 230.254(a) (2015); *see also* Hazen, *supra* note 1, at 1746 ("Unlike the other small issue exemptions, Regulation A is available for offerings using a general solicitation of investors but is conditioned upon dissemination of a disclosure document."); Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 502 (2014) ("Regulation A offerings may be made for up to $5 million, which should be ample for early round financing of small start-ups. But Regulation A still requires issuers to file a document with the SEC, Form 1-A, that involves considerable disclosure.").

97. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS (2012) (noting significant delays in SEC review of Regulation A filings as well as high abandonment rate by issuers).

98. Heminway & Hoffman, *supra* note 1, at 921.

Perhaps in an attempt to revive Regulation A, the JOBS Act added section 3(b)(2) which exempts offerings up to fifty million dollars.[99] In addition, an offering limit that is ten times greater, these new offerings, known as "Regulation A+" or "Tier 2 Regulation A," are also "covered" securities.[100] The fundamental problem as it might relate to crowdfunding, however, is that these new offerings require significant initial and ongoing disclosure—including audited financial statements, and annual and semi-annual reports.[101] To the extent these are even more onerous than section 4(a)(6)'s reporting requirements, this new option becomes a nonstarter.

Finally, we are left with new crowdfunding exemptions crafted by the states.[102] While superficially attractive, these new exemptions are unlikely to have much impact given the interstate nature of the Internet and crowdfunding.[103] Phrased more technically, such state exemptions can only exist if they can be fit into the intrastate offering exemption, section 3(a)(11) of the 1933 Act, which is interpreted strictly and requires that the issuer and all offerees be in-state, not to mention that the proceeds be used in-state as well.[104] While in theory

99. *See* Securities Act of 1933 § 3(b)(2), 15 U.S.C. § 77c(b)(2) (2012).

100. *See* Amendments For Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 2501, WL 1788375 (Mar. 2015).

101. *See id.*

102. *See, e.g.*, Stacy Cowley, *Tired of Waiting for U.S. to Act, States Pass Crowdfunding Laws and Rules*, N.Y. TIMES (June 3, 2015), http://www.nytimes.com/2015/06/04/business/smallbusiness/states-pass-crowdfunding-laws-for-small-businesses.html?_r=0 ("Twenty-two states and the District of Columbia have enacted such rules, nine of them within the last six months. Eleven states are considering creating such laws and procedures. Three more states—Florida, Illinois, and New Mexico—have rules or legislation awaiting the governor's signature."); Herrick K. Lidstone, Jr., *Crowdfunding in Colorado Is Now Available: Let The Offerings Roll*, COLO. BAR ASS'N: BUS. LAW NEWSL., Aug. 2015, http://www.cobar.org/index.cfm/ID/22954/subID/29470/CORP/#Crowdfunding.

103. *See, e.g.*, Am. Liberty Ass'n v. Pataki, 969 F. Supp. 160, 173 (S.D.N.Y. 1997) ("[T]he Internet represents an instrument of interstate commerce . . . ."); Heminway & Hoffman, *supra* note 1, at 959–60 ("[T]he inherent cross-border nature of Internet securities offerings (including crowdfunded offerings).").

104. *See, e.g.*, Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2015); Exemption for Local Offerings, Securities Act Release No. 4434, WL 61651 (1961); Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969) (discussing subsection 3(a)(11)); SEC v. Milanowski, Litigation Release No. 20536, WL 1820691 (April 23, 2008) (D. Nev. summary judgment entered Mar. 15, 2010) (finding fund manager unable to raise 3(a)(11) exemption as a defense to allegations of fraud because of his failure to register shares of Fund with SEC); *see also* Steven Overly, *As Federal Regulators Move Slowly on Equity Crowdfunding, States Adopt Their Own Rules*, WASH. POST (Aug. 24, 2014), http://www.washingtonpost.com/business/capitalbusiness/as-federal-regulators-move-slowly-on-equity-crowdfunding-states-adopt-their-own-rules/2014/08/22/81

these state exemptions might be used for offerings whose out-of-state reach could somehow be restricted over the internet,[105] they are unlikely to be significant. As one observer notes, "limiting the offering pool to residents of a single state—as is required for a federally exempt intrastate offering—renders the exemption unusable for crowdfunding efforts given the interstate reach of the Internet."[106] As the SEC has indicated:

> In the context of an offering conducted in accordance with state crowdfunding requirements, such measures would include, at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law, and limiting access to information about specific investment opportunities to persons who confirm they are residents of the relevant state (for example, by providing a representation as to residence or in-state residence information, such as a zip code or residence address).[107]

Perhaps unsurprisingly, preliminary research suggests the intrastate exemptions have not been popular.[108]

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c6da54-2942-11e4-958c-268a320a60ce_story.html ("Indeed, states can only regulate business within their borders. That means their provisions automatically shrink the scope of a business's crowdfunding efforts to investors who reside within the state.").

105. *See, e.g.*, *Hazen, supra n*ote 1, at 1745 ("Small issues that are *purely* local in nature may qualify for section 3(a)(11)'s intrastate exemption, which is not dependent on the size of the offering but also would not be suitable for crowdfunding because it cannot be limited to the confines of a single state." (emphasis added)).

106. *See, e.g.*, Hazen, *supra n*ote 1, at 1749; Heminway & Hoffman, *supra* note 1, at 912 n.160 ("While the intrastate offering exemption . . . may be applicable in some situations involving crowdfunding, most crowdfunded ventures seek to raise capital from investors residing in various states. Because of its unlikely applicability in this context, we do not further analyze the possible application of the intrastate offering exemption in the crowdfunding context.").

107. SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 141.04, https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (August 6, 2015).

108. *See* Ibrahim, *supra* note 85, at 137 ("[M]y preliminary review of those exemptions finds that they have not been used much . . . .").

IV. THE PATH FORWARD

So where do we go from here? Simply put, my prediction is that the new crowdfunding exemption, in trying both to allow crowdfunded capital while at the same time protecting investors, is doomed to fail. It is simply not possible to do both in this context.

In order to arrive at this prediction, I first explore the advantages and disadvantages of allowing crowdfunding, then argue that unfortunately the two are not necessarily reconcilable. As such, the securities regime faces a stark choice: either allow crowdfunding with few restrictions, or ban it.

A. ARGUMENT: PROS AND CONS

1. Brilliant Idea

There are a number of strong arguments to be made in favor of crowdfunding. Looking at the problem first from the point of view of issuers, public policy should encourage small business growth, and it is well known that small businesses face a funding shortfall. In the words of one scholar, "[c]rowdfunding offers significant promise for small business issuers, who face a capital funding gap. Traditional sources of business financing—bank lending, venture capital, and angel investors—are unavailable to many startups and other very small offerings."[109] There is a very modern allure to allowing entrepreneurs to raise money using the Internet, which may at least in part explain Congress' enthusiasm for crowdfunding.[110]

Looking at the problem through the lens of investors also appears compelling. Crowdfunding epitomizes democratization: why

109. Bradford, *Unfulfilled*, *supra* note 33, at 196; *see also* Heminway, *Investment Crowdfunding supra* note 26, at 865 ("Even promising small businesses have trouble finding friends-and-family, seed, angel, and venture capital in sufficient quantities to allow them to succeed and thrive."); Bradford, *Crowdfunding*, *supra* note 2, at 5.

110. *See* Ibrahim, *supra* note 85, at 105 ("In an age where bipartisan support for anything in Congress is rare, allowing entrepreneurs to use the Internet to raise money is a rarity: everyone seems to like it."); Heminway, *Public/Private*, *supra* note 5, at 485 ("[I]n response to public outcry, extensive lobbying efforts, and a perceived political need for the U.S. Congress to do something—anything—bipartisan in nature to better serve small businesses in the lingering shadows of the recent global financial crisis . . . .").

should unregistered offerings be limited to accredited and sophisticated investors, as for example under Rule 506?[111] The concern becomes particularly acute if one considers two factors specific to crowdfunding. First, why should someone be allowed to invest in a Kickstarter or IndieGoGo campaign, yet have to forego the upside?[112] Second, offshore crowdfunding sites, under laxer regulations in other jurisdictions, could appeal to American investors, thereby sidestepping American securities regulation[113]—indeed, my rather unscientific sampling of current crowdfunding sites suggests this phenomenon is already happening.[114]

Overall, then, "crowdfunding enables entrepreneurs to more quickly and easily identify supporter-investors who are willing and able to fund their businesses and projects. . . . Crowdfunding gives these investors a way to participate in corporate finance that they may not otherwise have."[115] The narrative that emerges is very seductive:

> Equity crowdfunding holds the appeal of being quintessentially American. It is the classic rags to riches story, where an enterprising young person turns a smart idea into a globe-straddling company and along the way makes fortunes for those investors perspicacious enough to see the idea's value early on.[116]

When phrased in this romantic language, who could disagree?

111. *See supra* notes 82–85 and accompanying text.

112. *See, e.g.*, Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Investors are already contributing substantial amounts of money to unregulated crowdfunding offerings, although not for securities. Those crowdfunding investments are subject to the same risk of loss as crowdfunded securities, but do not offer the upside potential of a securities investment.").

113. *See, e.g.*, *id.* at 14 ("Not surprisingly, given the international reach of the Internet, some of those foreign sites also sell to U.S. investors, and some of the investments they sell would almost certainly qualify as securities under U.S. law.").

114. *See, e.g.*, BUZZBNK https://www.buzzbnk.org/ (last visited Oct. 30, 2015) (serving U.K.); CROWDCUBE, https://www.crowdcube.com (last visited Oct. 30, 2015) (serving U.K.); INVESTIERE, https://www.investiere.ch (last visited Oct. 30, 2015) (serving Switzerland); SONICANGEL, www.angelgroup.me/ (last visited Oct. 30, 2015) (serving Belgium).

115. Heminway & Hoffman, *supra* note 1, at 931.

116. Dorff, *supra* note 96, at 13; *see also* Heminway, *Investment Crowdfunding*, *supra* note 26, at 879 ("Given presidential support and bipartisan backing in Congress (after all, who wants to oppose a bill that effectively promises to increase and broaden the base of investment capital and, perhaps, spur entrepreneurial activity and job creation during an economic downturn?), there undeniably was significant political pressure to pass the CROWDFUND Act.").

2. *Dismal Idea*

Yet not so fast. Crowdfunding also presents dramatic risks to investors. Most simply and importantly, investing in small emerging companies is risky—and most will fail.[117] This problem is exacerbated in the crowdfunding context by a number of troubling factors.

First, issuers that resort to crowdfunding may not have traditional financing options—friends and family, angel investors, venture capitalists, and banks—available to them.[118] And unaccredited, unsophisticated investors might perhaps be less discerning in their investment strategy. Consider, for instance, that existing crowdfunding platforms have raised money for some unusual ventures, apparently including more than $55,000 to fund a potato salad.[119] Moreover, the offerings are done via the Internet, "a common vehicle for securities fraud."[120] The Rule 504 saga of the mid-1990s—where the SEC relaxed, then had to reinstate the restrictions on solicitation and advertising in Rule 504 offerings based on concerns about fraud—is instructive in this regard:

> [I]n the mid-1990s, many companies relied on Rule 504 for online offerings without registration or any disclosure even close to what would be provided in a registered offering. Typically, companies would issue stock through the Internet and then provide a bulletin

117. *See, e.g.*, Cowley, *supra* note 102, ("Small companies are inherently risky investments—only half survive for five years, according to government data—and private businesses are not required to disclose much about how they operate. It can be nearly impossible for potential investors to really know what risks they face."); *see also* Robb Mandelbaum, *As the Delay Continues on Crowdfunding Rules, Concerns About Investor Risks Grow*, N.Y. TIMES (May 22, 2014), http://boss.blogs.nytimes.com/2014/05/22/as-the-crowdfunding-delay-continues-concerns-about-the-risks-grow/; Heminway & Hoffman, *supra* note 1, at 933 ("Small businesses, especially start-ups, fail at a relatively high rate, and investors are likely to lose all of their investment.").

118. *See generally* Ibrahim, *supra* note 85.

119. *See* Jonah Bromwich, *Crowd-Funding Gets Wacky*, N.Y. TIMES, Dec. 17, 2014 ("After joking with friends, a computer programmer from Ohio named Zack Brown created a campaign that asked for contributions to help raise $10 for a homemade batch of potato salad . . . . The campaign raised more than $55,000.").

120. Heminway & Hoffman, *supra* note 1, at 933, 935 ("Promoters of crowdfunding interests often are anonymous individuals and unknown entities."); Hazen, *supra* note 1, at 1769 ("If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud.").

> board or other online trading vehicle whereby initial purchasers could sell their shares to other investors. Frequently, these online offerings would be accompanied by considerable hype concerning the newly issued securities. In part as a response to these so-called "pump and dump" schemes, the SEC amended Rule 504 to prohibit not only a general solicitation but also to impose restrictions on resale unless the securities are registered under state law or issued under a state law exemption permitting a general solicitation.[121]

In addition, the securities are unlikely to be traded on efficient markets, where uninitiated investors could effectively "free-ride" on the coat tails of professionals.[122] There is the additional problem of "micro-fraud" perpetuated by and on small issuers whose securities are very thinly traded.[123]

The additional significant challenge that a small investor would face is the difficulty of diversifying bets among various investments—in other words, it would be impractical with presumably little capital to build a portfolio the way venture capital firms do. The latter, of course, realize that they will lose money on many, if not most, of their investments.[124] The bottom line is that crowdfunding "involves a

121. Hazen, *supra* note 1, at 1747–48; *see also* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, 64 Fed. Reg. 11090 (Mar. 8, 1999); Heminway & Hoffman, *supra* note 1, at 952 ("The SEC did, in fact, remove the proscription in Rule 504 offerings for a seven-year period during the 1990s only to reinstate it because of renewed concerns about fraud.").

122. *See, e.g.*, Ibrahim, *supra* note 85, at 146 ("While there are certainly well-known criticisms and shortcoming of the ECMH, it is still at least a crude mechanism that makes disclosure work for unsophisticated investors in the public markets context. Title III crowdfunding site would not be efficient markets, so the ECMH cannot benefits its unsophisticated participants.").

123. *See Microcap Fraud*, SEC, http://www.sec.gov/spotlight/microcap-fraud.shtml; *cf.* Hazen, *supra* note 1, at 1766 ("Fraud in small packages can be just as effective and damaging to the victims, many of whom may be least able to bear the risk of even a small investment in a speculative business.").

124. *See, e.g.*, Ibrahim, *supra* note 85, at 137–38 ("Unsophisticated investors are unlikely to appreciate the significant risk of losing their entire investment in a startup that fails (as most startups do). Compare this with angels and VCs who understand that most startups fail and therefore diversify for protection.").

potentially dangerous combination of investment risk and relatively unsophisticated investors."[125]

In the end, then, the policy arguments in favor and against crowdfunding are conducive to a dizzying schizophrenia:

> The relative ease with which an unsophisticated investor may lose money in investments with small business issuers, the high rate of securities fraud in the small business context, and the anonymity of the Internet may give us pause about extending exemptive relief to crowdfunded offerings. However, crowdfunding has the capacity to fuel small business growth and satisfy the demand for a securities market that serves the everyman.[126]

Given this mess, what to do?

B. A PESSIMISTIC PREDICTION

My pessimistic prediction, which I fervently hope will prove incorrect, is that the current attempt to legalize crowdfunding will have precious little impact. Crowdfunding will likely hobble along in a legal grey area.[127] At best, what some enterprising issuers might do is to parallel offerings: perhaps a small amount to unaccredited investors under the new crowdfunding rules,[128] but the bulk of the

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125. Bradford, *Unfulfilled*, *supra* note 33, at 196; *see also* Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Investing in small businesses is very risky. Small business investments are illiquid, and small businesses, especially startups, are much more likely to fail than are more established companies. Losses due to fraud and self-dealing are also much more likely."). Dorff, *supra* note 96, at 31 ("Eventually, investors will realize that money invested in crowdfunding enterprises will nearly always be money lost."); Bradford, *Crowdfunding*, *supra* note 2, at 105 ("Crowdfunding possesses no magical properties that prevent investors from losing money just like other investors.").

126. Heminway & Hoffman, *supra* note 1, at 937.

127. *See, e.g.,* Harry McCracken, *Indiegogo is Getting Ready for Equity Crowdfunding*, FAST COMPANY (Sept. 14, 2015), *available at* http://www.fastcompany.com/3050200/the-big-idea/indiegogo-is-getting-ready-for-equity-crowdfunding (as the co-founder of the Crowdfunding Professional Association puts it, "[f]acilitating regulated investments is very different from giving away T-shirts or hats or putting people's names in the credits of a movie."); Moira Vetter, *In With the In Crowd? The Entrepreneur's Guide to Crowdfunding (Or Not)*, FORBES (July 31, 2015), *available at* http://www.forbes.com/sites/moiravetter/2015/ 07/31/in-with-the-in-crowd-the-entrepreneurs-guide-to-crowdfunding-or-not/ ("SEC compliance can be mind numbing. Equity crowdfunding comes with regulatory responsibilities that may be too much for you to take on.").

128. Perhaps even to just below the $100,000 or $500,000 thresholds, to avoid the more

offering to accredited investors under Regulation D or perhaps even the new Regulation A+.

The other intriguing option is for companies—both startups eventually looking for venture capital, and those well-funded, deep-pocketed ones—to continue to use the existing nonequity crowdfunding platforms as a clever and inexpensive way to test products, while at the same time passing the costs to the backers.[129]

The more interesting question, though, is how to conceptualize a path forward. My argument is simple: we are deluding ourselves if we think we can have it both ways. Crowdfunding simply is not amenable to investor protection, and disclosure will not solve our problem.[130] As such, we need to pick our poison: Either make crowdfunding readily available, or ban it. Trying to do too much—as section 4(a)(6) and the Proposed Rules arguably do—is a recipe for disaster.

The arguments against banning crowdfunding track the negatives outlined above. Put simply, the notion is that "these investments are going to be *terrible*"[131] and that "there *is* no way to rescue retail crowdfunding. The problem is not with how Congress set up the system or how the SEC will eventually implement it. The problem is that this was always a terrible idea."[132] Indeed, in an attempt to protect investors, at least one commentator urges the SEC to put an end to section 4(a)(6) via excessive regulation:

> The best solution would be to scrap the crowdfunding portion of the JOBS Act entirely. But since Congress is highly unlikely to reverse itself so quickly, the SEC should use the power granted to it by the JOBS Act to achieve effectively the same end by piling on so many

onerous financial disclosure requirements that begin at the next level. *See, e.g.*, Neiss, *supra* note 69.

129. *See, e.g.*, Katherine Rosman, *Crowdfunding Isn't Just for the Little Guys: Deep-Pocketed Companies Test the Market on Indiegogo*, WALL ST. J. (July 9, 2014), http://www.wsj.com/articles/crowdfunding-isnt-just-for-the-little-guys-1404955610 ("By using these sites [such as IndieGoGo], bigger companies are finding they can do valuable market research often while passing the costs on to willing donors.").

130. In other words, I remain unconvinced that "a careful balancing of investor protection and capital formation" is possible in the crowdfunding context. *See* Bradford, *Crowdfunding*, *supra* note 2, at 8.

131. Dorff, *supra* note 96, at 496.

132. *Id.* at 523.

> additional investor protections and disclosure requirements that portals find it undesirable to list crowdfunding opportunities, and businesses are driven to look elsewhere for capital.[133]

Regardless of whether one might personally agree with this assessment, a better policy argument might be to craft a simple exemption—perhaps setting maximum investment limits and making crowdfunded securities exempt under section 3(a)[134]—and allow investors to spend their money, if they so choose. The analogy might be to gambling or to charitable donations, both of which are legal.[135]

I propose this largely because crowdfunding is the perennial horse that has already left the barn—not allowing it will lead to phenomena such as underground and offshore sites.[136] There is also something odd about taking people's money but disallowing any investment—as just one telling example, RocketHub puts investments in the same category as alcohol, drugs, gambling, and pornography.[137] There is, of course, the question of whether startups themselves will want to sell shares in themselves broadly or to a select few investors[138]—but allowing crowdfunding as an investment will eventually answer this question. If investors are willing to part with their money, why not give them some upside potential—as elusive

133. Dorff, *supra* note 96, at 498; *see also id.* at 523 ("At this point, the SEC's best option is to kill retail crowdfunding with excessive regulation.").

134. *Cf.* Heminway & Hoffman, *supra* note 1, at 912 ("Section 3(a) does not currently provide an exemption for crowdfunding interests.").

135. *Cf. id.* at 942 ("One way to address the uncertainties created by deregulating the offer and sale of crowdfunding interests under the federal securities laws is by regulating those transactions under another one or more existing areas of law (e.g., through gambling regulation or the regulation of charitable donations) or by regulating them under a new scheme of regulation created especially for crowdfunding.").

136. *See* Cohn, *supra* note 55, at 4 ("the crowdfunding phenomenon is growing at a rate that does not allow for continued benign sweeping under the enforcement radar screen.").

137. RocketHub's FAQ section asks "What can NOT be offered as a good or service at this time?" The following goods are not allowed: alcohol, drugs, gambling (including lotteries, raffles, or sweepstakes), *investment opportunities (including equity, loans, and revenue sharing),* pornography, and weapons. RocketHub, FAQs, https://www.rockethub.com/education/faq#not-offered (last visited Oct. 10, 2015) (emphasis added); *see also* Bradford, *Crowdfunding*, *supra* note 2, at 25 ("there are now no major, publicly accessible equity crowdfunding sites in the United States").

138. *See, e.g.*, McCracken, *supra* note 127 (in the words of the CEO of one startup, "Who you have around the table is as important as, if not more important than, the money you're bringing in."); Vetter, *supra* note 127 ("I would rather 'hand pick' my prospective investors than mass market to people I don't know, who will not be adding strategic value.").

and naïve as it might be, even the possibility of any upside would be better than zero.[139]

C. Taking Opportunities

Regardless of whether readers might agree or disagree with my proposal, the biggest tragedy is that we are missing the opportunity to examine major questions in securities regulation: as it turns out, the crowdfunding saga presents many themes in microcosm. More obviously, it broaches fundamental dilemmas such as defining securities, the small-business funding gap, the relative institutional roles of Congress and the SEC, the efficacy of disclosure, and the role of intermediaries as gatekeepers. More subtly, crowdfunding blends public and private, uncouples value-added services from capital, and asks whether crowds are consistent with efficient markets. Debating these issues would have real value; sadly, though, the framework's failures drown out such discourse.

1. Some Fundamental Questions

The ambiguities of how to define a "security" have been discussed above.[140] Crowdfunding would seem to provide a perfect opportunity to discuss whether a Unites States Supreme Court decision from 1946 should still be the benchmark for defining securities well into the twenty first century.[141] Similarly, crowdfunding forces us to ask whether—notwithstanding the concern with "microfraud"[142]—it makes sense to make the securities laws so difficult and expensive for small businesses to comply with.[143] As one scholar points out:

> Congress could have used crowdfunding as an opportunity to re-examine some of the basic premises

139. It is important to remember that "the crowdfunding backers don't share in the profits. Equity crowdfunders, however, receive actual shares in the companies they back." Cowley, *supra* note 102.

140. *See supra* notes 33–60 and accompanying text.

141. *See supra* notes 15–32 and accompanying text.

142. *See supra* notes 118–124 and accompanying text.

143. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 880 ("Funding small businesses while complying with applicable securities laws and regulations is tricky.").

> of securities regulation of small businesses and to seriously rethink how the Internet can be used to protect investors in less traditional, less expensive ways. Instead, it threw together a poorly drafted regulatory bundle of old ideas that is complicated, expensive, and unlikely to have much of an effect on the small business capital gap.[144]

Relatedly, crowdfunding could make us re-think what is arguably the fundamental premise of the entire securities regime: disclosure. There is new research that suggests mandated disclosure has, simply put, been a failure.[145] In the words of one scholar: "[t]he sheer volume of disclosure occasioned by the mandatory disclosure regime—especially when some of the information has little, if any, relevance in determining market prices or company-specific or systemic risks—may render mandatory disclosure ineffective or inefficient in serving its desired regulatory objectives."[146]

More specifically, securities exemptions typically require that solicitation be accompanied by disclosure[147]—contrast for example Rule 504 (no solicitation, no disclosure) with Regulation A (solicitation, disclosure).[148] But is this dichotomy correct? Moreover, will the average investor in the "crowd" understand, or even read, the disclosures whose creation is at least partially to blame for such high transaction costs?[149] This concern is only exacerbated when the Internet is the offering medium, given its tendency to provide an overwhelming amount of information which can be difficult to sift through.[150]

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144. Bradford, *Unfulfilled*, *supra* note 2, at 222; *see also* Heminway & Hoffman, *supra* note 1, at 951 ("There also may be a future time at which it would be advisable to initiate an overhaul of all small business capital formation regulation.").

145. OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 33 (Princeton Univ. Press 2014).

146. Heminway, *What is a Security*, *supra* note 13, at 349.

147. *See, e.g.*, Hazen, *supra* note 1, at 1748 ("Any exemption that involves a general solicitation of investors will require an offering circular or other affirmative disclosure.").

148. *See supra* note 1, at 1763; *see also supra* notes 81–84 and accompanying text.

149. *Id.*; *see also supra* notes 64–74 and accompanying text.

150. *See, e.g.*, Heminway & Hoffman, *supra* note 1, at 934 ("the Internet may over-inform and, as a result, obfuscate or bury important information in connection with securities offerings.").

The crowdfunding debacle also provides an exceptional opportunity to consider the relative institutional roles of Congress and the SEC. Sections 4(a)(6) and 4A are drafted in detail that one seldom sees in the securities regime—why?[151] To put it bluntly, likely because the Congress was fed up with the SEC's inertia on small offerings. It is important in this regard to remember that the SEC for decades had the statutory authority under section 3(b)[152] and section 28[153] to craft a crowdfunding exemption, but it did not.[154] As such, we have the legislature trying to do the regulatory agency's job, perhaps with predictable results.[155]

The idea of funding portals also invites a conversation on the role of intermediaries as gatekeepers in the securities regime. Given our struggles with the bifurcated regulatory regime for broker-dealers[156] on the one hand and investment advisors[157] on the other,[158] does it make sense to introduce yet another concept, namely the funding portal?[159] To the extent it does, might it have been better to

151. Contrast, for example, with section 10(b) of the 1934 Act which vaguely prohibits "any manipulative or deceptive device or contrivance . . . ." (codified in 15 U.S.C. 78j (2015)).

152. *See* Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1) (2012) ("Commission may from time to time by its rules and regulations . . . add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors . . . but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.").

153. Section 28 of the 1933 Act is even more generous, noting simply that the "Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 28. U.S.C. § 77z-3 (1998).

154. *See, e.g.*, Hazen, *supra* note 1, at 1749 ("the SEC already had statutory authority to craft an exemption that could apply to crowdfunding"); Bradford, *Crowdfunding*, *supra* note 2, at 87.

155. *See* Cohn, *supra* note 55, at 15 ("the SEC has a dismal record regarding the interests of small business. Congressional leaders therefore felt compelled to move into the regulatory vacuum. Yet, for all their good intentions, legislators are not experts in the nuances of securities laws. . . .").

156. *See* Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 77c (a)(4) (2012).

157. *See* Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2015).

158. *See, e.g.*, Reza Dibadj, *Brokers, Fiduciaries and a Beginning*, 30 REV. OF BANKING AND FIN. L. 205 (2010).

159. *Cf.* Bradford, *Crowdfunding*, *supra* note 2, at 49 ("If the investments offered on crowdfunding sites are securities, crowdfunding site operators could be brokers subject to regulation under the Exchange Act or investment advisers under the Investment Advisers Act.").

introduce something like the "Nomads" on London's AIM market, as at least one commentator has suggested.[160]

2. Intriguing Subtleties

So far, I have touched on some fairly obvious issues that crowdfunding brings to the fore; namely, defining securities, funding small businesses, and questioning disclosure and institutional roles. There are, however, additional more subtle topics, which center on crowds and efficient markets, the public/private distinction, and unbundling value added from capital.

The entire securities regime putatively revolves around efficient markets[161] and the mythical reasonable investor.[162] But are these assumptions applicable when we are talking about crowds?[163] One scholar puts the question particularly well when she asks: "[d]oes the securities-crowdfunding crowd have the attributes of a wise crowd, or will it have a tendency to madness?"[164] To what extent do crowds typify the concerns in behavioral economics and noise theories about the efficient market hypothesis?[165]

Another nuanced, but conceptually fascinating feature of crowdfunding is that it challenges the public/private divide in securities regulation.[166] Traditionally, the regulatory regime has been bifurcated: the entire machinery of public offerings on the public side,

160. *See* Ibrahim, *supra* note 85, at 151–59.

161. *See, e.g.,* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 550 (1984).

162. *See* Basic v. Levinson, 485 U.S. 224, 240 (1988) ("materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.").

163. *See, e.g.,* Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the "Crowd*," 38 VT. L. REV. 827, 829 (2014) [hereinafter Heminway, *Crowd*] ("Individual members of the crowd may or may not have the attributes of the reasonable investor—the type of investor protected by U.S. federal securities laws and rules.").

164. *Id.* at 844. *See also* Ibrahim, *supra* note 85, at 148 ("The concept of the "crowd" under Title III is messy and ambiguous.").

165. *See, e.g.*, Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 851–72 (1992); Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 3 (2003).

166. *See* Heminway, *Public/Private*, *supra* note 5, at 479 ("The very notions of a crowdfunded offering and issuer of securities challenge pre-existing public-private distinctions.").

and the relatively light-touch on the private side, typically when the offering is sold to accredited investors.[167] Crowdfunding challenges this. On the one hand, it is an exemption like those offered to "private" offerings; on the other, it is "public" in that there is solicitation and the securities are offered to the public at large.[168] As one example of this tension, consider that the JOBS Act had to exempt crowdfunded companies from the normal requirement under section 12(g) and Rule 12g-1 of the 1934 Act to categorize companies with more than two-thousand shareholders and ten million dollars in assets to reporting requirements as if they were a public reporting company.[169] The last time the SEC conflated public and private, Regulation A,[170] success was not forthcoming[171]—is the new crowdfunding exemption repeating the same mistake?

Finally, and perhaps most subtly, crowdfunding broaches the topic of unbundling governance rights and value-added services from capital. Consider, for instance, that startup companies seeking funds from angel investors and venture capital firms typically also receive "value-added" services in the form of strategic and management guidance, but crowdfunding essentially uncouples these services from the transfer of capital itself. To the extent that startups are thirsting for crowdfunding dollars, does this imply they do not value these services, or that crowdfunded funds are simply cheaper?[172] This idea is of course different, but has a conceptual similarity to another form of unbundling that occurred in the early days of crowdfunding: that of

167. *See supra* notes 156–159.

168. *See* Heminway & Hoffman, *supra* note 1, at 929–30 ("Crowdfunded offerings, as currently conducted, are not private offerings; by their nature, crowdfunded offerings are not limited offerings (in terms of their ability to reach potential investors) and are not isolated offers and sales of securities.").

169. Jumpstart Our Business Startups (JOBS) Act of 2012, H.R. 3606, 112th Cong. §§303, 501 (2nd Sess. 2012) (enacted).

170. *See* Heminway, *Public/Private*, *supra* note 5, at 488 ("Regulation A had earlier blurred the line between public and private offerings for mandatory disclosure under the 1933 Act by requiring limited offering disclosures structured to look like the disclosures used in registered public offerings. . . .").

171. *See supra* notes 92–98 and accompanying text.

172. *See* Ibrahim, *supra* note 85, at 140 ("the inherent passivity of Title III investors—a seeming negative—would actually appeal to entrepreneurs who wish to *unbundle* the cash and value-added service components of traditional entrepreneurial finance").

unbundling governance rights (notably, voting rights) from capital contributions, what one scholar has termed "unequity."[173]

V. CONCLUSION

The securities regime in the United States faces a fundamental, perhaps intractable, problem: "to reconcile the regulatory requirements of 1933 with the realities of the twenty-first century."[174] Crowdfunding, whose "socio-legal bounds are as yet relatively untested,"[175] presents a particular challenge: A resolutely twenty-first century phenomenon butting heads against a regulatory framework designed for the early twentieth century.[176]

It is unlikely that the limbo in which crowdfunding finds itself will emerge unless we are willing to face a normative choice: Either we think that individuals should be able to invest capital in risky ventures or not. If we decide the former, then we should have a streamlined regulation with significantly fewer requirements and concomitant lower transaction costs. On the other hand, if we decide the latter, then we should simply not allow crowdfunding. To think that we can allow it while at the same time protect investors may be a bit of a delusion.

To the extent my prediction about the new crowdfunding regime is accurate, my fervent hope is that we move beyond and learn from the opportunity crowdfunding has given us to examine some questions, both fundamental and esoteric, in securities regulation.

173. *See* Heminway, *What Is a Security*, *supra* note 13, at 360 (defining unequity as "a particular type of financial interest that provides for profit-sharing or revenue-sharing on a short-term basis, with no accompanying governance rights").

174. Bradford, *Crowdfunding*, *supra* note 2, at 150.

175. Heminway, *Public/Private*, *supra* note 5, at 477.

176. *Cf.* Heminway, *Crowd*, *supra* note 163, at 831 ("Crowdfunded securities offerings are a relatively recent, high-growth phenomenon borne, at least in part, from frustration with traditional capital-raising methods and processes.").