CROWDFUNDING AND THE FEDERAL SECURITIES LAWS

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

Crowdfunding poses two issues under federal securities law. First, crowdfunding sometimes involves the sale of securities, triggering the registration requirements of the Securities Act of 1933. Registration is prohibitively expensive for the small offerings that crowdfunding facilitates, and none of the current exemptions from registration fit the crowdfunding model. Second, the web sites that facilitate crowdfunding may be treated as brokers or investment advisers under the ambiguous standards applied by the SEC.

This article considers the costs and benefits of crowdfunding and proposes an exemption that would free crowdfunding from the registration requirements, but not the

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antifraud provisions, of federal securities law. Securities offerings for an amount less than $250,000–500,000 would be exempted if (1) each investor invests no more than the greater of $500 or 2% of the investor's annual income; and (2) the offering is made on an Internet crowdfunding site that meets the exemption's requirements.

To qualify for the exemption, crowdfunding sites would have to: (1) be open to the general public; (2) provide public communication portals for investors and potential investors; (3) require investors to fulfill a simple education requirement before investing; (4) prohibit certain conflicts of interest; (5) offer no investment advice or recommendations; and (6) notify the SEC that they are hosting crowdfunding offerings. Sites that meet these requirements would not be treated as brokers or investment advisers.

I. INTRODUCTION

Small businesses, especially startups, have a difficult time raising money. The usual sources of business finance—bank lending, venture capital, retained earnings—are difficult to obtain for small and micro-businesses. Wealthy individuals known as "angel investors" fill part of the funding gap, but angel investing is limited, and even angel investors tend to focus on larger investments. Entrepreneurs who lack the personal resources needed to finance their businesses turn to friends, family members, and personal acquaintances, but those sources are often insufficient. As a result, many potentially successful small businesses do not get funded.

Crowdfunding, sometimes called peer-to-peer lending when it involves debt financing, is a possible solution to the small business funding problem. Crowdfunding, is, as its name indicates, funding from the crowd—raising small amounts of money from a large number of investors. Unlike typical business financing, which comes primarily from wealthy individuals and institutional investors, crowdfunding raises money from the general public. In the past, the transaction costs associated with raising small amounts from a large number of investors would have made crowdfunding unworkable, but the Internet has significantly reduced those transaction costs. Web-based crowdfunding services such as Kickstarter, Lending Club, Prosper, ProFounder, IndieGoGo, and, the paragon of crowdfunding,[1] Kiva have proliferated. Through these sites, entrepreneurs have access to anyone in the world with a computer, Internet access, and free cash. Billions of dollars have been raised through Internet-based crowdfunding since its inception just a few years ago—possibly the beginning of a revolution in how the general public allocates capital.[2]

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[1] JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF BUSINESS 247 (2008).

[2] *See* KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 3 (2010) ("[I]n the same

A recent campaign by two ad executives, Michael Migliozzi II and Brian William Flatow, to raise $300 million to buy Pabst Brewing illustrates the power of crowdfunding.[3] They promised investors "certificates of ownership" and beer with a value equal to the amount invested.[4] According to their lawyer, the two were only conducting an online experiment and never actually intended to buy Pabst.[5] But they reportedly received $200 million in pledges from over five million individuals in the six-month period before the Securities and Exchange Commission ("SEC") shut them down for failing to register.[6]

As this example illustrates, crowdfunding 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 (the "Securities Act") unless an exemption is available. Registration would be prohibitively expensive. A couple of peer-to-peer lending sites have registered, but to do so, they substantially restructured their operations in a way unlikely to prove useful for most crowdfunding, particularly for equity offerings.

The current exemptions from the registration requirement also do not fit crowdfunding well. Crowdfunding sites trying to fit within these exemptions have had to restrict access either to sophisticated, wealthy investors or to preexisting acquaintances of the entrepreneur seeking funds.

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way that social networking changed how we allocate our time, crowdfunding will change how we allocate capital.").

[3] *See* Michael Migliozzi II, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, Securities Act Release No. 9216 (June 8, 2011), *available at* http://www.sec.gov/litigation/admin/2011/33-9216.pdf [hereinafter Migliozzi Cease-and-Desist Order]; Chad Bray, *Huge Beer Run Halted by Those No Fun D.C. Regulators*, WALL ST. J. L. BLOG (June 8, 2011, 4:05 PM), http://blogs.wsj.com/law/2011/06/08/huge-beer-run-halted-by-those-no-fun-d-c-regulators/?mod=WSJBlog.

[4] Migliozzi Cease-and-Desist Order, *supra* note 3, at 2.

[5] *See* Bray, *supra* note 3.

[6] Migliozzi Cease-and-Desist Order, *supra* note 3, at 3.

Such restrictions eliminate the power of crowdfunding—access to the public crowd of small investors. Securities-based crowdfunding is practicable only if a new exemption is created.

Several proposals have been made to exempt crowdfunding and certain other small business securities offerings from the registration requirements of the Securities Act. All of these proposals would cap both the dollar amount of a crowdfunded offering and the amount that each individual investor could invest.

But the Securities Act's registration requirement is not the only potential obstacle to crowdfunding. The web sites that facilitate crowdfunding face their own regulatory issues. If crowdfunding entrepreneurs offer securities on these sites, the sites could be acting as unregistered brokers or investment advisers under opaque SEC standards. Any proposal designed to facilitate crowdfunding must deal with these issues as well.

The White House recently endorsed a crowdfunding exemption,[7] and the SEC has promised to consider crowdfunding as part of a general review of regulatory constraints on capital formation. But Congress may not wait for the SEC to act. The House has passed a bill to add a crowdfunding exemption to the Securities Act and two bills have been introduced in the Senate. Some of those bills incorporate some of the recommendations made in this article. According to one source, crowdfunding sites are "gearing up for a boom" if a crowdfunding exemption passes.[8] The CEO of one crowdfunding site, ProFounder, indicated in

[7] *See* Press Release, White House Office of the Press Secretary issues Fact Sheet and Overview for American Jobs Act (Sept. 8, 2011) [hereinafter Fact Sheet and Overview for AJA], *available at* http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview.

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

May 2011 that she was "working with a legal team to lay the groundwork for online equity sales."[9]

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

This Article argues for an exemption that would free both crowdfunded offerings and the web sites on which they are made from the regulatory requirements, but not the antifraud provisions, of federal securities law. Under the exemption, the total dollar amount of an entrepreneur's offerings would be limited to $250,000–$500,000 a year, with individual investments limited to the greater of $500 or 2% of the investor's annual income. The offerings would have to be made on publicly accessible crowdfunding web sites that, among other things, meet conflict-of-interest standards and do not provide investment advice.

Part II of this article is an introduction to the crowdfunding phenomenon. It defines crowdfunding and briefly explores its precursors: crowdsourcing and microfinance. Part II also distinguishes among five different models of crowdfunding: the donation model; the reward model; the pre-purchase model; the lending model, sometimes called peer-to-peer lending; and the equity model. The models differ in what, if anything, contributors are promised in return for their contributions.

Part III discusses whether crowdfunding investments are securities subject to the Securities Act registration requirements and concludes that the answer depends on the particular form of crowdfunding. Crowdfunding contributions on donation, reward, and pre-purchase sites are not securities. Crowdfunding investments on equity

[9] *Id.*

sites would be securities in the usual case where investors are promised some investment return other than the return of their capital. The answer with respect to lending sites is a little less certain. If investors are promised interest on their loans, those investments are probably securities. If no interest is offered, lending sites would not be offering securities.

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

Part V discusses the various proposals to exempt crowdfunding from federal securities law and also briefly examines the SEC's authority to exempt crowdfunding, concluding that crowdfunding exemptions such as those proposed would fall within that authority.

Part VI addresses the benefits and costs of crowdfunding. Crowdfunding would help to ease the capital gap faced by startups and very small businesses. It would extend the geographical reach of small-business fundraising and make capital available to poorer entrepreneurs whose family, friends, and acquaintances have insufficient funds. But these gains come at a potential cost. Crowdfunding exposes relatively unsophisticated investors to the greater risks associated with small business offerings—illiquidity, fraud, business failure, and entrepreneurial self-dealing. Properly structured, crowdfunding reduces, but does not eliminate, those risks. However, investors are already exposed to those same risks in the existing, *non-securities* models of crowdfunding. A crowdfunding securities exemption would increase those investors' potential gains while mitigating associated risks.

Part VII considers what a crowdfunding exemption should look like.

II. AN INTRODUCTION TO CROWDFUNDING

A. What Is Crowdfunding?

The basic idea of crowdfunding is to raise money through relatively small contributions from a large number of people.[10] Using the Internet, an entrepreneur can "in real time and with no incremental cost . . . [sell] . . . to literally millions of potential investors."[11] No intermediary such as a bank or an underwriter is needed.[12] Anyone who can convince the public he has a good business idea can become an entrepreneur, and anyone with a few dollars to spend can become an investor.

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

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[10] *See* Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd* 2 (Center for Operations Discussion and Research, Discussion Paper No. 2011/32, 2011), *available at* http://ssrn.com/abstract=1836873.

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

[12] *See* Andrew Verstein, *The Misregulation of Peer-to-Peer Lending*, 45 U.C. DAVIS L. REV. (forthcoming 2012), *available at* http://ssrn.com/abstract=1823763.

Crowdfunding offerings are typically rather small. One study found that the median amount raised was only $28,583.[13] But crowdfunding is not necessarily limited to very small offerings. The largest amount raised in that same study was over $82 million.[14] And, in the aggregate, crowdfunding is huge. As of December 2011, 600,000 different Kiva lenders had loaned more than $270 million dollars to more than 700,000 entrepreneurs.[15] Peer-to-peer lending, just one form of crowdfunding, has alone been responsible for more than $1 billion dollars in funding, and some industry analysts believe peer-to-peer lending could exceed $5 billion annually by 2013.[16]

The basic concept of crowdfunding is not new. Politicians have been collecting small campaign donations from the general public for generations. That, in essence, is crowdfunding.[17] But Internet-based crowdfunding is relatively new. Kiva, the leading crowdfunding site today, did not open for business until 2005,[18] and the term "crowdfunding" did not appear until 2006.[19] In the brief time since Internet-based crowdfunding appeared, it has grown exponentially. It "is becoming a big business, with a steady

[13] Belleflamme et al., *supra* note 10, at 32–33 tbl. 2. The mean was $3.5 million. *Id.*

[14] *Id.* *See also* Armin Schwienbacher & Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures, in* HANDBOOK OF ENTREPRENEURIAL FINANCE (Douglas Cumming ed., forthcoming 2012), *available at*: http://ssrn.com/abstract=1699183 (discussing plans of Trampoline Systems, a British software company, to raise £1 million in four tranches).

[15] *See About Us - Statistics*, KIVA, http://www.kiva.org/about/stats (last visited Mar. 5, 2012).

[16] Verstein, *supra* note 12.

[17] Crowdfunding has "been the backbone of the American political system since politicians started kissing babies." HOWE, *supra* note 1, at 253.

[18] *See About Us - History*, KIVA, http://www.kiva.org/about/history (last visited Mar. 5, 2012).

[19] LAWTON & MAROM, *supra* note 2, at 66.

parade of services joining the fray."[20] Kiva is now so popular that it sometimes exhausts its available lending opportunities.[21]

Crowdfunding has been especially popular in the entertainment industry,[22] but there are crowdfunding sites for all types of projects. Some crowdfunding sites are limited to specific businesses or industries, such as book publishing,[23] gaming,[24] music,[25] journalism,[26] or agriculture

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

[21] *See* HOWE, *supra* note 1, at 248; Jilian Mincer, *Microlending for Microbankers*, WALL ST. J., Mar. 20, 2008, at D2.

[22] *See* Belleflamme et al., *supra* note 10, at 2–3; Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 375–76 (2009) ("[Crowdfunding] has been increasingly used in the entertainment industry by independent filmmakers, artists, writers, and performers."). Not surprisingly, politicians have adapted their crowdfunding to the Internet as well. Barak Obama used the Internet in his 2008 presidential campaign to raise over $750 million from just under four million donors. Tahman Bradley, *Final Fundraising Figure: Obama's $750M*, ABC NEWS (Dec. 5, 2008), http://abcnews.go.com/Politics/Vote2008/Story?id=6397572&page=1.

[23] *See, e.g.*, UNBOUND: BOOKS ARE NOW IN YOUR HANDS, http://www.unbound.co.uk/ (last visited Mar. 5, 2012). *See also* Keith Wagstaff, *Is Crowdfunding the Future of Book Publishing?*, THE UTOPIANIST (June 22, 2001), http://utopianist.com/2011/06/is-crowdfunding-the-future-of-book-publishing/ (discussing how crowd-funding works in book publishing).

[24] *See* 8-BIT FUNDING, http://www.8bitfunding.com/index.php (last visited Mar. 5, 2012). *See also The Power of Crowd Funding*, EDGE (June 20, 2011), http://www.next-gen.biz/features/powertothepeoplefeature (discussing how crowdfunding works in the video game industry).

[25] *See* MY MAJOR COMPANY, http://www.mymajorcompany.co.uk/ (last visited Mar. 5, 2012); SELLABAND, https://www.sellaband.com/ (last visited Mar. 5, 2012). Crowdfunding works in the music industry "because most of the market is controlled by a handful of risk-averse major labels and there's a huge underground that wants to break in." John Tozzi, *Scoring Money from an Online Crowd*, BLOOMBERG BUSINESSWEEK (Sept. 10, 2007, 8:15 AM), http://www.businessweek.com/smallbiz/content/sep2007/sb20070910_540342.htm (quoting Pim Tetist, one of the founders of Sellaband).

[26] *See* SPOT.US: COMMUNITY-FUNDED REPORTING, http://spot.us/ (last visited Mar. 5, 2012).

and ranching.[27] Crowdfunding is even being used to fund scientific research projects.[28] Other sites are open to broader categories, such as "creative projects"[29] or "sustainable or Fair Trade" projects.[30] Others are directed at particular types of entrepreneurs, such as women[31] or the poor.[32] Many crowdfunding sites are open to entrepreneurial projects generally.[33]

Crowdfunding is not just a U.S. innovation. There are crowdfunding sites serving, among other countries and regions, Great Britain,[34] Hong Kong,[35] Brazil,[36] Germany,[37]

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[27] *See* HEIFER INTERNATIONAL, http://www.heifer.org/ (last visited Mar. 5, 2012).

[28] *See* Thomas Lin, *Scientists Turn to Crowds on the Web to Finance Their Projects*, N.Y. TIMES, July 11, 2011, at D3.

[29] *See Learn More*, ROCKETHUB, http://rockethub.com/learnmore/intro (last visited Mar. 5, 2012) ("creative products and endeavors"); *Frequently Asked Questions: Kickstarter Basics*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter%20basics (last visited Mar. 5, 2012) ("Kickstarter is focused on creative projects. We're a great way for artists, filmmakers, musicians, designers, writers, illustrators, explorers, curators, performers, and others to bring their projects, events, and dreams to life.").

[30] *See* THE HOOP FUND, http://www.hoopfund.com/learn.webui (last visited Mar. 5, 2012).

[31] *See* INUKA, http://inuka.org/ (last visited Mar. 5, 2012).

[32] *See How MicroPlace Works*, MICROPLACE, https://www.microplace.com/howitworks/what_we_do (last visited Mar. 5, 2012); *About Us*, KIVA, http://www.kiva.org/about (last visited Mar. 5, 2012).

[33] *See, e.g.*, PROFOUNDER, https://www.profounder.com (last visited Mar. 5, 2012); GROW VC, http://www.growvc.com/main/ (last visited Mar. 5, 2012); PEERBACKERS: CROWDFUNDING BIG IDEAS, http://www.peerbackers.com/ (last visited Mar. 5, 2012); INDIEGOGO, http://www.indiegogo.com/ (last visited Mar. 5, 2012); MICROVENTURES, http://www.microventures.com/ (last visited Mar. 5, 2012).

[34] *See* MY MAJOR COMPANY, *supra* note 25; *Company Information*, UNBOUND, http://www.unbound.co.uk/company (last visited Mar. 5, 2012). *See generally* Catherine Burns, *Small Firms Seek Crowd Funding*, BBC (May 26, 2011), http://www.bbc.co.uk/news/business-13569912.

[35] *See About*, GROW VC, http://www.growvc.com/main/about/ (last visited Mar. 5, 2012).

[36] *See* Janet Gunter, *Brazil: Crowdfunding Potential*, GLOBAL VOICES: ENGLISH (May 24, 2011, 1:15 PM), http://globalvoicesonline.org/2011/05/24/brazil-crowdfunding-potential/.

the Netherlands,[38] and sub-Saharan Africa.[39] Some sites claim to be global, open to investors and entrepreneurs everywhere.[40]

Not surprisingly, given the international reach of the Internet, some of those foreign sites also sell to U.S. investors,[41] and some of the investments they sell would almost certainly qualify as securities under U.S. law. That raises a host of jurisdictional issues,[42] but this article focuses on the issues posed by domestic crowdfunding sites—web sites operated by U.S. companies that bring together U.S. entrepreneurs and U.S. investors.

B. Types of Crowdfunding

One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model;

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[37] *See generally* Karsten Wenzlaff, *Crowdfunding is on the Rise in Germany*, CROWDSOURCING.ORG (June 27, 2011, 9:47 AM), http://www.crowdsourcing.org/editorial/crowdfunding-is-on-the-rise-in-germany/4962.

[38] *See* SYMBID, http://www.symbid.com/ (last visited Mar. 5, 2012); *About Us*, SELLABAND, https://www.sellaband.com/en/pages/about_us (last visited Mar. 5, 2012).

[39] *See Introducing Inuka*, INUKA, http://inuka.org/ (last visited Mar. 5, 2012).

[40] *See, e.g.*, *About*, GROW VC, *supra* note 35 ("Grow Venture Community (Grow VC) is the first global, transparent, community-based platform dedicated to entrepreneurs and their needs. . . . We are located all over the world and growing constantly. We wish to establish a presence in all the most entrepreneurial countries on the planet."); *About Us*, KIVA, *supra* note 32 ("Kiva works with microfinance institutions on five continents.").

[41] For instance, an in-depth study of Sellaband found that its investors were concentrated in Europe and the eastern United States. Ajay Agrawal, Christian Catalini & Avid Goldfarb, *The Geography of Crowdfunding* 8 (NET Institution, Working Paper No. 10-08, 2010), *available at* http://ssrn.com/abstract=1692661.

[42] *See generally* 6 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 403–21 (6th ed. 2009). The answers to these questions are complicated by the Supreme Court's recent decision in *Morrison v. National Australian Bank Ltd.*, 130 S. Ct. 2869 (2010).

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

1. Donation Sites

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

Pure donation sites are rare, and those that exist focus on requests by charities and other non-profit institutions, rather than requests by businesses.[43] Some of the reward and pre-purchase sites also allow unrewarded requests for donations,[44] but one study found that only 22% of all crowdfunding initiatives were requests for donations, with no rewards offered.[45]

GlobalGiving is an example of a pure donation site.[46] It allows donors to direct contributions to development projects around the world.[47] The GlobalGiving Foundation, which operates the site, takes a 15% fee[48] and guarantees that the remainder of the donation will reach the project within sixty

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[43] *See, e.g.*, GLOBALGIVING, http://www.globalgiving.org/ (last visited Mar. 5, 2012); DONORSCHOOSE.ORG, http://www.donorschoose.org (last visited Mar. 5, 2012).

[44] For example, IndieGoGo recommends, but does not require that fundraisers offer what it calls "perks." *See Frequently Asked Questions: Creating a Campaign,* INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Mar. 5, 2012).

[45] Belleflamme et al., *supra* note 10, at 9.

[46] GLOBALGIVING, *supra* note 43. Another example is DonorsChoose.org, which allows donors to donate to specific classroom projects in public schools. *See* DONORSCHOOSE.ORG, *supra* note 43.

[47] *About Globalgiving*, GLOBALGIVING, http://www.globalgiving.org/aboutus/ (last visited Mar. 5, 2012).

[48] *Id.*

days.[49] However, GlobalGiving, like other pure donation sites, is limited to non-profit organizations.[50] None of the leading crowdfunding sites available to business entrepreneurs uses the pure-donation model.

2. Reward and Pre-Purchase Sites

The reward and pre-purchase crowdfunding models are similar to each other, and often appear together on the same sites. The reward model offers something to the investor in return for the contribution, but does not offer interest or a part of the earnings of the business. The reward could be small, such as a key chain, or it could be something with a little more cachet, such as the investor's name on the credits of a movie.[51]

The pre-purchase model, the most common type of crowdfunding,[52] is similar. As with the reward model, contributors do not receive a financial return such as interest, dividends, or part of the earnings of the business. Instead, they receive the product that the entrepreneur is making. For example, if the entrepreneur is producing a music album, contributors would receive the album or the right to buy the album at a reduced price upon completion.

Kickstarter[53] and IndieGoGo[54] are the leading reward/pre-purchase crowdfunding sites.[55] The two sites are similar.

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[49] *How Global Giving Works*, GLOBALGIVING, http://www.globalgiving.org/howitworks.html (last visited Mar. 5, 2012).

[50] *See GlobalGiving is Always Looking for More Incredible Grassroots Projects*, GLOBALGIVING, http://www.globalgiving.org/non-profits/join-globalgiving/ (last visited Mar. 5, 2012).

[51] *See, e.g.*, Kappel, *supra* note 22, at 376 (Patrons receive perks "such as the use of their name in the film credits or album liner notes, advanced autographed copies of the work, or backstage access at a performer's show.").

[52] Belleflamme et al., *supra* note 10, at 34–35 tbl. 3 (66.7% of crowdfunding offerings not involving pure donations offered the right to receive a product).

[53] *Kickstarter: A New Way to Fund & Follow Creativity*, KICKSTARTER, http://www.kickstarter.com/ (last visited Mar. 5, 2012).

[54] INDIEGOGO, *supra* note 33.

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

IndieGoGo, unlike Kickstarter, does not require campaigns to offer what it calls "perks," although it does recommend them.[62] Many of the perks offered on the IndieGoGo site follow the pre-purchase model, but some go well beyond that. The table below lists some of the perks

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[55] There are a number of other rewards/pre-purchase sites. *See, e.g.*, 8-BIT FUNDING, *supra* note 24; PEERBACKERS, *supra* note 33; ROCKETHUB, http://www.rockethub.com/ (last visited Mar. 5, 2012).

[56] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, *supra* note 29.

[57] *Id.*

[58] Farhad Manjoo, *Adopt a Genius: Kickstarter, the Brilliant Site that Lets You Fund Strangers' Brilliant Ideas*, SLATE (Jan. 27, 2011, 3:44 PM), http://www.slate.com/id/2282436.

[59] *See, e.g.*, *TikTok+LunaTik Multi-Touch Watch Kits*, KICKSTARTER, http://www.kickstarter.com/projects/1104350651/tiktok-lunatik-multi-touch-watch-kits (last visited Mar. 5, 2012). For a twenty-five dollar pledge, donors would receive a watch kit that will sell for $34.95. For a fifty dollar pledge, donors would receive a watch kit that would sell for $69.95.

[60] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, *supra* note 29.

[61] Manjoo, *supra* note 58.

[62] *Frequently Asked Questions: Creating a Campaign*, INDIEGOGO, *supra* note 44.

that Josh Freese of the band Nine Inch Nails offered to help fund an album.[63]

TABLE 1: SELECTED PERKS FOR FUNDERS

Contribution Amount	Perk
$7	Digital download of the album and videos
$15	CD/DVD set and digital download
$50	CD/DVD set T-shirt A "Thank you" phone call from Josh
$75,000	Signed CD/DVD Digital download T-shirt Tour with Josh for a few days Have Josh write, record and release a 5-song EP about you and your life story One of Josh's drum sets "Take shrooms and cruise Hollywood in Danny from Tool's Lamborghini OR play quarters and then hop on the Ouija board for a while" "Josh will join your band for a month . . . play shows, record, party with groupies,

[63] *See, e.g.*, Danae Ringelmann, *Want Ideas for VIP Perks? Listen to Nine Inch Nail's Former Drummer*, GOGO BLOG (Feb. 20, 2009, 7:23 PM), http://www.indiegogo.com/blog/2009/02/want-ideas-for-vip-perks-listen-to-nine-inch-nails-former-drummer.html. One hopes that at least a couple of the listed perks are intended as jokes.

Contribution Amount	Perk
$75,000	etc. If you don't have a band he'll be your personal assistant for a month (4-day work weeks, 10 am to 4 pm)." "Take a limo down to Tijuana and he'll show you how it's done (what that means exactly we can't legally get into here)" "If you don't live in Southern California (but are a U.S. resident) he'll come to you and be your personal assistant/cabana boy for 2 weeks" "Take a flying trapeze lesson with Josh and Robin from NIN, go back to Robin's place afterwards and his wife will make you raw lasagna"

Both Kickstarter and IndieGoGo take a cut of the money collected. Kickstarter uses an "all-or-nothing" funding model and does not allow projects to be funded unless they reach their stated funding goal.[64] If a project reaches its funding goal, Kickstarter collects a 5% fee;[65] if not, Kickstarter does not charge a fee.[66] IndieGoGo allows project creators to draw on pledged funds immediately, whether or not the funding goal is reached,[67] but the fee depends on whether the funding

[64] *Frequently Asked Questions: All or Nothing Funding*, KICKSTARTER, *supra* note 29.

[65] *Frequently Asked Questions: Creating a Project*, KICKSTARTER, *supra* note 29.

[66] *Id.*

[67] *Frequently Asked Questions*, INDIEGOGO, *supra* note 44. However, this requires that the entrepreneur elect the web site's "Flexible Funding" option. If an entrepreneur chooses the "Fixed Funding" alternative and fails to reach her fundraising goal, the web site refunds all pledged contributions.

goal is met. IndieGoGo charges a 4% fee if the funding goal is reached[68] and a 9% fee if it is not.[69]

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

The lending model of crowdfunding is often called peer-to-peer lending. Peer-to-peer lending involves loans. Contributors provide funds on a temporary basis, expecting repayment. In some cases, investors are promised interest on the funds they loan. In other cases, they are only entitled to receive the return of their principal.

a. Sites Not Offering Interest

Kiva is, without a doubt, the leading crowdfunding site using the lending model,[70] and probably the leading crowdfunding site of any type. One source calls Kiva "the hottest nonprofit on the planet."[71]

Kiva does not lend directly to entrepreneurs, but instead partners with microfinance lenders around the world, which Kiva calls "field partners."[72] The local institutions make

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[68] *Frequently Asked Questions: General FAQs*, INDIEGOGO, *supra* note 44.

[69] *Frequently Asked Questions: Creating a Campaign*, INDIEGOGO, *supra* note 44. However, an entrepreneur who elects the web site's Fixed Funding option and fails to reach the funding goal is charged no fee, and all pledged contributions are refunded to investors.

[70] *See* KIVA, http://www.kiva.org/ (last visited Mar. 5, 2012). Another example of a lending site that does not charge interest is Inuka, which is limited to requests from female entrepreneurs. *See Introducing Inuka*, INUKA, *supra* note 31.

[71] Jeffrey M. O'Brien, *The Only Nonprofit That Matters*, CNNMONEY (Feb. 26, 2008, 11:31 AM), http://money.cnn.com/magazines/fortune/fortune_archive/2008/03/03/103796533/index.htm?postversion=2008022611. Kiva was originally not open to entrepreneurs in the United States. That policy was changed in 2009. *See* Tamara Schweitzer, *Microloans for All?*, INC. (June 10, 2009), http://www.inc.com/the-kiva-connection/2009/06/microloans_for_all.html; Michael Liedtke, *Kiva to Feed Cash-Starved US Small Businesses*, USA TODAY (June 10, 2009, 9:51 AM), http://www.usatoday.com/tech/hotsites/2009-06-10-kiva_N.htm.

[72] *How Kiva Works*, KIVA, http://www.kiva.org/about/how (last visited Mar. 5, 2012).

loans to entrepreneurs, often before the loan request is even posted on Kiva.[73] Each entrepreneur's loan request is posted on the Kiva web site, where potential lenders can browse the requests and fund each one in any amount from $25 to the full amount of the loan.[74] Kiva collects and distributes this money back to the field partners and credits lenders with any repayments the entrepreneurs make.[75] Lenders on the Kiva site only receive their principal back; the field partners use any interest received to cover their operating costs.[76]

b. Sites Offering Interest

Prosper and Lending Club are the two leading peer-to-peer lending sites that offer interest.[77] Not all of the loans on these sites are for business purposes. Most of the loans are for personal expenses,[78] but the amount of the small business lending on these sites is increasing.[79]

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[73] *Id.* *See also* Stephanie Strom, *Confusion On Where Money Lent Via Kiva Goes*, N.Y. TIMES, Nov. 8, 2009, at B6 (noting that "[t]he person-to-person donor-to-borrower connections created by Kiva are partly fictional" and that "most Kiva users do not realize this").

[74] *How Kiva Works*, KIVA, *supra* note 72.

[75] *Id.*

[76] *Id.*

[77] PROSPER, http://www.prosper.com/ (last visited Mar. 5, 2012); LENDING CLUB, http://www.lendingclub.com/home.action (last visited Mar. 5, 2012). *See also* Verstein, *supra* note 12 (Prosper and Lending Club "dominate . . . [peer-to-peer lending] . . . in America."). Other lending sites that offer interest are Microplace and the Calvert Foundation. *See* MICROPLACE, http://www.microplace.com (last visited Mar. 5, 2012); CALVERT FOUNDATION, http://www.calvertfoundation.org/ (last visited Mar. 5, 2012).

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

[79] Loten, *Peer-to-Peer Loans*, *supra* note 78. As of May 2011, about 7.5% of Lending Club's loans and about 11% of Prosper's loans were for small business. *Id.*

Prosper and Lending Club operate similar, but not identical, platforms.[80] Borrowers submit requests for loans in amounts ranging from $1,000 to $25,000.[81] Potential lenders review those requests and decide which to fund.[82] The minimum investment for each loan request is $25.[83] When a loan receives sufficient commitments to close, the borrower executes a three-year unsecured note for the amount of the loan.[84]

The nature of investors' participation in these loans has changed since Prosper and Lending Club first launched. Originally, borrowers on both sites issued notes directly to the crowdfunding lenders, with the site maintaining custody of the notes and servicing them for a 1% fee.[85] Now, however, lenders on the two sites do not make loans directly to the underlying borrowers.[86] Instead, lenders purchase

[80] For a more detailed discussion of the operations of Prosper and Lending Club, see generally Verstein, *supra* note 12 (describing the operations of Prosper and Lending Club).

[81] *See* Prosper Marketplace, Inc., Amendment No. 6 to Registration Statement 8 (Form S-1) (July 13, 2009), *available at* http://www.sec.gov/Archives/edgar/data/1416265/000141626509000017/prosper_s-1a6.htm [hereinafter Prosper Registration Statement]; LendingClub Corp., Amendment No. 3 to Registration Statement 8 (Form S-1) (Oct. 9, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1409970/000095013408017739/f41480a3sv1za.htm [hereinafter Lending Club Registration Statement].

[82] All of the Lending Club lenders must meet suitability standards based on gross income and/or net worth. Lending Club Registration Statement, *supra* note 81, at 5. Prosper imposes suitability standards only on lenders living in certain states. Prosper Registration Statement, *supra* note 81, at 6.

[83] Prosper Registration Statement, *supra* note 81, at 12; Lending Club Registration Statement, *supra* note 81, at 48.

[84] Prosper Registration Statement, *supra* note 81, at 8; Lending Club Registration Statement, *supra* note 81, at 7. Prosper has said it plans to vary the terms of its loans in the future, with a range between three months and seven years. Prosper Registration Statement, *supra* note 81, at 8.

[85] Prosper Registration Statement, *supra* note 81, at 76; Lending Club Registration Statement, *supra* note 81, at 89.

[86] *See* Prosper Registration Statement, *supra* note 81, at 8; Lending Club Registration Statement, *supra* note 81, at 7. The change resulted

notes issued by Prosper or Lending Club themselves, and the sites use those funds to make loans through WebBank[87] to the underlying borrowers.[88] Although the sites are the issuers of the notes that the lenders purchase, the sites are obligated to pay only if the underlying borrowers repay the corresponding loans.[89] In effect, the sites act as conduits for borrower payments, taking 1% of the payments before passing them along to the lenders.[90] Both Prosper and Lending Club also charge borrowers an origination fee on each loan; the amount of the fee depends on the borrower's credit risk.[91]

Prosper and Lending Club set interest rates on the notes (and on the underlying loans) differently. Lending Club evaluates each borrower and sets an interest rate on each loan based on the "loan grade" it assigns to the loan.[92] Prosper also rates each potential loan,[93] but those scores are used only to set a minimum rate.[94] The actual interest rate is determined by an auction process. Each lender bids the minimum percentage he is willing to accept,[95] and the interest rate on each loan (and on the notes issued by

directly from the SEC's position that the sites were illegally offering securities without registration. *See* Prosper Marketplace, Inc., Securities Act Release No. 8984 (Nov. 24, 2008).

[87] Prosper Registration Statement, *supra* note 81, at 5; Lending Club Registration Statement, *supra* note 81, at 6.

[88] Prosper Registration Statement, *supra* note 81, at 8; Lending Club Registration Statement, *supra* note 81, at 7.

[89] Prosper Registration Statement, *supra* note 81, at 8; Lending Club Registration Statement, *supra* note 81, at 7–8. Each loan involves a different series of note. The notes are registered pursuant to a Form S-1 shelf registration, and each loan requires a different prospectus supplement. Verstein, *supra* note 12.

[90] Prosper Registration Statement, *supra* note 81, at 5; Lending Club Registration Statement, *supra* note 81, at 3.

[91] Verstein, *supra* note 12.

[92] Lending Club Registration Statement, *supra* note 81, at 37–43.

[93] Prosper Registration Statement, *supra* note 81, at 12, 41–43.

[94] *Id.* at 4.

[95] *Id.*

Prosper) is the minimum percentage acceptable to enough lenders to fund the entire loan.[96]

4. Equity Sites

Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund. The equity model is the model that most clearly involves the sale of a security. Because of the regulatory issues it raises, the equity crowdfunding model is not common in the United States. Equity crowdfunding is more common elsewhere, however.[97] One study found that one-third of all crowdfunding sites that offered investor rewards offered stock.[98]

Until recently, ProFounder was the leading equity-model crowdfunding site in the United States.[99] However, ProFounder announced in June 2011 that it would no longer be offering securities on its site.[100] The reason for the change became apparent when the California Department of Corporations subsequently issued a consent order barring ProFounder from selling securities on its web site unless it first registered as a broker-dealer under California law.[101]

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[96] *Id.*

[97] Eric Markowitz, *Coming Soon: More Cash for Start-ups?*, YAHOO SMALL BUSINESS ADVISOR (Dec. 8, 2011, 12:01 AM), http://smallbusiness.yahoo.com/advisor/why-crowdfunding-bill-good-start-050100895.html.

[98] Belleflamme et al., *supra* note 10, at 33–35 tbl. 3. Another 22% offered direct cash payments other than dividends on stock. *Id.*

[99] PROFOUNDER, *supra* note 33. See also Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 978–81 (discussing a few direct Internet offerings not mediated through crowdfunding sites).

[100] *See* Jessica Jackley, *Changes to Our Site*, PROFOUNDER, THE BLOG (June 27, 2011), http://profounderblog.wordpress.com/2011/06/27/changes-to-our-site/. On February 17, 2012, ProFounder announced that it was shutting down. *ProFounder Shutting Down*, PROFOUNDER (Feb. 17, 2012), http://blog.profounder.com/2012/02/17/profounder-shutting-down/.

[101] *See* ProFounder Fin., Inc., Cal. Bus., Transp. & Hous. Agency Dep't of Corps. Consent Order to Desist and Refrain (Aug. 31, 2011), *available at* www.corp.ca.gov/ENF/pdf/2011/ ProFounder_CO.pdf.

As a result of this change, there are now no major, publicly accessible equity crowdfunding sites in the United States, although there are sites that facilitate private equity offerings to sophisticated and accredited investors.[102]

When it was operating, ProFounder offered two different types of investment, which it called "public rounds" and "private rounds."[103] The types of offerings differed in two ways: (1) the return offered to investors; and (2) the investors allowed to participate. In public rounds, the amount paid back to investors was limited to the amount they contributed, without any return on their investment; investors in private rounds could receive more than what they invested.[104] Public rounds were open to the general public while private rounds were limited to friends, family members and existing acquaintances of each entrepreneur—an attempt to fit within the SEC's Rule 504 exemption from registration.[105]

Investors on ProFounder were promised a percentage of the gross revenues of the businesses in which they invested.[106] The exact percentage of revenues to be paid to investors and the period over which investors were to receive those funds was left to the individual entrepreneur to

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[102] *See* MICROVENTURES, *supra* note 33; *Terms*, GROW VC, http://www.growvc.com/main/tour/terms/ (last visited Mar. 5, 2012) (limited to accredited investors).

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

[104] *See id.*

[105] *See infra* Part III.B.2.c.

[106] David Lang, *Entrepreneur—Read This First!,* PROFOUNDER (Nov. 4, 2010), http://support.profounder.com/entries/321128-common-questions-read-this-first (on file with author). ProFounder did not explain why investors shared gross revenues rather than profits, but this was probably an attempt to avoid creating a partnership between the entrepreneur and the investors. Under the Uniform Partnership Act, profit-sharing is presumptive evidence of the existence of a partnership. UNIF. P'SHIP ACT § 202(c)(3) (1997). Sharing gross returns is not. *Id.* § 202(c)(2).

determine,[107] but the maximum payout period was five years.[108] This share of revenues was the only equity interest investors received—they received no stock or any other ownership interest.[109]

Entrepreneurs had to pay to list on ProFounder, but the amount and structure of those payments is a little unclear. According to the ProFounder web site, entrepreneurs had to pay an initial fee of $100 to post a fundraising appeal.[110] But, according to ProFounder's CEO, the initial fee for a private round was $1,000.[111] For a public round, the entrepreneur had to pay 5% of the amount raised if the fundraising succeeded.[112] If a private round was successful, both the ProFounder web site and one interview of its CEO indicated that the entrepreneur had to pay an additional $1,000.[113] But the CEO indicated in another interview that no additional fee was charged for a private round—that entrepreneurs paid a flat $1,000 fee, whether or not the offering succeeded.[114]

Entrepreneurs had thirty days to raise the funds needed.[115] If entrepreneurs failed to reach their goal, they

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[107] Lang, *supra* note 106.

[108] *Id.*

[109] *Investment Terms*, PROFOUNDER, https://www.profounder.com/investors/investment-terms/ (last visited Mar. 5, 2012).

[110] *FAQs*, PROFOUNDER, http://www.profounder.com/entrepreneurs/faq (last visited Mar. 5, 2012). *See also* Lang, *supra* note 106.

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

[112] *Company Terms and Conditions for Services*, PROFOUNDER, https://www.profounder.com/legal/terms_and_conditions (last visited Mar. 5, 2012); *Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, *supra* note 111.

[113] *FAQs*, PROFOUNDER, *supra* note 110. *See also* Lang, *supra* note 106; Ferner, *supra* note 103.

[114] *See Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, *supra* note 111 (statement by Jessica Jackley).

[115] *FAQs*, PROFOUNDER, *supra* note 110.

received none of the pledged funds.[116] Investors did not sign term sheets or make any payments until the goal was met.

C. The Antecedents of Crowdfunding

Internet-based crowdfunding is a merger of two distinct antecedents: crowdsourcing and microfinance.[117] Crowdsourcing is, quite simply, "collecting contributions from many individuals to achieve a goal."[118] It divides "an overwhelming task . . . into small enough chunks that completing it becomes . . . feasible."[119] Wikipedia is probably the most prominent example of crowdsourcing—an entire encyclopedia consisting of articles written and edited by the general public.[120] Linux, the open-source computer operating system, was developed through crowdsourcing, and other software companies, including IBM, have adopted the open-source model.[121] From astronomy to stock photography to "prediction markets" to eBay, platforms based on the

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[116] *Company Terms and Conditions for Services*, PROFOUNDER, *supra* note 112.

[117] *See* Belleflamme et al., *supra* note 10, at 2 (stating that crowdfunding is rooted in crowdsourcing); *When Small Loans Make a Big Difference*, FORBES.COM (June 3, 2008, 4:08 PM), http://www.forbes.com/2008/06/03/kiva-microfinance-uganda-ent-fin-cx_0603whartonkiva.html (noting that crowdfunding is a merger of social networking and microfinance); Nick Mendoza, *How Filmmakers Use Crowdfunding to Kickstart Productions*, PBS MEDIASHIFT (Sept. 21, 2010), http://www.pbs.org/mediashift/2010/09/how-filmmakers-use-crowdfunding-to-kickstart-productions264.html (describing crowdfunding as a mix of crowdsourcing, marketing and fundraising); Schwienbacher & Larralde, *supra* note 14, at 5.

[118] Tina Rosenberg, *Crowdsourcing a Better World*, N.Y. TIMES.COM OPINIONATOR (Mar. 28, 2011, 9:15 PM), http://opinionator.blogs.nytimes.com/2011/03/28/crowdsourcing-a-better-world.

[119] HOWE, *supra* note 1, at 11.

[120] *See* CHRIS ANDERSON, THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE 65–70 (2006); HOWE, *supra* note 1, at 56–61; DON TAPSCOTT & ANTHONY D. WILLIAMS, WIKINOMICS: HOW MASS COLLABORATION CHANGES EVERYTHING 71–77 (2006).

[121] *See* HOWE, *supra* note 1, at 47–70; CLAY SHIRKY, Here COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS 237–43 (2008); TAPSCOTT & WILLIAMS, *supra* note 120, at 77–83.

collective contributions of a large number of people are commonplace today.[122] Even the all-pervasive Google search system is crowdsourcing; Google's algorithm captures the sites that everyone collectively is linking to and visiting.[123] The Internet significantly reduces the transaction costs of decentralized group action[124] and "opens . . . the economy to new Linux-like projects every day."[125] The "rigid institutional structures" previously required to organize economic action are, in many cases, no longer necessary.[126]

The other antecedent of crowdfunding is microlending, sometimes called microfinance. Microlending involves lending very small amounts of money, typically to poorer borrowers.[127] Microlending can be traced back to Irish loan funds in the 1700s,[128] but it became prominent in recent times through the work of Muhammad Yunus and the Grameen Bank.[129] Yunus's project began when he loaned $27

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[122] For a more detailed look at crowdsourcing, see generally HOWE, *supra* note 1; TAPSCOTT & WILLIAMS, *supra* note 120.

[123] YOCHAI BENKLER, THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM 76 (2006). *See also* JAMES SUROWIECKI, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS 16–17 (2004) (describing Google as an example of the wisdom of the crowds).

[124] BENKLER, *supra* note 123, at 3; SHIRKY, *supra* note 121, at 48.

[125] TAPSCOTT & WILLIAMS, *supra* note 120, at 24. However, crowdsourcing predates the Internet. For example, since 1900, the National Audubon Society has been organizing bird-watchers to do an annual count of birds in the Western hemisphere. *See* Rosenberg, *supra* note 118. The famous Pillsbury Bake-Off is a long-standing means of crowdsourcing recipes. *See id.*

[126] SHIRKY, *supra* note 121, at 21–22.

[127] *See* Mincer, *supra* note 21.

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

[129] *See* Mincer, *supra* note 21; Olivia L. Walker, *The Future of Microlending in the United States: A Shift from Charity to Profits?*, 6 OHIO ST. BUS. L.J. 383, 384 (2011); Kathleen Kingsbury, *Microfinance: Lending a Hand*, TIME (Apr. 5, 2007), http://www.time.com/time/magazine/article/0,9171,1607256,00.html.

of his own money to 42 villagers in Bangladesh.[130] He subsequently established a multi-branch bank, the Grameen Bank, that specialized in such loans.[131] In 2006, Yunus and the Grameen Bank shared the Nobel Peace Prize. Micro-lending has its detractors,[132] but it has ballooned into a multi-billion-dollar industry.[133]

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

III. ARE CROWDFUNDING INVESTMENTS SUBJECT TO THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT?

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

Section 5 of the Securities Act and the SEC rules associated with Section 5 are a morass of prohibitions,

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[130] MUHAMMAD YUNUS, BANKER TO THE POOR: MICRO-LENDING AND THE BATTLE AGAINST WORLD POVERTY 49–50 (2003).

[131] *Id.* at 89–97.

[132] *See* Kingsbury, *supra* note 129 (noting complaints that microcredit does little to alleviate overall poverty, crowds out locally owned banks, and can leave the poor drowning in debt).

[133] *See id.* As of 2007, about 10,000 microfinance institutions held more than $7 billion in outstanding loans.

exceptions, conditions, and exceptions to exceptions,[134] but the basic prohibitions are clear. Absent an exemption, an issuer may not offer a security for sale until a registration statement has been filed with the SEC.[135] And an issuer may not sell a security[136] until that registration statement has become effective.[137] But the registration requirements apply only if the entrepreneurs on crowdfunding sites are offering securities.[138] If crowdfunding investments are not securities, the federal securities laws do not apply.

A. Are Crowdfunding Investments Securities?

Each federal securities statute has its own definition of "security," but the language of the various definitions, for purposes of the issues raised here, is roughly the same.[139] The most expansive part of the definition of security, the catch-all category, is the term "investment contract." In *SEC v. W. J. Howey Co.*, the Supreme Court defined an investment contract as (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4)

[134] Consider, for example, Securities Act Rule 433. Whether a communication falls within the Rule 433 safe harbor can depend on, among other things: whether the issuer has filed a registration statement, Rule 433(a); characteristics of the company issuing the securities, such as its size and how long it has been a reporting company, Rule 433(b); the content of the communication, Rule 433(b)(2)(i), (c); who is making the communication, Rule 433(d), (f); where the information in the communication originally came from, Rule 433(d)(1)(i)(B), (h)(2); whether the information in the communication is otherwise available to the general public, Rule 433(d)(8)(ii); and whether the issuer or anyone else associated with the offering paid for the communication, Rule 433(b)(2)(i), (f)(1)(i).

[135] Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2010).

[136] "Selling" includes entering into a contract of sale. *See id.* § 77b(a)(3).

[137] *Id.* § 77e(a)(1).

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

[139] *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10); Investment Company Act of 1940 § 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (2010); Investment Advisers Act of 1940 § 202(a)(18), 15 U.S.C. § 80b-2(a)(18) (2010). For convenience, this article generally refers to the Securities Act definition unless there is some relevant difference.

arising solely from the efforts of the promoter or a third party.[140] Both the Supreme Court and the lower courts have refined the *Howey* test over the years, but its basic elements remain unchanged—with one significant exception. The word "solely" has been eliminated from the efforts-of-others part of the test. Instead, the question is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[141]

Crowdfunding offerings of the donation, reward, and pre-purchase type clearly do not involve securities for purposes of federal law. Crowdfunding sites organized on the lending model probably are offering securities if the lender is promised interest. Crowdfunding sites organized on the equity model are usually offering securities.[142]

1. The Donation Model

Donation-model crowdfunding sites are not offering securities to investors. Contributors receive absolutely nothing in return for their contributions, so they clearly have no expectation of profits, a requirement for something to be an investment contract under *Howey*. And contributors to donation-model sites are offered nothing else, such as stock[143] or notes,[144] that would fall within the general definition of a

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

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

[142] Heminway and Hoffman have similarly concluded that at least some crowdfunding offerings are securities under the *Howey* investment contract test. *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 892–906 (2011).

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

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

security.[145] Gratuitous contributions, even to a business entity, simply are not securities.

2. The Reward and Pre-Purchase Models

The reward and pre-purchase models also do not involve securities under federal law, as long as the reward or the pre-purchased product is all the investor is promised in return for her contribution. The Supreme Court has drawn a clear distinction between investment and consumption. An investment contract is present only when an investor is offered a financial return on his investment, such as capital appreciation or a participation in earnings[146] or even a fixed rate of interest.[147] If "a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."[148] It does not matter that the contributor is promised a lower price for the product than the general public will pay.

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

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[145] Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010).

[146] United Hous. Found., Inc. v. Forman, 421 U.S. 837, 853 (1975).

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

[148] *United Hous. Found.*, 421 U.S. at 852–53. It is possible that these might be securities under state law. Some states use a risk capital test to define securities. The risk capital test has three elements: "(1) an investment, (2) in the risk capital of an enterprise, and (3) the expectation of a benefit." JOSEPH C. LONG, 12 BLUE SKY L. 2:80 (2011). The benefit expected need not be an interest in profits, but can be any benefit that motivates the investor to invest. *Id. See also* Silver Hills Country Club v. Sobieski, 361 P.2d 906 (Cal. 1961) (finding a security where a country club pre-sold club memberships to raise startup capital); HAZEN, *supra* note 42, at 110.

3. The Equity Model

Equity-model crowdfunding would usually involve securities. If investors receive ordinary corporate stock in exchange for their contributions, they clearly are purchasing securities. The definition of security includes "stock,"[149] and the Supreme Court has held that ordinary corporate stock is a security, with no additional analysis required.[150] Even if crowdfunding investors are offered some participation in the return of the business that does not involve corporate stock, their investments would still be securities. Interests in partnerships and limited liability companies, and other non-stock equity interests, are analyzed under the *Howey* investment contract test.[151] The interests offered to investors on equity-model sites would clearly be investment contracts under *Howey*.

Crowdfunding almost by definition involves a common enterprise among many different investors. The whole point of crowdfunding is to collect small amounts of money from a number of different investors. The business pools these investors' funds, and the investors share in the returns of the business. Although there is some disagreement among the lower courts about what exactly constitutes a common enterprise, all courts agree that horizontal commonality of this sort meets the *Howey* test.[152]

Investors on equity-model sites would also have an expectation of profits. Contributors are providing cash in return for some sort of revenue- or profit-sharing.[153] The

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

[150] Calling something stock is not alone enough to make it a security. *United Hous. Found.*, 421 U.S. at 848. However, "[i]nstruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition." Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1985).

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

[152] *See* HAZEN, *supra* note 42, at 98 ("Horizontal commonality clearly satisfies the *Howey* common enterprise requirement.").

[153] Even if investors are offered a fixed return, rather than one that depends on how well the business does, that would still meet the *Howey*

"public raise" type of funding offered by ProFounder[154] would not meet this requirement, however. Public-raise investors are promised a share of the entrepreneur's revenues, but only until their original contributions are repaid. A person who contributed $1,000 would receive, at most, only $1,000 back, no matter how well the business did. Since no profits are expected, public-raise investments would not be securities.

Finally, the profits expected are to come solely from the efforts of the promoters or other third parties. Crowdfunding investors will not usually be involved in the operation of the business in which they invest, and, even if the crowdfunding site allows them some minor role, the "essential managerial efforts which affect the failure or success of the enterprise"[155] will be those of the entrepreneur.

4. The Lending Model

The analysis is most complicated for lending-model crowdfunding.[156] The federal securities laws are not limited to equity interests in businesses. The definition of security encompasses some forms of debt,[157] and an investment may be a security even though the return consists of a fixed

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requirement of an expectation of profits. *See* SEC v. Edwards, 540 U.S. 389 (2004) (holding that an agreement to pay investors $82 a month constituted a security).

[154] *See supra* text accompanying notes 107–09.

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

[156] Many lending sites offer consumer loans, and not just loans to business entrepreneurs. The following discussion is limited to loans to businesses and business projects. Loans for consumer purposes are less likely to be treated as securities. *See* Verstein, *supra* note 12 (arguing that consumer notes would not be securities under either the *Howey* or *Reves* tests). For a general introduction to peer-to-peer lending, see Kevin E. Davis & Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. INT'L L. & POL. 1209 (2010); Verstein, *supra* note 12.

[157] The definition of a security includes, among other things, "notes," "bonds," "debentures," and "evidence of indebtedness." *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010).

payment or a fixed rate of interest.[158] *Howey* is still relevant but, if investors are offered notes, the Supreme Court's analysis in *Reves v. Ernst & Young*, discussed below, must also be considered. Under that analysis, sites like Kiva that offer investors no interest or other return, only a return of their principal, are probably not offering securities, but, if investors are promised interest, their investments probably are securities.

Consider first whether crowdfunding sites offering interest are selling investment contracts. Contributors are investing money with an expectation of profits. A fixed rate of interest, such as that which is offered on the Lending Club and Prosper sites, would be "profit" for purposes of *Howey*.[159] If more than one lender contributes to each business, there is a horizontal common enterprise. And the profits are going to result solely, or at least primarily, from the efforts of the entrepreneur. Thus, investments made on lending sites that offer investors interest would be investment contracts under the *Howey* test. However, if the site, like Kiva, offers investors only a return of their principal, without any interest or other gain, investors would have no expectation of profits.[160] Consequently, the investment contract test would not be met.[161]

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[158] *Edwards*, 540 U.S. at 397 (holding that an investment offering a fixed return of $82 a month was an investment contract).

[159] *Id.*

[160] *See* Verstein, *supra* note 12 (setting forth a similar analysis). This is why Kiva does not offer interest to investors. According to Matt Flannery, a co-founder of Kiva, Kiva would like to offer investors interest. Matt Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, 2 INNOVATIONS 31, 53 (2007). Kiva decided not to offer interest after Flannery had a conversation with an attorney in the SEC's Office of Small Business Policy and concluded that the key to avoiding SEC interference was not to pay interest. *Id.* at 41.

[161] *See* Global Dev. Co-operative, SEC No-Action Letter, 2011 WL 5013895 (Oct. 19, 2011) (granting no-action relief to a cooperative that planned to sell interest-free notes to help fund capital investment projects in developing countries). *See also* Davis & Gelpern, *supra* note 156, at 1241, 1258–59 (conceding that sites like Kiva are not offering securities under current law, but arguing that such investments *should* be regulated).

Investments made through lending-model sites might also involve notes, and thus be securities under another part of the definition.[162] Some of the lending sites, such as Kiva, do not give investors a formal note in return for their investments; others, such as Lending Club and Prosper, do. The term "note" appears in the definition of a security,[163] but not all notes are securities.

The Supreme Court applies a different analysis, first articulated in *Reves v. Ernst & Young*,[164] to determine whether a note is a security. Crowdfunding notes that promise to pay interest to investors would probably be securities under the *Reves* test. The *Reves* analysis, known as the "family resemblance test," begins with a rebuttable presumption that every note is a security.[165] It then looks to a list of notes that are not securities, but crowdfunding loans to businesses would not fit any of the categories on that list.[166] The final step of the *Reves* analysis is therefore

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[162] When an instrument is a note, the applicability of the *Howey* investment contract analysis is a little unclear. Most courts have applied the *Howey* investment contract test and the *Reves* note test in the alternative with little analysis. *See, e.g.*, SEC v. U.S. Reservation Bank & Trust, 289 F. App'x 228, 230–31 (9th Cir. 2008); Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1539 (10th Cir. 1993); SEC v. Novus Tech., LLC, No. 2:07–CV–235–TC, 2010 WL 4180550 (D. Utah Oct. 20, 2010); *In re* Tucker Freight Lines, Inc., 789 F. Supp. 884, 888–89 (W.D. Mich. 1991); Reeder v. Succession of Palmer, 736 F. Supp. 128, 131–32 (E.D. La. 1990). *See also* Dennis S. Corgill, *Securities as Investments at Risk*, 67 TUL. L. REV. 861, 900 (1993) (concluding that a note that is not a security under the *Reves* test could still be a security under the *Howey* investment contract test). *But see* Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1231 (2003) (arguing against applying a second-stage investment contract analysis to something that is not a security under *Reves*).

[163] *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010).

[164] 494 U.S. 56, 63–68 (1990).

[165] *Id.* at 63.

[166] *Reves* accepted the following categories of non-securities:

> [T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer,

decisive: applying a four-part test to determine whether crowdfunding notes bear sufficient "family resemblance" to the listed non-securities such that crowdfunding notes should also not be treated as securities. The four factors are (1) the motivations of the buyer and seller of the note; (2) the plan of distribution of the notes; (3) the reasonable expectations of the investing public; and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[167] In applying this test, it is important to keep in mind that the presumption is in favor of treating notes as securities.

The last factor is easily dismissed. Crowdfunding loans, like the notes at issue in *Reves*, are uncollateralized and uninsured, and no other federal regulatory scheme covers them. They "would escape federal regulation entirely if the . . . [federal securities laws] . . . were held not to apply."[168]

The motivations factor supports treating interest-bearing crowdfunding notes as securities. The entrepreneur's purpose—or in the case of sites like Lending Club and Prosper that issue their own notes to finance entrepreneurs, the site's purpose—"is to raise money for the general use of a business," a securities purpose.[169] Investors are "interested primarily in the profit the note is expected to generate,"[170] with profit defined by the Court to include ordinary interest.[171] This is also a securities purpose. However, investors on sites that offer no interest are not interested in

> short-term notes secured by an assignment of accounts receivable, . . . a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized), . . . [and] . . . notes evidencing loans by commercial banks for current operations.

Id. at 65.

[167] *Id.* at 67.

[168] *Id.* at 69.

[169] *Id.* at 66.

[170] *Id.*

[171] *Id.* at 68 n.4.

profit because no profit is expected.[172] Their motivations are of a more charitable nature, which cuts against security status. This alone might be enough to keep the loans on sites like Kiva from being securities.

The plan-of-distribution factor also appears to point toward securities status. Some of the crowdfunding sites are tied to trading markets where investors buy notes from, or sell them to, other investors. Notes purchased on the Lending Club and Prosper sites, for example, may be traded on a platform maintained by FOLIOfn Investments, a registered broker-dealer.[173] But notes can meet the plan-of-distribution test even if there is no trading market. After first indicating that the plan-of-distribution factor depends on whether "there is 'common trading for speculation or investment,'"[174] the *Reves* opinion said that it was sufficient if the notes are "offered and sold to a broad segment of the public," even if, as in *Reves*, there is no market to trade the notes.[175] Crowdfunding lending sites are open to the public, and, by definition, crowdfunding involves investments by a number of small investors. The number of investors will not always be as many as the 1600 purchasers in *Reves*,[176] but it will typically be more than a few. Thus, notes sold on crowdfunding sites could meet this part of the *Reves* test even if there is no trading market.

The final factor to consider is the investing public's reasonable expectations. *Reves* said little about this factor, other than to indicate that notes might be treated as securities on the basis of such public perceptions, "even where an economic analysis of the circumstances of the particular transaction" would suggest otherwise.[177] In applying this factor, the *Reves* Court observed only that the

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[172] *See* Verstein, *supra* note 12 (setting forth a similar analysis).

[173] *See* Prosper Registration Statement, *supra* note 81, at 11; Lending Club Registration Statement, *supra* note 81, at 11.

[174] *Reves*, 494 U.S. at 66 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).

[175] *Id.* at 68.

[176] *Id.* at 59.

[177] *Id.* at 66.

notes were characterized as investments, and nothing "would have led a reasonable person to question this characterization."[178] The question, as analyzed in the lower courts, seems to be "whether a reasonable member of the investing public would consider these notes as investments."[179] That, in turn, probably depends on whether interest is offered and on whether or not the note is presented to investors as an investment.[180] If purchasers are buying the notes for the interest they promise, they appear to be investments, no matter how the crowdfunding site characterizes them.[181] Sites like Kiva that offer no interest are less likely to meet this factor.[182]

As indicated earlier,[183] Lending Club and Prosper have changed their business models since their inception. Originally, lenders on those sites made loans directly to the underlying borrowers and received notes from those borrowers in return. Now, Lending Club and Prosper issue their own notes to lenders, and lenders are not directly lending to the underlying borrowers. As far as the definitions of "investment contract" and "note" are

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

[179] McNabb v. SEC, 298 F.3d 1126, 1132 (9th Cir. 2002); *accord* SEC v. Wallenbrock, 313 F.3d 532, 539 (9th Cir. 2002); *Stoiber*, 161 F.3d at 751.

[180] *Stoiber*, 161 F.3d at 751 ("When a note seller calls a note an investment, in the absence of contrary indications it would be reasonable for a prospective purchaser to take the [offeror] at its word . . . . Conversely, when note purchasers are expressly put on notice that a note is not an investment, it is usually reasonable to conclude that the 'investing public' would not expect the notes to be securities.") (quotations omitted). *But see Wallenbrock*, 313 F.3d at 539 (noting that the failure of the promoter to "use the term 'investment' to describe the notes is of little import, given the nature of the transactions").

[181] *See Wallenbrock*, 313 F.3d at 539 (noting that the reasonable expectations factor is closely related to the motivations factor and that the failure to describe the notes as investments is "of little import").

[182] *See* Verstein, *supra* note 12 (setting forth a similar analysis).

[183] *See supra* text accompanying notes 87–92.

concerned, this difference is irrelevant.[184] Nothing in the analysis above depends on who the issuer is.[185]

The SEC certainly believes that interest-bearing crowdfunding notes are securities. It has forced both Lending Club and Prosper to register the notes they offer.[186] Prior to that registration, the SEC entered a consent cease-and-desist order against Prosper, finding that Prosper was improperly selling securities without registration. [187] Both companies' registration statements indicate that it is "reasonably possible" that the sites will be liable to lenders for securities sold prior to registration,[188] and Prosper is currently fighting a class action lawsuit brought by pre-registration lenders.[189]

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[184] *See* Prosper Marketplace, Inc., *supra* note 86 (taking the position that the notes offered by Prosper, under its original model, were securities).

[185] The identity of the issuer might matter for purposes of registration. If Lending Club and Prosper have no obligation on the notes they issue and payment depends entirely on the success of the underlying borrower, should the sites really be considered the issuers for purposes of registration and the disclosure requirements? *See* Stefan J. Padfield, *Peer-to-Peer Lending: Who Is the Issuer?*, BUS. LAW PROF BLOG (June 16, 2011), http://lawprofessors.typepad.com/business_law/2011/06/peer-to-peer-lending-who-is-the-issuer.html. *See also* Heminway & Hoffman, *supra* note 142, at 922–27 (discussing whether the entrepreneur, the crowdfunding site, or both are the issuer for purposes of registration).

[186] *See* Prosper Registration Statement, *supra* note 81; Lending Club Registration Statement, *supra* note 81.

[187] Prosper Marketplace, Inc., *supra* note 86.

[188] Prosper Registration Statement, *supra* note 81, at F-40; Lending Club Registration Statement, *supra* note 81, at 90.

[189] Prosper Registration Statement, *supra* note 81, at 75. A blog has been set up to monitor and report on that case. *See* PROSPER CLASS ACTION SUIT MONITOR, http://prosperclassaction.wordpress.com/ (last visited Mar. 5, 2012). Prosper has also entered into a settlement with the North American Securities Administrators Association of regulatory claims under state securities law and has agreed not to sell securities unless it complies with state securities laws. *See* Prosper Registration Statement, *supra* note 81, at 75; *Prosper Marketplace Inc. Enters Settlement With State Securities Regulators Over Sales of Unregistered Securities*, N. AM. SEC. ADM'RS ASS'N (Dec. 1, 2008), http://www.nasaa.org/5622/prosper-

The use of notes adds one additional complication. The definition of a security in the Securities Exchange Act of 1934 (the "Exchange Act") excepts notes with "a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."[190] The Securities Act definition of security includes no such exception. However, Section 3(a)(3) of the Securities Act exempts from some, but not all,[191] of the Act's requirements:

> Any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[192]

Crowdfunders might try to avoid the application of federal securities law by promising repayment within nine months.[193] However, both the Exchange Act exception and the Securities Act exemption have traditionally been read to cover only prime-quality commercial paper bought by sophisticated traders.[194] Four dissenters in *Reves* questioned

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marketplace-inc-enters-settlement-with-state-securities-regulators-over-sales-of-unregistered-securities/.

[190] Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2010).

[191] *See* Securities Act of 1933 §§ 12(a)(2), 17(c), 15 U.S.C. §§ 77l(a)(2), 77q(c) (2010).

[192] 15 U.S.C. § 77c(a)(3).

[193] It appears that no crowdfunding site currently requires repayment within nine months. Prosper and Lending Club, for example, sell notes with three-year terms. Prosper Registration Statement, *supra* note 81, at 8; Lending Club Registration Statement, *supra* note 81, at 7.

[194] *See* HAZEN, *supra* note 42, at 460 (Exemption in Section 3(a)(3) of the Securities Act "applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public."); Wendy Gerwick Couture, *The Securities Acts' Treatment of Notes Maturing in Less Than Nine Months: A Solution to the Enigma*, 31 SEC. REG. L.J. 496, 505 (2003) ("Almost every court addressing the issue has held that the § 3(a)(3) exemption and the § 3(a)(10) exclusion apply to the same notes.").

this interpretation of the Exchange Act exception,[195] but that long-standing reading still stands. The risky debt issued by startup entrepreneurs to the general public would not qualify as commercial paper.[196]

B. Registration and Exemption of Crowdfunded Securities Offerings

1. Registration

Offerings of securities must be registered with the SEC unless an exemption is available.[197] Unfortunately, registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital.[198] It is too expensive and too time-consuming for crowdfunded offerings.

First, the cost of registration will in most cases exceed the amount small entrepreneurs want to raise.[199] The direct costs of preparing and filing the registration statement—registration fees, accounting fees, legal fees, and printing costs—can be hundreds of thousands of dollars, even excluding underwriting costs.[200] Smaller offerings are less

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

[196] For a full discussion of the commercial paper test, see Couture, *supra* note 194, at 512–31.

[197] Section 5(c) of the Securities Act provides that no one may offer securities until a registration statement has been filed with the SEC. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2010). Section 5(a)(1) of the Act prohibits sales of those securities until the registration statement has become effective. *Id.* § 77e(a)(1).

[198] *See* Cohn & Yadley, *supra* note 11, at 7–8; Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They 'Suitable' for the Retail Investor?*, 72 S. CAL. L. REV. 67, 75 (1998); William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. L. REV. 1, 8 (2004) [hereinafter Sjostrom, *Relaxing the Ban*].

[199] *See* Kappel, *supra* note 22, at 384.

[200] A GAO report estimated the average cost for a $25 million underwritten public offering to be $2.3 million, but much of that was underwriting discounts and commissions. U.S. GOV'T. ACCOUNTABILITY

expensive to register than larger ones,[201] but the cost is disproportionately greater for smaller offerings.

Second, registration takes too much time. Small companies often need to raise capital quickly.[202] Today's rapid changes in technology result in "a compressed life-time and a quicker requisite time-to-market."[203] A 1996 report indicated that the average delay between filing and effectiveness for an initial public offering on special, simplified forms then available to small businesses was 103.7 days.[204] That does not include the time required to prepare for filing. The total time from inception to effectiveness can be six months—or even longer.[205]

Registration, however, is not impossible. Peer-to-peer lenders Prosper and Lending Club register the notes they offer, but they had to completely restructure their business

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OFFICE, GAO, GAO/GGD-00190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 23 (2000) [hereinafter GAO Report]. The estimated cost included $9,914 for SEC registration fees, $160,000 for accounting fees and expenses, $200,000 for legal fees and expenses, and $100,000 for printing fees and expenses. *Id.* Another source provides the following estimates for a Form S-1 public offering: underwriting fees 7–15% of the offering amount; registration fees 1/29 of 1%; printing costs $2,500–75,000; engraving of certificates $2,500–4,000; legal costs ¾–3% of the offering amount; accounting costs $25,000–250,000; experts $300–15,000; state filing fees $150–4,000 per state; and NASD filing fees $500–30,500. WILLIAM M. PRIFTI, 24 SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 1A:17 (2d ed. 2010). *See also* William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 575–76 (2001) [hereinafter Sjostrom, *Going Public*] (finding that legal, accounting, filing, and other fees for an underwritten public offering generally range from $300,000 to $500,000).

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

[202] LAWTON & MAROM, *supra* note 2, at 37–38; Cohn & Yadley, *supra* note 11, at 80.

[203] LAWTON & MAROM, *supra* note 2, at 37.

[204] SEC, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834, at 88,439 tbl. 2 (July 24, 1996), *available at* http://www.sec.gov/news/studies/capform.htm.

[205] *See* Cohn & Yadley, *supra* note 11, at 7.

models to make it work. Instead of investors providing money directly to the underlying entrepreneurs, investors loan money to the sites themselves, and the sites issue non-recourse notes dependent on payment by the underlying borrower.[206] Prosper and Lending Club each file a single shelf registration statement for all of the notes they issue, with each funding treated as a separate series requiring its own prospectus supplement.[207] This mechanism is costly, burdensome, and does not translate easily to equity crowdfunding.

2. Possible Exemptions Under Current Law

Companies selling securities on crowdfunding sites could avoid registration if an exemption were available.[208] Several exemptions might possibly apply: the private offering exemption in Section 4(2) of the Securities Act[209] or its regulatory safe harbor, Rule 506 of Regulation D;[210] Section 4(5) of the Securities Act;[211] Rule 504 of Regulation D;[212] Rule 505 of Regulation D;[213] or Regulation A.[214] Unfortunately, none of those exemptions is conducive to crowdfunding.[215]

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[206] *See supra* text accompanying notes 86–91.

[207] *See* Verstein, *supra* note 12. This requires platforms to file two or three times a day. *Id.* at 45–46. Each of those prospectus supplements must contain all of the borrower information available on the platform, "no matter how trivial." *Id.* at 44.

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

[209] Securities Act of 1933 § 4(2), 15 U.S.C. § 77d (2) (2010).

[210] Securities Act Rule 506, 17 C.F.R. § 230.506 (2012).

[211] 15 U.S.C. § 77d(5).

[212] 17 C.F.R. § 230.504.

[213] 17 C.F.R. § 230.505.

[214] 17 C.F.R. § 230.251 *et seq.*

[215] *See* Cohn & Yadley, *supra* note 11, at 35 ("[S]mall companies are hard pressed to find an exemption consistent with their timing, financing, and marketing needs.").

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

Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."[216] The exact boundaries of this exemption are hazy,[217] but the Supreme Court held in *Ralston Purina* that the exemption's availability turns on whether offerees "need the protection of the Act" or are "able to fend for themselves."[218] Subsequent cases have focused on the sophistication of the offerees and their access to information about the issuer.[219]

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

The SEC has adopted a regulatory safe harbor for Section 4(2), Rule 506 of Regulation D,[220] but that safe harbor would also not be helpful. Purchasers in a Rule 506 offering must either be "accredited investors" or meet a sophistication requirement.[221] Accredited investors are primarily sophisticated institutions or individual investors who meet wealth or income standards.[222] Not all of the purchasers on a

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[216] Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2010).

[217] *See* HAZEN, *supra* note 42, at 573 ("[A]n issuer relying on the statutory section 4(2) exemption . . . may be subjecting itself to a great deal of uncertainty.").

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

[219] *See* HAZEN, *supra* note 42, at 565.

[220] Offers and sales that satisfy the conditions of Rule 506 "shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act." Securities Act Rule 506(a), 17 C.F.R. § 230.506(a) (2012).

[221] 17 C.F.R. § 230.506(b)(2)(ii). If a purchaser is not an accredited investor, she or her purchaser representative must have "such knowledge and experience in financial and business matters that [s]he is capable of evaluating the merits and risks of the prospective investment." *Id.* The rule is satisfied even if the purchaser does not meet this standard, as long as the issuer reasonably believes that she does. *Id.*

[222] *See* 17 C.F.R. § 230.501(a).

publicly accessible crowdfunding site would meet these requirements.

In addition, Rule 506 prohibits "general solicitation" and "general advertising" of the offering.[223] The SEC and its staff take the position that any solicitation of an investor with whom the issuer or its sales representatives do not have a preexisting relationship violates the general solicitation restriction.[224] Offerings to the general public on crowdfunding sites would clearly violate this prohibition.[225] Finally, sales under Rule 506 are limited to no more than thirty-five non-accredited investors.[226] Some crowdfunding offerings might meet this limit on the number of purchasers, but, given the small amounts contributed by each investor, others would not.[227]

Section 4(5) of the Securities Act, until recently Section 4(6), is similar to Rule 506. [228] It allows offers and sales solely to accredited investors provided that there is no "advertising or public solicitation."[229] Thus, Section 4(5), like Rule 506, is of little use to small businesses engaged in crowdfunding.[230]

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[223] 17 C.F.R. § 230.502(c).

[224] *See, e.g.*, Kenman Corp., Exchange Act Release No. 21,962, 32 S.E.C. Docket 1352 n.6 (Apr. 19, 1985). *See generally* HAZEN, *supra* note 42, at 540; Sjostrom, *Relaxing the Ban*, *supra* note 198, at 13–14. According to Sjostrom, the SEC has indicated that a preexisting relationship is not the only way to avoid the general solicitation ban, but it has not granted any no-action relief where a preexisting relationship is absent. *Id.*

[225] *See* Heminway & Hoffman, *supra* note 142, at 918 ("The most serious obstacle to the use of Regulation D to exempt crowdfunded offerings from Securities Act registration is Regulation D's overall prohibition of general solicitation and general advertising.").

[226] *See* 17 C.F.R. § 230.506(b)(2)(i).

[227] *See* Cohn & Yadley, *supra* note 11, at 12 (noting that small companies are likely to need to sell to a large number of investors and cannot do that within the numerical limits imposed by Rules 505 and 506).

[228] Unlike Rule 506, Section 4(5) limits the amount of the offering to $5 million. Securities Act of 1933 § 4(5), 15 U.S.C. § 77d(5), (2010).

[229] *Id.*

[230] *See* Cohn & Yadley, *supra* note 11, at 24.

b. Rule 505

Rule 505 exempts offerings of up to $5 million.[231] Rule 505 is not restricted to accredited or sophisticated purchasers, but it is subject to the same general solicitation prohibition as Rule 506.[232] Also, as under Rule 506, an issuer may sell to no more than thirty-five non-accredited investors.[233] These conditions make Rule 505 unsuitable for crowdfunding.

c. Rule 504

Rule 504 exempts offerings of up to $1 million,[234] but Rule 504, like Rules 505 and 506, is subject to the general solicitation restriction.[235] The only exception is if the Rule 504 offering is subject to state registration requirements or sold pursuant to a state exemption that limits sales to accredited investors.[236] One major crowdfunding site, ProFounder, attempted to fit within this rule[237] by limiting access to friends, family members, and preexisting acquaintances of each entrepreneur—in other words, those

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[231] 17 C.F.R. § 230.505(b)(2)(i).

[232] *See* 17 C.F.R. § 230.502(c).

[233] *See* 17 C.F.R. § 230.505(b)(2)(ii) (permitting no more than thirty-five purchasers); 17 C.F.R. § 230.501 (excluding accredited investors from that limited number of purchasers).

[234] 17 C.F.R. § 230.504(b)(2).

[235] 17 C.F.R. § 230.502(c). The SEC eliminated the general solicitation ban for Rule 504 offerings in 1992, but reinstated it in its current form in 1999. *See* Sjostrom, *Relaxing the Ban*, *supra* note 198, at 25.

[236] *See* 17 C.F.R. § 230.502(c) (stating that Regulation D offerings may not sell securities by solicitation or advertising "[e]xcept as provided in § 230.504(b)(1) . . ."); 17 C.F.R. § 230.504(b)(1) (exempting offerings sold in one or more states requiring registration and delivery of a disclosure document to investors or pursuant to a state exemption allowing general solicitation in offerings limited to accredited investors).

[237] *See* Lang, *supra* note 106 ("ProFounder facilitates compliance with Regulation D, Rule 504."). As previously discussed, ProFounder is no longer selling securities. *See supra* text accompanying notes 100–03.

with whom the issuer has a preexisting relationship.[238] This may solve the general solicitation problem, but it eliminates much of the value of crowdfunding. A publicly accessible crowdfunding offering could not use Rule 504 unless the offering was registered at the state level, and that state registration would be prohibitively expensive.[239]

d. Regulation A

Regulation A is available to offerings by non-reporting companies[240] of up to $5 million.[241] Unlike Regulation D, Regulation A does not prohibit general solicitation. It does, however, require issuers to file a disclosure document,[242] and, like Section 5 of the Securities Act, Regulation A includes rather extensive limits on communications with investors, tied to the filing and disclosure requirements.[243] Regulation A is, in effect, a "mini-registration," a less expensive version of what the Act itself requires absent an exemption.[244] Regulation A is not cheap; the average cost of a Regulation A offering in 1997 was $40,000–60,000.[245] This is too expensive for the very small offerings that crowdfunding attracts.[246]

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[238] Entrepreneurs were instructed to "invite investors who are friends, family, or others who you know in your community." Lang, *supra* note 106. Entrepreneurs were cautioned not to invite anyone with whom the company "does not personally have a substantial, pre-existing personal relationship." *Company Terms and Conditions for Services*, PROFOUNDER, *supra* note 112.

[239] *See infra* Part VII.D. *See also* Heminway & Hoffman, *supra* note 142, at 919–20.

[240] 17 C.F.R. § 230.251(a)(2).

[241] 17 C.F.R. § 230.251(b).

[242] 17 C.F.R. §§ 230.251(d)(1)(i), 230.252.

[243] *See* 17 C.F.R. § 230.251(d).

[244] *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3A SECURITIES AND FEDERAL CORPORATE LAW 6-67 (2011 rev.) ("The Regulation A procedures are designed to emulate the procedures relating to the filing and processing of registration statements with some insubstantial exceptions."); HAZEN, *supra* note 42, at 509 (calling Regulation A a "mini-registration").

[245] HAZEN *supra* note 42, at 512 n.20. *See also* PRIFTI, *supra* note 200, at 1A:17 (listing costs of a Regulation A offering, including: filing fee $100;

IV. THE STATUS OF CROWDFUNDING SITES UNDER FEDERAL SECURITIES LAW

The proposals to exempt crowdfunding focus primarily on the offerings themselves and the need for an exemption from Securities Act registration.[247] But crowdfunding can function effectively only through web sites that bring entrepreneurs and potential investors together. The operation of those sites raises a different set of issues under federal securities law. 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. They would not, however, be regulated as exchanges.

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underwriting costs 10–18% of the offering amount; printing costs $7,500–15,000; engraving stock certificates $1,500; legal costs ¾–3% of the offering amount; accounting costs $5,000–20,000; expert fees $300–5,000; state filing fees $150–4,000 per state; and NASD filing fees $500 plus 0.01% of the offering amount).

[246] *See* Rutheford B Campbell, *Regulation A: Small Businesses' Search for 'A Moderate Capital,'* 31 DEL. J. CORP. L. 77, 111 (2006) ("On the small offering end of the Regulation A spectrum . . . issuers are discouraged from using Regulation A by the complexities of the filing, disclosure, and other requirements and by the difficulties in many instances of meeting state blue sky law requirements. Together, the costs of meeting these federal and state requirements overwhelm any benefit a small business would attain from utilizing Regulation A."). *See also* BLOOMENTHAL & WOLFF, *supra* note 244, at 6-49 (noting that small businesses do not use Regulation A much); Sjostrom, *Relaxing the Ban*, *supra* note 198, at 26 ("Preparing a Regulation A offering statement can cost a small company a significant amount of money and management time.").

[247] *See, e.g.*, Letter from Woodie Neiss, Member, SBE Council Advisory Committee, to Gerald J. Laporte, Chief, Office of Small Business Policy, Division of Corporate Finance, SEC (Dec. 21, 2010), *available at* http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf [hereinafter SBE Council Proposal]; Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration, SEC, File No. 4-605, *available at* http://www.sec.gov/rules/petitions.shtml; Factsheet and Overview for AJA, *supra* note 7; *About Us*, STARTUP EXEMPTION, http://www.startupexemption.com/?page_id=91#axzz1T9YWT6vM (last visited Mar. 5, 2012).

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

A. Are Crowdfunding Sites Exchanges?

At first blush, crowdfunding sites might seem to be securities "exchanges" required to register under the Exchange Act. Section 3(a)(1) of the Exchange Act defines "exchange" as an "organization, association, or group of persons" that "constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood . . . ."[248] Crowdfunding sites bring together investors buying securities and the entrepreneurs selling them and facilitate execution of the sales much as a securities exchange would.

In spite of this superficial resemblance, it is reasonably clear that crowdfunding sites, unless they engage in additional activities, would not be exchanges under federal securities law. Rule 3b-16 provides that, to fall within the definition of exchange, a trading system must, among other things, "[bring] together the orders for securities of multiple buyers and sellers."[249] In other words, for a system's trading of a particular security to make it an exchange, there must be more than one person on each side of the transactions in that security. The SEC made it clear that "systems in which there is only a single seller, such as systems that permit issuers to sell their own securities to investors, would not be included within Rule 3b-16."[250]

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[248] Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78c(a)(1) (2010).

[249] Exchange Act Rule 3b-16, 17 C.F.R. § 240.3b-16 (2012).

[250] Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 70844-01, 70849 (Dec. 22, 1998) (to be codified at 17 C.F.R. pts. 202,

Crowdfunding sites fit this single-seller model, and therefore are not exchanges. Although each company's security has a large number of buyers, meeting the multiple-buyer requirement, there is only one seller—the issuer itself. Crowdfunding sites list the securities of a number of different sellers, but the question is not whether there are multiple sellers on the site, but whether there are multiple sellers *for a particular security*. According to the SEC, "a system that has multiple sellers, but only one seller for each instrument, . . . would not . . . meet the 'multiple parties' requirement."[251] Unless crowdfunding sites get involved in post-funding trading of listed company's securities,[252] none of the securities offered would have multiple sellers. Therefore, crowdfunding sites would not be exchanges.

B. Are Crowdfunding Sites Brokers?

Section 3(a)(4) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[253] The Exchange Act provides no further guidance as to what it means to be "engaged in a business" or "effecting transactions in securities," and the law in this area is uncertain.[254] Whether

242), *available at* http://www.gpo.gov/fdsys/pkg/FR-1998-12-22/pdf/98-33299.pdf.

[251] Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 23504-01, 23508 (Apr. 29, 1998) (to be codified at 17 C.F.R. pt. 242), *available at* http://www.gpo.gov/fdsys/pkg/FR-1998-04-29/pdf/98-10945.pdf (interpreting the proposed rule that became Rule 3b-16).

[252] *See infra* Part VII.C.3 for a discussion of issues involving the resale of crowdfunded securities.

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

[254] *See* HAZEN, *supra* note 42, at 228 ("[I]t is not always easy to tell when a finder's activities would require broker-dealer registration.");

an individual or entity is a broker is "one of the more nebulous questions in U.S. securities regulation."[255]

The case law is limited, so most of the guidance in this area comes from SEC no-action letters.[256] The SEC staff "does not typically provide a rationale for its position" in those letters, forcing the reader "to speculate which of numerous facts recited in the response and/or letter of inquiry triggered the staff reaction."[257] The analysis is "extremely flexible"[258] and therefore inherently unpredictable.

It is impossible to state definitively whether crowdfunding sites would be brokers if they hosted securities offerings. None of the major crowdfunding sites has received

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NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION 5-15 (4th ed. 2009) (indicating "some uncertainty" as to whether finders who bring together two parties who wish to engage in a securities transaction are brokers); Abraham J. B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 136 (2010) ("[I]t is difficult to derive . . . a single, comprehensible framework for evaluating broker-dealer status, and this can be a source of frustration when trying to analyze the regulatory status of new developments . . . .").

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

[256] LIPTON, *supra* note 253, at 1-222. No-action letters express the views of the staff and are not the official view of the SEC. 17 C.F.R. § 202.1(d). The SEC does not consider them binding precedent. Press Release, SEC, Adoption of Section 200.81 (17 CFR 200.81), Concerning Public Availability of Requests for No-Action and Interpretative Letters and the Responses Thereto by the Commission's Staff, and Amendment of Section 200.80 (17 CFR 200.80) (Oct. 29, 1970), 1970 WL 10582, at *2. "Nonetheless, as a practical matter, practitioners place significant reliance on" them and "they clearly influence judicial opinions." LIPTON, *supra* note 253, at 1-224.

[257] LIPTON, *supra* note 253, at 1-226 ("Even comparing the facts cited in one no-action letter with those in numerous other letters does not necessarily indicate which factors were most persuasive for the staff because the staff has placed different emphasis on the same factors at varying times.").

[258] *Id.* at 1-48.

no-action relief from the SEC.[259] However, the SEC's view of what constitutes a broker is expansive, and crowdfunding sites deviate in important ways from what the SEC has allowed in other contexts. Because of this, there is a strong possibility that sites hosting crowdfunded securities offerings would be required to register as brokers.[260]

1. Engaged in the Business

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

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

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[259] Prosper, one of the peer-to-peer lending sites, submitted a no-action request shortly after its launch but withdrew it before the staff responded. Verstein, *supra* note 12.

[260] At least one state, California, has taken the position that a crowdfunding site that sells securities is a broker for purposes of state law. *See* ProFounder Fin., Inc., Consent Order to Desist and Refrain (Aug. 31, 2011), *available at* www.corp.ca.gov/ENF/pdf/2011/ProFounder_CO.pdf.

[261] SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 12 (D.D.C. 1998); Mass. Fin. Servs., Inc. v. Sec. Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1st Cir. 1976); HAZEN, *supra* note 42, at 213; LIPTON, *supra* note 253, at 1-42.4–1-42.5; POSER & FANTO, *supra* note 254, at 5-11.

[262] UFITEC, S.A. v. Carter, 571 P.2d 990, 994 (Cal. 1977); LIPTON, *supra* note 253, at 1-42.8; POSER & FANTO, *supra* note 254, at 5-11.

[263] *Kenton Capital*, 69 F. Supp. 2d at 13.

[264] *See infra* Part IV.B.2.e.

the real question is whether crowdfunding sites are effecting transactions in securities.

2. Effecting Transactions in Securities

a. General Guidance

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

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

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[265] *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), http://www.sec.gov/divisions/marketreg/bdguide.htm [hereinafter *Guide to Registration*].

[266] POSER & FANTO, *supra* note 254, at 5-14. *See also* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 16-5 (3d ed. 2005) [hereinafter FRIEDMAN, SECURITIES REGULATION].

[267] Mass. Fin. Servs., Inc. v. Sec. Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1st Cir. 1976); *accord* SEC v. Martino, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003); SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

[268] LIPTON, *supra* note 253, at 1-51. *See also Martino*, 255 F. Supp. 2d at 284 (finding a broker even though the written agreements described the work as "consulting services").

[269] *Profounder Terms and Conditions for Services*, PROFOUNDER, *supra* note 112.

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

> (1) "Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?"
>
> (2) "Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? . . . Do you receive any other transaction-related compensation?"
>
> (3) "Are you otherwise engaged in the business of effecting or facilitating securities transactions?"
>
> (4) "Do you handle the securities or funds of others in connection with securities transactions?"[272]

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

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

[271] *Guide to Registration, supra* note 265.

[272] *Id.*

[273] *See* Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Mid-Atlantic Inv. Network, SEC No-Action Letter, 1993 WL 173768 (May 18, 1993); Private Investor Network, SEC No-Action Letter, 1987 WL 108869 (Nov. 2, 1987); VCN of Tex., SEC No-Action Letter, 1987 WL 108250 (June 18, 1987); Venture Match of N.J., SEC No-Action Letter, 1987 WL 108917 (June 11, 1988); Atlanta Econ.

> (1) They were run by non-profit entities, and any fees collected were used only to cover administrative expenses.
>
> (2) Fees did not depend on whether a successful match occurred or whether the entrepreneur raised the desired funds.
>
> (3) The matching site's role was essentially completed when the entrepreneur and the investor were introduced. From that point forward, everything occurred off-site.
>
> (4) The matching service was not involved in negotiating or closing any transactions between the entrepreneur and investors.
>
> (5) The matching service did not handle any funds or securities in connection with the financing.
>
> (6) The matching service provided no advice to either entrepreneurs or investors and did not assist them in completing the financing.

b. Transaction-Based Compensation

Unlike the matching services in the no-action letters, many of the crowdfunding sites charge fees that depend on whether the financing is successful. [274] Kickstarter's fee is 5% of the funds raised; however, if the fundraising is unsuccessful, entrepreneurs pay no fee.[275] IndieGoGo takes 4% or 9% of the funds raised, depending on whether the entrepreneur meets her funding goal.[276] Prosper and

Dev. Corp., SEC No-Action Letter, 1987 WL 107835 (Mar. 19, 1987); Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644 (Nov. 25, 1985).

[274] Kiva, however, operates exclusively on a donation basis. It does not receive a fee from either entrepreneurs or borrowers, although it does accept donations from its lenders. *See About Us,* KIVA, *supra* note 32.

[275] *See Frequently Asked Questions: Fees*, KICKSTARTER, *supra* note 29.

[276] *See Pricing*, INDIEGOGO, http://www.indiegogo.com/about/pricing (last visited Mar. 5, 2012).

Lending Club each charge a 1% fee.[277] When ProFounder was selling securities, at least part of its fee apparently depended on whether the offering was successful.[278]

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

However, it is possible to receive transaction-based compensation in connection with securities transactions without being considered a broker. A recent district court

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[277] Prosper Registration Statement, *supra* note 81, at 5; Lending Club Registration Statement, *supra* note 81, at 3.

[278] *See supra* Part II.B.4.

[279] *See Guide to Registration*, *supra* note 265 ("Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? . . . Do you receive any other transaction-related compensation?"). *See also* SEC v. Margolin, No. 92 Civ. 6307 (PKL), 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992) (listing transaction-based compensation as one factor); HAZEN, *supra* note 42, at 210 (same); LIPTON, *supra* note 253, at 1-70.1 (same).

[280] Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 BUS. LAW. 959, 975 (2005). *See also* Orcutt, *supra* note 255, at 908 (noting that transaction-based compensation has "garnered substantial attention").

[281] Task Force on Private Placement Broker-Dealers, *supra* note 280, at 977. *See also* POSER & FANTO, *supra* note 254, at 5-17 (noting that transaction-based compensation "may be the determinative factor").

[282] Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010); 1st Global, Inc., SEC No-Action Letter, 2001 WL 499080 (May 7, 2001). *See also* Orcutt, *supra* note 255, at 910; John Polanin, Jr., *The "Finder's" Exception from Federal Broker-Dealer Registration*, 40 CATH. U. L. REV. 787, 814 (1991).

case recognized that transaction-based compensation "is the hallmark of a salesman,"[283] but nevertheless held that an individual who received transaction-based compensation for merely bringing people together for a securities transaction was not a broker.[284] The SEC staff has also occasionally granted no-action relief to finders who received transaction-based compensation. The most well-known of these no-action letters involved the entertainer Paul Anka, who provided the names of potential investors to the Ottawa Senators Hockey Club in return for a finder's fee equal to 10% of the amount the investors invested.[285]

The Paul Anka letter and the other no-action letters allowing transaction-based compensation involved finders who were not involved in negotiations, consummation of the financing, or transferring funds or securities to effect the deal.[286] Anka, for instance, only provided the names of potential investors to the Club; he did not solicit or even contact the potential investors and was not involved in negotiations between the Club and the investors.[287] David Lipton reads these letters as allowing finders to receive transaction-based compensation only if the finder is "totally isolated from the process of selling the units."[288] In such cases, the finder cannot act on the incentive "to engage in

[283] SEC v. Kramer, 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011).

[284] *Id.* at 1336, 1338–39.

[285] Paul Anka, SEC No-Action Letter, 1991 WL 176891 (July 24, 1991) [hereinafter Anka No-Action Letter].

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

[287] Anka No-Action Letter, *supra* note 285. Anka was doing this on a one-time basis, so, even if he was effecting transactions in securities, he arguably was not in the business of doing so, and would not be a broker for this reason as well.

[288] LIPTON, *supra* note 253, at 1-87.

abusive or sharp selling practices" that transaction-based compensation might otherwise create.[289]

Finders who go beyond simple introductions risk being treated as brokers if they receive transaction-based compensation. Involvement in structuring or negotiating the terms of a securities transaction would make one a broker under the SEC's analysis.[290] If one receives transaction-based compensation, merely contacting investors and describing the deal in general terms may cross the line between broker and non-broker.[291] Paul Anka had originally proposed to contact the investors to describe the potential investment and forward investors' names to the Club only if they expressed interest. The SEC staff granted the request only after a follow-up letter limited Anka's role to providing names.[292]

The SEC staff may no longer accept even the limited position it took in the Paul Anka letter.[293] It currently views the limited activity of introducing a potential buyer and seller of securities "with skepticism when coupled with transaction-based compensation."[294]

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[289] Orcutt, *supra* note 255, at 911–12. *See also* LIPTON, *supra* note 253, at 1-87; Polanin, *supra* note 282, at 814.

[290] *See., e.g.*, Ram Capital Res., LLC, Exch. Act Release No. 34-60149, 96 S.E.C. Docket 459, 2009 WL 1723950 (June 19, 2009); Mike Bantuveris, SEC No-Action Letter, 1975 WL 10654 (Sept. 23, 1975); May-Pac Mgmt. Co., SEC No-Action Letter, 1973 WL 10806 (Nov. 20, 1973); Fulham & Co., Inc., SEC No-Action Letter, 1972 WL 9129 (Nov. 20, 1972).

[291] *See* Richard S. Appel, SEC No-Action Letter, 1983 WL 30911, at *1 (Jan. 13, 1983) (denying a no-action request from a finder whose only role would be to contact existing business associates and friends, describe potential oil and gas investments in general terms, and provide the approximate cost of drilling a well).

[292] Anka No-Action Letter, *supra* note 285.

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

[294] *Id.* at 966.

Consider, for example, the staff's recent response in *Brumberg, Mackey & Wall, P.C.*[295] A law firm proposed to introduce potential investors to a company seeking financing in return for a percentage of the money raised from those investors. The firm was not going to be involved in negotiations, provide the potential investors with any information about the company, recommend or have any responsibility for the terms of any agreement, or have any other involvement in obtaining financing for the transactions. In rejecting the request, the staff noted that transaction-based compensation "is a hallmark of broker-dealer activity. Accordingly, any person receiving transaction-based compensation in connection with another person's purchase or sale of securities typically must register as a broker-dealer or be an associated person of a registered broker-dealer."[296]

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

Unfortunately, a relatively recent district court case muddies the water and casts doubt on the validity of the SEC staff's position with respect to transaction-based compensation. In *SEC v. M & A West, Inc.*,[297] the defendant worked with the shareholders of private companies to identify suitable public companies for reverse mergers, actually prepared the documents for those transactions, and coordinated among the parties.[298] The defendant (or his

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

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

[297] No. C-01-3376 VRW, 2005 WL 1514101 (N.D. Cal. June 20, 2005).

[298] *Id.* at *3.

nominees) received shares in the completed transactions for his work[299]—clearly transaction-based compensation—but the court nevertheless held that he was not a broker. According to the court, although the defendant facilitated securities transactions, his actions were not "effecting" transactions in securities.[300]

c. Involvement in the Transactions

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

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

i. Providing Advice or Recommendations

Providing advice or recommendations to investors is a factor in deciding whether one is a broker,[303] but most crowdfunding sites provide only general advice, and do not recommend or rate particular investment opportunities.

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[299] *Id.* at *3–*4.

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

[301] LIPTON, *supra* note 253, at 1-100–1-101.

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

[303] HAZEN, *supra* note 42, at 210; LIPTON, *supra* note 253, at 1-70.1; POSER & FANTO, *supra* note 254, at 5–12; Task Force on Private Placement Broker-Dealers, *supra* note 280, at 975.

Kickstarter, for example, provides general advice to investors about how to avoid fraud.[304] Also, some of the sites provide general advice to entrepreneurs about how to structure a successful fundraising campaign. The Kickstarter site, for example, includes advice about how much money to ask for and "the secret" to successful fundraising.[305] IndieGoGo and ProFounder offer general advice about how to create a fundraising campaign and what to offer in return for contributions.[306]

Other crowdfunding sites provide more specific advice to entrepreneurs and investors. Both Lending Club and Prosper rate borrowers, effectively advising investors as to the quality of the loans.[307] ProFounder, before it quit offering securities, helped entrepreneurs structure and complete their offerings. It agreed to make a good faith effort "to provide all documents necessary for compliance with securities and other laws applicable to Company's issuance of securities and Investor's PRIVATE investment," although it noted that compliance was ultimately the entrepreneur's responsibility.[308] ProFounder also provided term sheets and "compliance tools" to entrepreneurs[309] and helped entrepreneurs track compliance requirements and filing fees.[310]

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[304] *See Frequently Asked Questions*, KICKSTARTER, *supra* note 29.

[305] *See Start Your Project,* KICKSTARTER, http://www.kickstarter.com/start (last visited Mar. 5, 2012).

[306] *See Frequently Asked Questions*, INDIEGOGO, supra note 44; Lang, *supra* note 106.

[307] *See e.g.*, *Prosper Ratings*, PROSPER, http://www.prosper.com/invest/how-to-invest/prosper-ratings/ (last visited Mar. 5, 2012).

[308] *Company Terms and Conditions for Services*, PROFOUNDER, *supra* note 112. *See also* Lang, *supra* note 106 ("ProFounder facilitates compliance with Regulation D, Rule 504.").

[309] *See Why Crowdfund?*, PROFOUNDER, http://www.profounder.com/entrepreneurs/why_crowdfund (last visited Mar. 5, 2012).

[310] *See* Lang, *supra* note 106.

ii. Structuring the Transaction

Involvement in structuring a securities transaction is another factor pointing toward broker status.[311] Prosper and Lending Club each specify the terms of the loans on their sites.[312] Other sites restrict the structure of the resulting transaction. IndieGoGo and ProFounder, for example, limit how long a funding request may remain open.[313] ProFounder required quarterly payments to investors and imposed a five-year limit on how long an entrepreneur could share returns with investors.[314] ProFounder also allowed entrepreneurs to exit their commitments early, but only if they paid investors twice their investment.[315]

iii. Receipt or Transmission of Funds / Continued Involvement after the Financing

The receipt or transmission of funds or securities is another criterion considered in determining whether someone is a broker.[316] All of the major crowdfunding sites actually collect funds from investors and forward them to the entrepreneurs.[317] The sites where entrepreneurs offer

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[311] *See* Orcutt, *supra* note 255, at 904–05; *Guide to Registration*, *supra* note 265.

[312] *See generally* Prosper Registration Statement, *supra* note 81; Lending Club Registration Statement, *supra* note 81.

[313] *Frequently Asked Questions: Creating a Campaign*, INDIEGOGO, *supra* note 44 (120-day limit); *FAQs*, PROFOUNDER, *supra* note 110.

[314] Lang, *supra* note 106.

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

[316] LIPTON, *supra* note 253, at 1-43. *See also* SEC v. Margolin, No. 92 CIV. 6307 (PKL), 1992 WL 279735 (S.D.N.Y. Sept. 30, 1992) ("possessing client funds and securities"); POSER & FANTO, *supra* note 254, at 5-12 ("taking custody of clients' funds and securities"); *Guide to Registration*, *supra* note 265 ("Do you handle the securities or funds of others in connection with securities transactions?").

[317] *See, e.g.*, *Frequently Asked Questions: Pledging*, KICKSTARTER, *supra* note 29; *How Kiva Works*, *supra* note 72; *Frequently Asked Questions*, INDIEGOGO, *supra* note 44; Lang, *supra* note 106 (ProFounder).

financial rewards also transfer those funds back to investors.[318] Sites are also involved in other ways after completion of the transaction. At ProFounder, entrepreneurs had to report their revenues on a quarterly basis and even upload their tax returns each year to verify the reported revenues.[319] Similarly, Kickstarter and IndieGoGo encourage entrepreneurs to post project updates.[320]

iv. Involvement in Negotiations

Another relevant factor is involvement in negotiations between investors and entrepreneurs. A person involved in the negotiation of securities transactions is "virtually always" treated as a broker.[321] Crowdfunding sites are not actively involved in negotiations between the entrepreneurs who list on the sites and potential investors. The communications portals on crowdfunding sites obviously facilitate negotiations, but merely facilitating the exchange of information or documents is not sufficient to make one a broker.[322]

d. Solicitation and Advertising

Another factor relevant to broker status is whether the person is actively advertising or otherwise soliciting investors.[323] Solicitation is defined fairly broadly. The

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[318] *See, e.g.*, *How Kiva Works*, *supra* note 72; Lang, *supra* note 106.

[319] *See* Lang, *supra* note 106.

[320] *See Frequently Asked Questions: Project Updates*, KICKSTARTER, *supra* note 29; *Frequently Asked Questions: Creating a Campaign*, INDIEGOGO, *supra* note 44.

[321] LIPTON, *supra* note 253, at 1-74. *See also* HAZEN, *supra* note 42, at 210 (listing involvement in negotiations as a factor pointing towards broker status); POSER & FANTO, *supra* note 254, at 5-12 (same).

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

[323] *See* SEC v. Margolin, No. 92 Civ. 6307 (PKL), 1992 WL 279735, at *5 (S.D.N.Y. Sept. 30, 1992); SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); HAZEN, *supra* note 43, at 210; LIPTON,

question is whether the possible broker is contacting investors with whom it has a preexisting relationship or is instead actively identifying previously unknown third parties; the latter qualifies as a solicitation.[324] A public web site, by definition, is engaged in continued public solicitation, even if it does not otherwise advertise. Moreover, "mere repeated advertising to purchase or sell securities would trigger the broker-dealer registration requirement."[325]

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

supra note 253, at 1-42.13; POSER & FANTO, *supra* note 254, at 5-12; Task Force on Private Placement Broker-Dealers, *supra* note 280, at 975.

[324] Orcutt, *supra* note 255, at 914.

[325] LIPTON, *supra* note 253, at 1-42.13.

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

[327] Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644 (Oct. 25, 1985).

[328] Atlanta Econ. Dev. Corp., SEC No-Action Letter, 1987 WL 107835 (Feb. 17, 1987).

purchase oil and gas interests (for example, by targeting potential investors with direct mailings and follow-up e-mail)."[329]

e. For-Profit Status

Finally, many crowdfunding sites are for-profit entities. Almost all of the no-action letters have involved "state instrumentalities, private non-profit corporations, and quasi-governmental organizations,"[330] and the staff has generally required representations that these systems would be run solely on a cost-recovery basis, and not for profit.[331] For-profit status does not automatically make one a broker. The SEC staff has granted no-action relief to a few private matching sites. However, none of those sites received transaction-based compensation, and in all those cases the securities transactions were negotiated and completed, and funds were transferred, off the site.[332]

3. Conclusion: Would Crowdfunding Sites Be Brokers?

Given the messy state of the law, no definitive answer is possible, but there is a strong possibility that crowdfunding sites would be considered brokers if they listed offerings of securities. The crowdfunding sites' receipt of transaction-based compensation, continued involvement in the investor-entrepreneur relationship, public advertising, and for-profit

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

[330] *Cf.* Polanin, *supra* note 282, at 821.

[331] *Id.*

[332] *See* Investex Inv. Exch. Inc., SEC No-Action Letter, 1990 WL 286331 (Apr. 9, 1990); Petroleum Info. Corp., SEC No-Action Letter, 1989 WL 246625 (Nov. 28, 1989); Internet Capital Corp., SEC No-Action Letter, 1997 WL 796944 (Dec. 24, 1997). *But see* OilOre.com, SEC No-Action Letter, 2000 WL 546573 (Apr. 21, 2000) (denying no-action relief to a for-profit entity that was to receive compensation contingent on the investor making an investment).

status may cumulatively be too much to allow them to avoid broker status.

C. Are Crowdfunding Sites Investment Advisers?

Crowdfunding sites might also be investment advisers within the meaning of the Investment Advisers Act of 1940. Unfortunately, the definition of "investment adviser" in this context is as unclear as the definition of "broker"—if anything, there is less guidance available on the investment-adviser question. Two issues must be addressed. First, do crowdfunding sites fall within the general definition of "investment adviser"? Second, if so, do they qualify for the "publisher" exception in that definition?

1. The General Definition of Investment Adviser

The basic definition of investment adviser, in Section 202(a)(11) of the Investment Advisers Act,[333] has two parts, either of which suffices to make one an investment adviser. First, a person is an investment adviser if she, "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[334] Alternatively, a person is an investment adviser, if she, "for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[335] Under either part of the definition, three basic requirements must be met:

> (1) The person must be providing advice or issuing reports or analyses concerning securities;
>
> (2) The person must be in the business of doing so; and

[333] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).

[334] *Id.*

[335] *Id.*

(3) The person must be doing so for compensation.[336]

Though crowdfunding sites clearly meet the last two requirements, it is unclear whether they satisfy the first.

2. In the Business

The business requirement is phrased slightly differently in the two parts of Section 202(a)(11). The first alternative uses the phrase "engages in the business" and the second alternative requires that the analysis be given "as part of a regular business,"[337] but the SEC interprets the business element of both parts identically.[338]

Some regularity is required—isolated instances of investment advice do not make one an investment adviser.[339] But investment advice does not have to be the person's principal business, as long as the advice is given on a regular basis.[340] Crowdfunding sites would undoubtedly meet this regularity requirement. If their services constitute securities advice or analysis, they are providing that service on an ongoing, regular basis.

As with broker status, transaction-based compensation is important. The SEC has indicated that a person meets the "business" requirement if she "receives transaction-based compensation if the client implements the investment

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[336] Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, 52 Fed. Reg. 38400-01, 38402 (Oct. 16, 1987) (to be codified in 17 C.F.R. pt. 276) [hereinafter Investment Advisers Release]. *See also* United States v. Elliott, 62 F.3d 1304, 1309–10 (11th Cir. 1995).

[337] 15 U.S.C. § 80b-2(a)(11).

[338] Investment Advisers Release, *supra* note 336, at 38402.

[339] *Id. See also* Zinn v. Parrish, 644 F.2d 360 (7th Cir. 1981); HAZEN, *supra* note 42, at 29.

[340] Investment Advisers Release, *supra* note 336, at 38402; HAZEN, *supra* note 42, at 27; THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISORS 5 (2011).

advice."[341] Thus, it is reasonably clear that for-profit crowdfunding sites would meet the "business" requirement.

3. For Compensation

For one to be an investment adviser, analysis or advice must be provided for compensation.[342] Any economic benefit is sufficient to meet this requirement; the adviser does not have to charge a separate fee for the advisory portion of the services.[343] Most crowdfunding sites charge a fee of some kind, usually either a flat fee, a percentage of the amount raised, or interest.[344] This satisfies the compensation requirement.[345]

4. Advice, Analyses, or Reports Concerning Securities

Most crowdfunding sites are not offering advice "as to the value of securities or as to the advisability of investing in,

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[341] According to the SEC, a person is in the business if "(i) [he] holds himself out as an investment adviser or as one who provides investment advice, (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, *or* receives transaction-based compensation if the client implements in the investment advice, *or* (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice." Investment Advisers Release, *supra* note 336, at 38402 (emphasis added).

[342] *See* HAZEN, *supra* note 42, at 29 ("The rendering of investment advice without compensation is likely to take the person rendering the advice out from under the purview of the Investment Advisers Act.").

[343] Investment Advisers Release, *supra* note 336, at 38403. *See also* Thomas v. Metropolitan Life Ins. Co., 631 F.3d 1153, 1164 (10th Cir. 2011); United States v. Elliott, 62 F.3d 1304, 1311 (11th Cir. 1995); LEMKE & LINS, *supra* note 340, at 4.

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

[345] FRIEDMAN, SECURITIES REGULATION, *supra* note 266, at 17-5 ("If a website offering investment advice grants access only to those who pay a subscription fee, clearly its sponsor is receiving compensation for investment advice."). Friedman notes that the question would be more difficult if the web site were funded only by advertisements. *Id.*

purchasing, or selling securities."[346] They may, however, be issuing "analyses or reports concerning securities,"[347] assuming that securities are being offered on the site. The case law and guidance from the SEC are simply too uncertain to offer a definitive conclusion.

Consider first the advice portion of the definition. Most of the existing crowdfunding sites do not advise investors as to the merits of particular opportunities, or evaluate or rate the potential investments. Advice does not have to relate to specific securities to make one an investment adviser.[348] A discussion of the relative advantages of investing in securities rather than other investments would suffice,[349] but crowdfunding sites typically do not even do this.

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

For the other crowdfunding sites, the problem, if there is one, comes under the second part of the definition. Crowdfunding sites may be issuing "analyses or reports concerning securities." The SEC staff has indicated that someone providing investors with statistical data on companies or a listing of investment opportunities is not issuing analyses or reports if (1) the information is readily

[346] *See* Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).

[347] *Id.*

[348] Investment Advisers Release, *supra* note 336, at 38402.

[349] *Id. See also* LEMKE & LINS, *supra* note 340, at 6–7.

available to the public in its raw state; (2) the categories of information presented are not highly selective; and (3) the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security.[350]

These requirements seem problematic for crowdfunding sites. The entrepreneur's information is not readily available to the public other than through the crowdfunding site. And the whole point of the listing is to suggest that investors purchase a security by investing in the entrepreneurs' companies.

However, the SEC staff has granted no-action relief to several matching services, which, like crowdfunding sites, are created to promote the purchase of entrepreneurs' securities and typically provide non-public information. Like crowdfunding sites, those matching services are created to promote the purchase of entrepreneurs' securities, and the information provided by those small business entrepreneurs is not typically publicly available.

No cases directly address whether crowdfunding sites are investment advisers, but other investment-adviser cases support treating crowdfunding sites as investment advisers. Two cases have held that general partners' financial reports to limited partners on the status of the partnerships' investments constituted investment advice for purposes of the definition.[351] Those reports, like the company reports available to investors on some crowdfunding sites, included financial statements and a calculation of investors' returns.[352] Even though the defendants were not offering the limited partners any actual advice in these reports—they

[350] *See, e.g.*, Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995); Media Gen. Fin. Servs., Inc., SEC No-Action Letter, 1992 WL 198262 (July 20, 1992); Investex Inv. Exch. Inc., SEC No-Action Letter, 1990 WL 286331 (Apr. 9, 1990); Charles St. Sec., Inc., SEC No-Action Letter, 1987 WL 107616 (Jan. 28, 1987). *See generally* FRIEDMAN, SECURITIES REGULATION, *supra* note 266, at 17-3; LEMKE & LINS, *supra* note 340, at 7.

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

[352] *See Fleschner*, 568 F.2d at 866; *Saltzman*, 127 F. Supp. 2d at 669.

were only providing performance data—the courts concluded that the Investment Advisers Act applied because the limited partners would use the reports to decide whether to continue their investments in the partnership.[353] Similarly, even though crowdfunding sites are not advising investors to invest in a particular company, they are providing the reports that the investors will use to make investment decisions.

Most crowdfunding sites, however, do not independently generate reports on the companies listed. They merely post funding requests and other information produced by the entrepreneurs themselves. Because they function as mere conduits for information and do not create anything themselves, they arguably are not providing any "advice" or "analyses" or "reports" at all. However, at least two cases have rejected this "mere conduit" argument. In *SEC v. Wall Street Transcript Corp.*,[354] the defendant published a weekly tabloid containing verbatim reprints of reports on securities issued by brokers. The court concluded that "there can be no doubt that, for purposes of the . . . [Investment Advisers Act], . . . [the defendant] . . . 'issues' analyses and reports concerning securities . . . . That a publication acts as a mere conduit for investment advice written by others obviously does not insure against the possibility that the publisher will engage in the fraudulent activities the Act was designed to prevent."[355] Similarly, in *Zinn v. Parrish*,[356] a sports agent occasionally transmitted to one of his clients securities recommendations made by others.[357] The court held that the agent was not "in the business" of offering investment

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

[354] 454 F. Supp. 559 (S.D.N.Y. 1978).

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

[356] 644 F.2d 360 (7th Cir. 1981).

[357] *Id.* at 364.

advice, but noted that, if the agent had passed along such recommendations more regularly, he might be an investment adviser.[358]

5. SEC No-Action Letters

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

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[358] *Id.*

[359] *See* Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094, at *1 (Oct. 25, 1996); Capital Res. Network, SEC No-Action Letter, 1993 WL 164600, at *1 (Apr. 23, 1993); Tech. Capital Network, Inc., SEC No-Action Letter, 1992 WL 175694, at *1 (June 5, 1992); Heartland Venture Capital Network, Inc., SEC No-Action Letter, 1987 WL 108286 (June 7, 1987); Venture Capital Network of N.Y., Inc., SEC No-Action Letter, 1986 WL 67371, at *1 (Nov. 10, 1986); Univ. of Ark., SEC No-Action Letter, 1986 WL 67354, at *1 (Oct. 27, 1986); Inv. Contacts Network, SEC No-Action Letter, 1986 WL 68350 (Sept. 24, 1986); Venture Capital Exch., Inc., SEC No-Action Letter, 1986 WL 66613, at *1 (Mar. 24, 1986); Indep. Inst. for N.Y. Bus. Ventures, Inc., SEC No-Action Letter, 1986 WL 65138, at *1 (Jan. 10, 1986); Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644, at *1 (Nov. 25, 1985); Venture Capital Network, Inc., SEC No-Action Letter, 1984 WL 45334, at *1 (May 7, 1984).

[360] *See* Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949, at *2 (Oct. 17, 1995); Investex Inv. Exch. Inc., SEC No-Action Letter, 1990 WL 286331, at *1 (Apr. 9, 1990); Petroleum Info. Corp., SEC No-Action Letter, 1989 WL 246625, at *1 (Nov. 28, 1989); Richmond Venture Capital Network, Inc., SEC No-Action Letter, 1989 WL 246296, at *2 (May 12, 1989).

[361] *See* Envtl. Capital Network, SEC No-Action Letter, 1995 LEXIS 1030, at *8 (Dec. 28, 1995); Colo. Capital Alliance, Inc., 1995 WL 271123, at *2 (May 4, 1995); Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949, at *4 (Oct. 17, 1995); Capital Res. Network, SEC No-Action Letter, 1993 WL 164600, at *5 (Apr. 23, 1993).

explaining why those particular features matter.[362] Those features include the following:

> (1) The network is operated by a non-profit organization.[363]
>
> (2) The network does not give any advice on the merits or shortcomings of particular investments[364] and does not otherwise endorse, analyze, or recommend the listed investment opportunities.[365]
>
> (3) The network receives only a small application fee, typically used to offset administrative costs,[366] and no employees of the network will receive any compensation based on the outcome of investment transactions.[367]
>
> (4) The network is not involved in negotiating any purchase or sale[368] and will not provide any

[362] Almost all of the letters share these common features. The following notes cite letters in which the staff expressly noted the feature in granting relief.

[363] Capital Res. Network, SEC No-Action Letter, 1993 WL 164600, at *1 (Apr. 23, 1993); Venture Capital Exch., Inc., SEC No-Action Letter, 1986 WL 66613, at *1 (Apr. 23, 1986). *But see* Tech. Capital Network, Inc., SEC No-Action Letter, 1992 WL 175694, at *8 n.2 (June 5, 1992) (non-profit status "is not solely determinative" of whether a company is an investment adviser).

[364] Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094, at *1 (Oct. 25, 1996); Venture Capital Exch., Inc., SEC No-Action Letter, 1986 WL 66613, at *1 (Apr. 23, 1986); Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644, at *1 (Nov. 25, 1985).

[365] Mo. Innovation Center, Inc., SEC No-Action Letter, 1995 WL 643949, at *10 (Oct. 17, 1995).

[366] Capital Res. Network, SEC No-Action Letter, 1993 WL 164600 (Apr. 23, 1993); Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644 (Nov. 25, 1985); Heartland Venture Capital Network, SEC No-Action Letter, 1986 WL 65138, at *1 (Mar. 26, 1987) (indicating that the fee need not be a one-time fee; a renewal fee is acceptable).

[367] Capital Res. Network, SEC No-Action Letter, 1993 WL 164600, at *2 (Apr. 23, 1993); Tech. Capital Network, Inc., SEC No-Action Letter, 1992 WL 175694, at *7 (June 5, 1992).

[368] Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094, at *2 (Oct. 25, 1996); Capital Res. Network, SEC No-Action

> information concerning how to complete a transaction.[369]
>
> (5) The network does not handle any funds or securities involved in completing a transaction.[370]

Thomas Hazen reads these no-action letters as allowing the use of "passive" bulletin boards that merely post information about securities as long as two conditions are met: (1) the bulletin boards are not involved in any negotiations regarding investments arising from using of the bulletin board; and (2) the board operator gives no advice "regarding the merits or shortcomings of any particular trade."[371] Thomas Lemke and Gerald Lins add a third condition: the bulletin board operator may not "receive compensation in connection with the purchase or sale of any stock listed on the bulletin board."[372]

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

However, one important distinction between crowdfunding sites and matching services points in the

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Letter, 1993 WL 164600, at *2 (Apr. 23, 1993); Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644 (Nov. 25, 1985).

[369] Venture Capital Res., Inc., SEC No-Action Letter, 1985 WL 55644, at *2 (Nov. 25, 1985).

[370] *Id.*

[371] 7 HAZEN, *supra* note 42, at 30.

[372] LEMKE & LINS, *supra* note 340, at 10.

opposite direction. Matching services, by definition, attempt to match investors with suitable offerings. By making a match, the service is, in effect, "advising" the investor that the particular offering fits the investor's needs. Crowdfunding sites, by contrast, do not typically screen investment opportunities in this way. Investors can see all of the opportunities available on the site, and it is up to the investor to screen them to determine which is appropriate. The element of "advice or "analysis" being provided by the site is thus arguably missing.

The SEC staff has in fact granted no-action relief to several sites that merely posted available opportunities, with no attempt to match investors to those opportunities.[373] However, those sites differed in other important ways from crowdfunding sites. Moreover, only one no-action letter suggests that this distinction is important for the SEC's purposes. In its response to Venture Capital Network, Inc.,[374] the staff indicated that a matching network was issuing analyses or reports concerning securities, and therefore met the criteria to be an "investment adviser," because it "represents that, on the basis of the investors' responses to the questionnaire drawn up by VCN and the information provided by the entrepreneurs in response to questionnaires drawn up by VCN, the information provided by VCN concerns an investment opportunity in a company or companies which satisfy the investors' indicated investment criteria."[375] Crowdfunding sites do not usually pick opportunities for investors or attempt to match them to "appropriate" opportunities. However, given the SEC letter's limited discussion, it is unclear if this distinction from the

[373] *See* Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949, at *4 (Oct. 17, 1995); Investex Investors Exch. Inc., SEC No-Action Letter, 1990 WL 286331, at *2 (Apr. 9, 1990); Petroleum Info. Corp., SEC No-Action Letter, 1989 WL 246625, at *2 (Nov. 28, 1989); Richmond Venture Capital Network, Inc., SEC No-Action Letter, 1989 WL 246296, at *1 (May 12, 1989).

[374] Venture Capital Network, Inc., SEC No-Action Letter, 1984 WL 45334 (May 7, 1984).

[375] *Id.* at *2.

matching services is sufficient to keep crowdfunding sites from being investment advisers.

6. The Publisher Exception

Section 202(a)(11) of the Investment Advisers Act contains several exceptions to the general definition of investment adviser. One of those exceptions, the subsection (D) exception for "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation,"[376] might apply to crowdfunding sites. The exception covers "publications," but it is "clear that the exclusion for publishers is not limited to publications or paper media."[377] It has been applied to web sites,[378] Internet postings,[379] electronic messages,[380] and a private video information network.[381] Consequently, Internet-based crowdfunding sites could potentially use the exception.

The Supreme Court outlined the parameters of the subsection (D) exception in 1985, in *Lowe v. SEC.*[382] According to the Court, in passing the Investment Advisers Act, Congress "was primarily interested in regulating the business of rendering personalized investment advice."[383] Communications that "do not offer individualized advice

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[376] Investment Advisers Act of 1940 § 80b-2(a)(11)(D), 15 U.S.C. § 80b-2(a)(11)(D) (2006).

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

[378] SEC v. Park, 99 F. Supp. 2d 889, 900–02 (N.D. Ill. 2000) (rejecting the application of the subsection (D) exception for other reasons).

[379] *See id.* at 894–96 (rejecting the application of the subsection (D) exception for other reasons).

[380] *See* SEC v. Terry's Tips, Inc., 409 F. Supp. 2d 526, 530–32 (D. Vt. 2006) (holding that the publisher exception applies to non-personalized e-mail, but nevertheless finding the defendants to be investment advisers); Mr. Russell H. Smith, SEC No-Action Letter, 1996 WL 282564, at *2 (May 2, 1996) (noting that a person providing advice through electronic mail could qualify for the publisher exception).

[381] *See* Reuters Info. Servs., SEC No-Action Letter, 1991 WL 176539, at *1–*3 (Jan. 17, 1991).

[382] 472 U.S. 181, 203–11 (1985).

[383] *Id.* at 204.

attuned to any specific portfolio or to any client's particular needs" are not within the purpose of the Act[384] and are at least presumptively within the subsection (D) exclusion.[385] A few lower court cases since *Lowe* have concluded that publications offering non-personalized advice to investors are not investment advisers.[386]

The SEC staff derives three requirements from *Lowe*. The publication must (1) offer only impersonalized advice, i.e., advice not tailored to the individual needs of a specific client or group of clients; (2) be "bona fide" or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and (3) be of general and regular circulation, i.e., not timed to specific market activity or to events affecting or having the ability to affect the securities industry.[387]

Crowdfunding sites clearly do not offer personalized investment advice. Everyone who enters a publicly available crowdfunding site receives exactly the same information. In

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[384] *Id.* at 208. Prior to *Lowe*, courts made no distinction between personal and impersonal investment advice in applying subsection (D). *See* Lani M. Lee, *The Effects of* Lowe *on the Application of the Investment Advisers Act of 1940 to Impersonal Investment Advisory Publications*, 42 BUS. LAW. 507, 507 (1987).

[385] *Lowe* might be interpreted to require that one offer personalized advice to be an investment adviser at all, but the majority opinion clearly indicates that "on its face, the basic definition applies to petitioners." *Lowe*, 472 U.S. at 203–04. Thus, the better reading is that the distinction between personalized and impersonal advice relates to the publisher exception. *See* David B. Levant, *Financial Columnists as Investment Advisers: After* Lowe *and* Carpenter, 74 CAL. L. REV. 2061, 2093 (1986). *See also* SEC v. Park, 99 F. Supp. 2d 889, 894–95 (N.D. Ill. 2000) (holding that publications that do not offer personalized advice could still be investment advisers if the publications are not bona fide).

[386] *See* Compuware Corp. v. Moody's Investors Servs., Inc., 273 F. Supp. 2d 914, 916 (E.D. Mich. 2002); SEC v. Wall St. Publ'g Inst., 664 F. Supp. 554, 555 (D.D.C. 1986).

[387] Nito GmbH, SEC No-Action Letter, 1996 WL 473433, at *1–*2 (Aug. 9, 1996). *See also, e.g.*, Mr. Russell H. Smith, SEC No-Action Letter, 1996 WL 282564, at *2 (May 2, 1996); InTouch Global, LLC, SEC No-Action Letter, 1995 WL 693301, at *2 (Nov. 14, 1995); David Parkinson, Ph.D., SEC No-Action Letter, 1995 WL 619930, at *1 (Oct. 19, 1995).

fact, unlike most of the electronic matching services, most crowdfunding sites do not even attempt to collect information about investors that would allow them to match investors to particular offerings.

Therefore, crowdfunding sites would fall within the publisher exception if they are "bona fide" and "of general and regular circulation."[388] These two requirements, according to *Lowe*, are designed to eliminate "hit and run tipsters" and "touts" from using the exception.[389] In the Court's view, the exception is intended for publications that "contain disinterested commentary and analysis as opposed to promotional material disseminated by a 'tout.'"[390]

Crowdfunding sites are not designed to tout particular stocks or issues; rather, they are open to any entrepreneur who wishes to raise money. Moreover, they are not "personal communications masquerading in the clothing of" general publications.[391] Every investor who logs on receives exactly the same content. However, the materials on crowdfunding sites are not "disinterested commentary"—they are intended to be "promotional." The whole point of the entrepreneurs' postings is to convince people to invest in their businesses, and the crowdfunding sites themselves, which receive transaction-based compensation, have a pecuniary interest in investors following that "advice." This alone may be sufficient to preclude application of the publisher exception.[392]

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[388] *See* Investment Advisers Act of 1940 § 80b-2(a)(11)(D), 15 U.S.C. §80b-2(a)(11)(D) (2006).

[389] *Lowe*, 472 U.S. at 206.

[390] *Id.*

[391] *Id.* at 209.

[392] *See* SEC v. Laurins, No. 89-16708, 1991 WL 57933, at *2 (9th Cir. Apr. 16, 1991) (where the publisher of an investment report had an undisclosed pecuniary interest in the advice contained in the report, the publication was not bona fide, and the publisher therefore was an investment adviser); SEC v. Park, 99 F. Supp. 2d 889, 894 (N.D. Ill. 2000) (publication may not be bona fide, and therefore may not be entitled to the publisher exception, where the defendants were promoting stocks "in which they either had an interest or for which they were being paid to recommend without revealing their interests").

Unfortunately, the case law in this area is somewhat confused. One district court opinion has essentially read the "bona fide" requirement out of the *Lowe* opinion, holding that publications not offering individualized advice were not investment advisers, even though they "do not contain completely disinterested commentary, and do contain promotional material."[393] Another district court held that a magazine was a bona fide publication that fit within the exception, even though much of the magazine's content was provided by featured companies and their public relations agents.[394]

To fall within the publisher exception, crowdfunding sites must also be of general and regular circulation. Web sites are, by definition, continually published, and crowdfunding sites are open to the general public. But the Supreme Court indicated in *Lowe* that a publication is not regular if its publication is "timed to specific market activity, or to events affecting or having the ability to affect the securities industry."[395] It is not clear exactly what this means in the context of a web site. Although crowdfunding sites are continually available, they are changed each time an entrepreneur posts a new fundraising request. Thus, in a sense, each "new edition" of the site is timed to specific market activity—a new securities offering by an entrepreneur. The SEC might seize on this to argue that crowdfunding sites are timed to specific market activity, and therefore do not qualify for the exception.

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

[394] *See* SEC v. Wall St. Publ'g Inst., Inc., 664 F. Supp. 554, 555 (D.D.C. 1986), *rev'd on other grounds*, 851 F.2d 365 (D.C. Cir. 1988). The magazine is described in an earlier opinion, *SEC v. Wall Street Publishing Institute*, 591 F. Supp. 1070, 1075–77 (D.D.C. 1984), *stayed*, No. 84-5485, 1984 WL 21133, at *1 (D.C. Cir. Aug. 10, 1984).

[395] *Lowe*, 472 U.S. at 209.

V. PROPOSALS TO EXEMPT CROWDFUNDING

As crowdfunding has grown, proponents of crowdfunding have, not surprisingly, turned their attention to federal securities law and the possibility of selling securities through crowdfunding. The result has been several proposals to exempt crowdfunding from Securities Act registration. Even the White House has endorsed a crowdfunding exemption.

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

The SEC, under pressure from Congress, had agreed to look at crowdfunding even before the White House announcement. But the White House endorsement definitely raises the ante and makes it more likely that the SEC will at least consider rule-making. However, Congress may not wait for SEC action. Three bills have been introduced that would create statutory crowdfunding exemptions, and one of those bills has passed in the House.

A. The Sustainable Economies Law Center Petition

The first exemption proposal came in 2010. The Sustainable Economies Law Center petitioned the SEC to exempt offerings of up to $100,000, provided that no single investor contributed more than $100.[396] The proposed exemption includes additional limitations: (1) the offerors must be individual U.S residents, not entities;[397] (2) each offeror may make only one offering at a time; and (3) all

[396] Sustainable Economies Law Ctr., Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration, SEC File No. 4-605, at 2 (July 1, 2010), *available at* http://www.sec.gov/rules/petitions/2010/petn4-605.pdf.

[397] *Id.* at 7. The Center argues that allowing only individuals, and not companies, to use the exemption would limit fraud because the identity of each offeror could be verified and no one could "hide behind a corporate shell."

offering materials and communications must include a disclaimer "stating the possibility of total loss of the investment, and the necessity of careful evaluation of each offeror's trustworthiness."[398] The petition itself is an illustration of the power of crowdfunding: it was funded by a campaign on the crowdfunding web site IndieGoGo.[399]

The SEC dutifully logged the petition[400] and began accepting comments. Aided by a mention on the blog BoingBoing,[401] the petition has generated dozens of individual comments, almost all supportive, plus almost one hundred form comments.[402] The petition even has its own website.[403] Moreover, the final report of the 2010 SEC Government-Business Forum on Small Business Capital Formation recommended a similar exemption, although the

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[398] *Id.*

[399] *See* LAWTON & MAROM, *supra* note 2, at 187–88; *Crowdfunding Campaign to Change Crowdfunding Law*, INDIEGOGO, http://www.indiegogo.com/Change-Crowdfunding-Law (last visited Mar. 5, 2012).

[400] *See* Request for Rulemaking to Exempt Securities Offerings Up to $100,000 With $100 Maximum Per Investor From Registration, SEC, File No. 4-605, *available at* http://www.sec.gov/rules/petitions/2010/petn4-605.pdf.

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

[402] *See* Comments on Rulemaking Petition: Request for Rulemaking to Exempt Securities Offerings up to $100 from Registration Under Section 5 of the Securities Act of 1933, SEC, File No. 4-605, *available at* http://www.sec.gov/comments/4-605/4-605.shtml. Some of those comments proposed raising the maximum offering amount and the maximum individual investment. *See, e.g.*, the comments of Michael Sauvante (Nov. 9, 2010); James J. Angel (Sept. 21, 2010); Andres La Saga (Aug. 24, 2010), Comments on Rulemaking Petition: Request for Rulemaking to Exempt Securities Offerings up to $100 from Registration Under Section 5 of the Securities Act of 1933, SEC, File No. 4-605, *available at* http://www.sec.gov/comments/4-605/4-605.shtml. *See also* Pope, *supra* note 99, at 997 (discussing the SELC proposal and arguing that the per-investor cap should be increased to $1,000 and the aggregate offering limit should be increased to $250,000).

[403] *See Change Crowdfunding Law*, CROWDFUNDINGLAW.COM http://crowdfundinglaw.com/ (last visited Mar. 5, 2012).

recommendation does not specifically name the Center as its source.[404]

B. The Small Business & Entrepreneurship Council Proposal

Near the end of 2010, the Small Business & Entrepreneurship Council proposed a similar exemption.[405] The Council's exemption was also included in, but not directly endorsed by, the final report of the 2010 SEC Forum.[406]

The maximum offering amount under the Council's proposal would be $1 million, and the maximum for any individual investor would be either $10,000 or 10% of the person's "stated income" for the prior year.[407] Offerings could be made on SEC-approved web sites.[408] To participate in such an offering, an investor would be required to take an online test, but if the Council's single proposed question for this test is representative, the test would be more of an interactive disclaimer than a test of investment sophistication. The question asks whether investors understand that all of their capital is at risk.[409] The Council's proposed exemption would not completely free issuers from SEC disclosure requirements. Issuers would

[404] 2010 ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT 21 (2011), *available at* http://www.sec.gov/info/smallbus/gbfor29.pdf (recommending that the SEC "exempt from 1933 Act registration aggregate offerings of up to $100,000, where each individual may invest no more than a certain maximum amount, say $100 per individual").

[405] *See* SBE Council Proposal, *supra* note 247.

[406] *See* 2010 ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, *supra* note 404, at 29–30.

[407] SBE Council Proposal, *supra* note 247, at 4. It is not clear from the proposal exactly what "stated income" means or whether the individual limit is supposed to select the greater or the lesser of the two amounts.

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

[409] *See id.*

have to provide disclosure on something similar to the Small Company Offering Registration ("SCOR") form used by the states.[410]

C. The Startup Exemption Proposal

Entrepreneur Sherwood Neiss[411] has created an online petition in favor of another crowdfunding exemption.[412] The petition calls for a $1 million exemption, available only to businesses with annual gross revenues of less than $5 million during the prior three years.[413] All investors would have "to complete a questionnaire to determine their aptitude to participate . . . and answer a series of disclosures" to demonstrate that they have sufficient knowledge and experience to invest.[414] Unaccredited investors would not be able to invest more than $10,000.[415] The platforms hosting these offerings would be required to register with the SEC but would not need a broker's license.[416] Offerings pursuant to the exemption would also be exempted from state registration requirements but would have to file a notice with the states.[417]

D. The White House Endorsement

On September 8, 2011, the White House released a "Fact Sheet and Overview" detailing President Obama's proposed

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[410] *See id.* at 4. *See also SCOR Forms,* NASAA, http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/ (last visited Mar. 5, 2012).

[411] *See About Us,* STARTUP EXEMPTION, http://www.startupexemption.com/about-us#axzz1idaRGVy9 (last visited Mar. 5, 2012).

[412] *See* STARTUP EXEMPTION, http://www.startupexemption.com (last visited Mar. 5, 2012).

[413] *See Exemption Framework* ¶ 1, STARTUP EXEMPTION, http://www.startupexemption.com/exemption-framework#axzz1idaRGVy9 (last visited Mar. 5, 2012).

[414] *Id.* ¶ 3.

[415] *Id.* ¶ 2.

[416] *Id.* ¶¶ 6, 8. It is unclear exactly what requirements this registration would entail.

[417] *Id.* ¶ 5.

job-creating measures.[418] Buried in that ten-page document is a single sentence about crowdfunding: "The administration also supports establishing a 'crowdfunding' exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to $10,000 or 10% of investors' annual income) . . . ."[419] The release provides no further details. The proposed offering and individual investment limits match those in the Small Business & Entrepreneurship Council proposal, but the release neither acknowledges that proposal nor indicates whether the President supports the other requirements in that proposal.

E. SEC Activity

The SEC has not yet proposed a crowdfunding exemption or officially responded to any of the exemption proposals detailed above. It has, however, agreed to consider some kind of special treatment for crowdfunding. On March 22, 2011, Congressman Darrell Issa, Chairman of the House Committee on Oversight and Government Reform, sent a seventeen-page letter to Mary Schapiro, Chairman of the SEC, criticizing the SEC's treatment of private capital formation and posing numerous questions about regulation of the capital formation process.[420] Congressman Issa's letter specifically asked whether the SEC had considered creating exemptions for crowdfunding.[421]

Chairman Schapiro responded to Congressman Issa on April 6, 2011.[422] In her letter, she informed him that she was

[418] Fact Sheet and Overview for AJA, *supra* note 7.

[419] *Id.* at 2.

[420] Letter from Darrell E. Issa, Chairman, House Comm. on Oversight & Gov't Reform, to Mary L. Schapiro, Chairman, SEC (Mar. 22, 2011), *available at* www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf [hereinafter Issa Letter].

[421] *Id.* at 11.

[422] Letter from Mary L. Schapiro, Chairman, SEC, to Darrell E. Issa, Chairman, House Comm. on Oversight & Gov't Reform (Apr. 6, 2011), *available at* www.sec.gov/news/press/schapiro-issa-letter-040611.pdf [hereinafter Schapiro Letter].

creating a new Advisory Committee on Small and Emerging Companies and that the SEC staff was "taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation."[423] She noted the Sustainable Economies Law Center proposal for a crowdfunding exemption,[424] said that the SEC staff had been discussing crowdfunding,[425] and promised a staff review of "the impact of our regulations on capital formation for small businesses," specifically including "the regulatory questions posed by new capital raising strategies."[426]

This promise, made prior to President Obama's endorsement, should not have caused undue optimism among crowdfunding's supporters. The SEC often pays lip service to small business needs, but it seldom acts on those concerns.[427] The annual forum it holds on small business issues has produced "repeated and strongly-worded recommendations from small business advocates to lessen the SEC's regulatory burdens on raising capital . . . [, but] with rare exception, the SEC has turned a deaf ear to the Forum's recommendations and concerns."[428] However, President Obama's subsequent endorsement may make a crowdfunding exemption more likely. At the House subcommittee hearing, Meredith Cross, director of the SEC's Division of Corporation Finance, indicated that she expects the SEC to consider crowdfunding in the near future.[429]

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[423] *Id.* at 1.

[424] *Id.* at 22 n.77.

[425] *Id.* at 22–23.

[426] *Id.* at 24.

[427] *See* Cohn & Yadley, *supra* note 11, at 64 ("Despite the SEC profession of interest in small business, there has been a great deal more smoke than fire.").

[428] *Id.* at 3–4.

[429] Yin Wilczek, *SEC Under Pressure to Allow Crowdfunding; Agency to Consider Issue Soon, Official Says*, 43 SEC. REG. & L. REP. (BNA) 1872 (Sept. 19, 2011).

F. The SEC's Authority to Exempt Crowdfunding

The SEC clearly has the authority to exempt crowdfunding from the registration requirements of the Securities Act and to exempt crowdfunding web sites from registration as brokers or investment advisers. Two separate provisions of the Securities Act are possible sources of authority for the SEC to exempt crowdfunding from the Act's registration requirements. Section 3(b) of the Securities Act[430] authorizes the SEC to exempt offerings of less than a specified dollar amount, currently $5 million.[431] To authorize a Section 3(b) exemption, the SEC must find that "enforcement . . . with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[432] The SEC has used its Section 3(b) authority rather extensively: Rules 504 and 505 of Regulation D are both Section 3(b) exemptions,[433] as is Regulation A.[434]

The SEC's authority under Section 28 of the Securities Act is even more extensive, authorizing the SEC to exempt "any person, security, or transaction, or any class or classes of persons, securities, or transactions," from any provision of the Act or associated rules.[435] Unlike Section 3(b), Section 28

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[430] Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (2010).

[431] The Sustainable Economies Law Center petition points to Section 3(b) as a potential source of authority. *See* Request for Rulemaking to Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration, *supra* note 400, at 8–9. The Center also argued that its proposed exemption could be a safe harbor for Section 4(2) of the Securities Act. *See id.* at 9. *But cf. supra* Part III.B.2.a (suggesting that it is doubtful that the Center's proposed exemption could be a safe harbor for Section 4(2) given how the section has been interpreted).

[432] Request for Rulemaking to Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration, *supra* note 400, at 8–9.

[433] *See* Securities Act Rules 504(a) and 505(a), 17 C.F.R. §§ 230.504(a), 230.505(a) (2012).

[434] *See* 17 C.F.R. § 230.251.

[435] 15 U.S.C. § 77z-3.

does not limit the dollar amount of exempted offerings. To use its Section 28 exemption authority, the SEC must find that the "exemption is necessary or appropriate in the public interest and is consistent with the protection of investors."[436]

The SEC has similar authority to exempt those who would otherwise be regulated as brokers under the Exchange Act or regulated as investment advisers under the Investment Advisers Act. Section 36(a) of the Exchange Act authorizes the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions" from any provisions of the Act.[437] To adopt such an exemption, the SEC would have to find that it "is necessary or appropriate in the public interest, and . . . consistent with the protection of investors."[438] Section 202(a)(11) of the Investment Advisers Act, which defines "investment adviser," authorizes the SEC to exclude "other persons not within the intent of [the definition]."[439] More broadly, Section 206A of the Advisers Act authorizes the SEC to "conditionally or unconditionally exempt any person or transaction, or any class or classes of persons, or transactions," provided that the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this [Act]."[440]

G. The Congressional Response

Congress may not give the SEC an opportunity to develop a crowdfunding exemption. The House has passed a crowdfunding bill, and a similar bill has been introduced in

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[436] *Id.*

[437] Securities Exchange Act of 1934 § 36(a), 15 U.S.C. § 78mm(a) (2010). The exception to the SEC's authority involving government securities and government securities brokers is provided at 15 U.S.C. § 78mm(b). This exception would not apply to crowdfunding.

[438] 15 U.S.C. § 78mm(a).

[439] Investment Advisers Act of 1940 § 202(a)(11)(G), 15 U.S.C. § 80b-2(a)(11)(G) (2006).

[440] 15 U.S.C. § 80b-6a.

the Senate. Thus, it is possible that there will soon be a statutory crowdfunding exemption.

1. House Bill 2930

On November 3, 2011, the House passed House Bill 2930, the Entrepreneur Access to Capital Act, introduced by Congressman Patrick McHenry.[441] The bipartisan 407–17 vote came shortly after the Obama administration released a statement supporting the bill.[442] The bill, which would add to the Securities Act a new statutory exemption for crowdfunding, incorporates many of the policy recommendations made in this article.[443]

House Bill 2930 allows sales of securities either directly by the issuer or through intermediaries.[444] Intermediaries who meet the requirements of the exemption are protected from treatment as brokers under the Exchange Act.[445]

The maximum offering amount allowed by the bill is $1 million, or $2 million if the issuer provides investors with audited financial statements.[446] The aggregate amount sold to any investor in a twelve month period may not exceed the lesser of $10,000 or 10% of the investor's annual income.[447]

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[441] *See* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011).

[442] *See* Executive Office of the President, Statement of Administration Policy (Nov. 2, 2011), *available at* www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr2930r_20111102.pdf ("The Administration supports House passage of H.R. 2930.").

[443] A draft of this article was publicly available on the Social Science Research Network long before any of these bills was introduced. The author had an extensive discussion with a member of Congressman McHenry's legislative staff after Congressman McHenry first introduced his bill. The original bill was rather spartan; the bill that passed the House added many of the provisions recommended in this article. However, the author was not directly involved in drafting the bill.

[444] H.R. 2930 § 2. Certain issuers are disqualified from using the exemption. *See id.* § 2(d).

[445] *Id.* § 2(b).

[446] *Id.* § 2(a). These limits are for a twelve month period.

[447] *Id.*

However, the issuer and any intermediary may rely on investors' self-certifications of income.[448]

Investors who purchase crowdfunded securities generally may not resell them for one year, except in limited circumstances.[449] In addition, those investors are not counted as record shareholders for purposes of Exchange Act registration requirements.[450]

House Bill 2930 includes a number of disclosure-related provisions. To qualify for the exemption, issuers (or intermediaries if the issuer is selling through an intermediary) must[451]:

> (1) warn investors about the speculative nature of the securities, the risk of illiquidity, and the restriction on resale;
>
> (2) require investors to answer questions demonstrating an understanding of the risk, including the risk of illiquidity, and any other matters that the SEC adds by rule;
>
> (3) provide the SEC with limited information about the intermediary, if one is used;
>
> (4) provide the SEC and potential investors with information about the issuer, its principals, the purpose of the offering, the target offering amount, and the deadline for reaching that amount;[452] and
>
> (5) when the offering is completed, provide the SEC with a notice of the aggregate offering amount and the number of purchasers.

If the offering is being made directly by the issuer, the issuer must also disclose its interest in the offering.[453] If an intermediary is used, the intermediary must do a

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[448] *Id.* § 2(b).

[449] *Id.*

[450] *Id.* § 3.

[451] *See id.* § 2(b).

[452] Issuers may not draw on the pledged funds until investors have pledged at least 60% of the target amount. *Id.* § 2(b).

[453] *Id.*

background check on the issuer's principals.[454] The issuer or the intermediary must also take "reasonable measures to reduce the risk of fraud with respect to such transaction," although the bill provides no guidance as to what this requires.[455]

The bill also includes several structural requirements. Investors and issuers must be able to communicate with each other on the web site used for the offering.[456] The SEC must be granted investor-level access to the site.[457] Cash-management functions must be outsourced to a third-party custodian, such as a registered broker-dealer or an insured depository institution.[458] The issuer or intermediary (depending on whether it is a direct or intermediated offering) must maintain such books and records as the SEC deems appropriate.[459] Finally, neither the issuer nor the intermediary may offer investment advice.[460]

House Bill 2930 preempts state offering registration requirements, but otherwise leaves state authority intact.[461] In addition, the SEC must make the information it receives pursuant to the exemption available to state securities administrators.[462]

2. Senate Bill 1791

On November 2, 2011, Senator Scott Brown introduced Senate Bill 1791, the Democratizing Access to Capital Act of 2011.[463] Senator Brown's bill, like House Bill 2930,

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[454] *Id.*

[455] *Id.*

[456] *Id.*

[457] *Id.*

[458] *Id.*

[459] *Id.*

[460] *Id.*

[461] *Id.* § 4.

[462] *Id.* § 2.

[463] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (2011).

incorporates several of this article's policy recommendations.[464]

Senate Bill 1791, unlike House Bill 2930, would allow offerings to be conducted only through a crowdfunding intermediary.[465] The annual offering amount would be capped at $1 million, with individual investments limited to $1,000 or less.[466] To qualify for the exemption, issuers would have to file such notice with the SEC as it shall require and "disclose to investors all rights of investors, including complete information about the risks, obligations, benefits, history, and costs of offering."[467] As in House Bill 2930, resale of crowdfunded securities would be restricted for one year,[468] and crowdfunded securities-holders would not count as record shareholders for purposes of Section 12(g) of the Exchange Act.[469]

Most of the conditions in Senate Bill 1791 are imposed on crowdfunding intermediaries as requirements to obtain an exemption from regulation as brokers.[470] Some of the disclosure-related requirements[471] mirror those in House Bill 2930. The intermediary must:

> (1) warn investors about the investments' speculative nature, the problem of illiquidity, and the one-year restriction on resale;
>
> (2) require every potential investor to answer questions demonstrating competency as to the level

[464] *Id.* § 2. The author had no direct contact with anyone on Senator Brown's staff prior to the introduction of his bill, and the author was not involved in its drafting. The author has, however, had discussions with several other Senate staff members.

[465] *Id.* As in H.R. 2930, certain issuers would be disqualified from using the exemption under disqualification provisions to be determined from the SEC. *Id.*

[466] *Id.*

[467] *Id.*

[468] *Id.*

[469] *Id.* § 3.

[470] *Id.* § 7.

[471] *See id.* § 6.

> of risk, the risk of illiquidity, and other areas as determined by the SEC;
>
> (3) provide information to the SEC about the intermediary and its employees; and
>
> (4) provide a notice to the SEC that includes information about the issuer, its principals, the purpose of the offering, the intended use of proceeds, and the target offering amount.

In addition, as in House Bill 2930, the intermediary must do a background check on the issuer's principals and take "reasonable measures to reduce the risk of fraud."[472]

Senate Bill 1791 also imposes various structural requirements on crowdfunding intermediaries. They must[473]:

> (1) be open to the public and provide investor-level access to the SEC;
>
> (2) provide public communication portals for investors and potential investors;
>
> (3) prohibit their employees from investing in the offerings or having any financial interest in issuers posting offerings;
>
> (4) refrain from offering investment advice or recommendations;
>
> (5) require the issuer to state a target offering amount and withhold funds from the issuer until at least 60% of that target amount has been raised;
>
> (6) outsource cash-management functions to a third-party custodian, such as a broker or an insured depository institution;
>
> (7) maintain such books and records as the SEC requires; and
>
> (8) provide a complaint-resolution mechanism for investors.

[472] *Id.* § 6.

[473] *Id.*

Senate Bill 1791 would preempt state offering registration requirements.[474] However, the issuer's state of organization and any state in which the purchasers of 50% or more of the offering amount reside could still collect fees and require that any documents filed with the SEC also be filed with the state securities commission.[475]

3. Senate Bill 1970

On December 8, 2011, Senator Jeff Merkley introduced Senate Bill 1970, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011.[476] Senator Merkley's bill also incorporates several of the policy recommendations made in this article.[477]

Senate Bill 1970 requires that the securities be sold through a broker or an intermediary that meets specific criteria.[478] The bill makes it very difficult for a non-broker to facilitate crowdfunding. Non-broker intermediaries must register with the SEC as "funding portals,"[479] and are subject to regulation by the SEC.[480] These funding portals may not solicit purchases or sales and may not handle investor funds or securities.[481] They also may not compensate employees or third parties for solicitation or based on the sale of securities on the site.[482] Finally, funding portals may not offer investment advice or recommendations to investors.[483]

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[474] *Id.* § 4.

[475] *Id.* § 6.

[476] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. (2011).

[477] The author had an extensive discussion with members of Senator Merkley's staff prior to the introduction of Senator Merkley's bill. However, the author was not directly involved in drafting the bill.

[478] S. 1970 § 2.

[479] *Id.*

[480] *Id.* § 4.

[481] *Id.*

[482] *Id.*

[483] *Id.*

Senate Bill 1970 caps the annual offering amount at $1 million,[484] and also includes investor limits, but the investor limits are more complicated than in the other bills. For a single offering, the limit is the greater of $500 or an amount that depends on the investor's annual income.[485] If the investor's annual income is between $50,000 and $100,000, the limit is 1% of income.[486] If the investor's annual income is more than $100,000, the limit is 2% of income.[487] The bill provides no alternative limit for investors whose income is $50,000 or less, so presumably their investment limit is the $500 alternative.

These limits are for a twelve-month period for a single issuer.[488] The bill also includes cumulative annual limits for all crowdfunded offerings in which a given investor participates.[489] Crowdfunding intermediaries are required to take such steps as the SEC deems appropriate to verify that no investor has purchased securities from all crowdfunding issuers that exceed the greater of $2,000 or an income-based limit, in any twelve-month period.[490] The income limit would be 4% of income for those investors in the $50,000–$100,000 range and 8% of income for those with incomes greater than $100,000.[491]

Senate Bill 1970 does not allow issuers to advertise their offerings, except to direct people to the intermediary,[492] and also imposes fairly substantial filing and disclosure requirements on issuers. Crowdfunding issuers must file with the SEC, and must provide to investors and potential investors, among other information[493]:

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[484] *Id.* § 2.
[485] *Id.*
[486] *Id.*
[487] *Id.*
[488] *Id.*
[489] *Id.*
[490] *Id.*
[491] *Id.*
[492] *Id.*
[493] *Id.*

> (1) the names of the issuer's officers and directors, and of persons owning more than 20% of the issuer's shares;
>
> (2) a description of the business of the issuer and its anticipated business plan;
>
> (3) financial statements reviewed by an independent public accountant, and audited for offerings of more than $500,000;
>
> (4) a description of the purpose of the offering and the intended use of the proceeds; and
>
> (5) "a description of the ownership and capital structure of the issuer, how the securities being offered are being valued, what the rights of the securities are, and how rights may be exercised by the issuer and shareholders."[494]

Issuers must also provide investors and the SEC with regular updates about the issuer's progress toward meeting the target offering amount, as well as quarterly reports on operations and financial statements.[495]

Crowdfunding intermediaries, including brokers, must also meet certain disclosure-related requirements. Intermediaries must provide SEC-required disclosures and investor education materials and must "ensure" that each investor (1) reviews those materials; (2) "positively affirms" her understanding that her entire investment is at risk and that she could bear such a loss; and (3) answers questions demonstrating an understanding of the risk, including the risk of illiquidity, and such other matters as the SEC deems appropriate.[496] In addition, at least one month prior to any offering, the intermediary must provide, in writing, to both the SEC and investors, any information that has been provided by the issuer pursuant to the issuer's filing requirements.[497] Intermediaries are also required to take

[494] *Id.*
[495] *Id.*
[496] *Id.*
[497] *Id.*

such measures as the SEC requires to reduce the risk of fraud, including criminal background checks and securities enforcement regulatory checks on the issuer's officers and directors, and on holders of more than 20% of the issuer's shares.[498]

Senate Bill 1970 includes a number of other structural restrictions on intermediaries. Intermediaries may not allow issuers to draw on offering funds until the capital contributed by investors is equal to the target offering amount, and must allow investors to cancel their commitments to invest under rules to be adopted by the SEC.[499] The directors, officers, partners, and employees of an intermediary may not have a financial interest in any of the issuers using the intermediary.[500] The intermediary may not compensate promoters, finders, or others for finding potential investors.[501] Finally, intermediaries must take steps to protect investors' privacy, as mandated by SEC rules.[502]

Senate Bill 1970 adds a miscellany of other conditions. Certain issuers, brokers, and other intermediaries are disqualified from using the exemption.[503] Resales are restricted for two years, with certain exceptions.[504] The SEC is allowed, but not required, to exclude crowdfunding investors from the calculation of record shareholders for purposes of Section 12(g) of the Exchange Act.[505] Senate Bill 1970 also requires the SEC to periodically review the exemption's effects on investor protection.[506] Furthermore, the bill adds a special liability provision making

[498] *Id.*
[499] *Id.*
[500] *Id.*
[501] *Id.*
[502] *Id.*
[503] *Id.*
[504] *Id.*
[505] *Id.*
[506] *Id.* § 5.

crowdfunding issuers and their officers and directors liable for materially false and misleading statements.[507]

Unlike the other bills, Senate Bill 1970 does not preempt state securities law. It does, however, require that the SEC make the information it receives pursuant to the exemption available to state securities regulators.[508]

VI. THE COSTS AND BENEFITS OF A CROWDFUNDING EXEMPTION

A crowdfunding exemption, like any securities law exemption, requires a complicated balancing of two sometimes conflicting goals: investor protection and capital formation.[509] The SEC has long seen its mission as "investor protection in the sense of remedying information asymmetries and rooting out fraud,"[510] but all of the SEC's foundational statutes require it to consider, "in addition to the protection of investors, whether the . . . [SEC's] action will promote efficiency, competition, and capital formation."[511] Balancing those competing interests is "a fundamental challenge of securities regulation,"[512] and the

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[507] *Id.* § 2.

[508] *Id.*

[509] *See generally* C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591 (1996) [hereinafter Bradford, *Transaction Exemptions*] (discussing the costs and benefits of registration and the justifications for exemptions from the registration requirement).

[510] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1005 (2006). *See also* Stephen Choi, *Regulating Investors, Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 280 (2000) ("Securities regulation in the United States revolves around investor protection.").

[511] Investment Advisers Act of 1940 § 203(c), 15 U.S.C. § 80b-2(c) (2010); Investment Company Act of 1940 § 2(c), 15 U.S.C. § 80a-2(c) (2010);. Securities Act of 1933 § 2(b), 15 U.S.C. § 77(b) (2010); Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (2010).

[512] Paredes, *supra* note 510, at 1005.

SEC usually tilts the balance in favor of investor protection.[513]

A crowdfunding exemption would undoubtedly facilitate capital formation. Very small businesses, particularly startups, have an unmet need for capital that securities crowdfunding would help to meet.

The investor-protection consequences of a crowdfunding exemption, however, are less clear. Small business investments are inherently risky, posing not only greater risks of business failure, but also of fraud and overreaching by controlling entrepreneurs. A crowdfunding exemption would expose members of the general public to those risks without ensuring that they have the financial sophistication necessary to deal with them. The structure of crowdfunding might, to some extent, ameliorate those risks, but investors would still face a significant chance of loss.

But this risk of loss is inherent in small business startups. The only way to completely eliminate it would be to bar small business financing altogether. Crowdfunding exemption proposals are structured so that losses to any single investor would be relatively small and bearable. Moreover, the public is already contributing billions of dollars to non-securities crowdfunding, and those crowdfunding investments are subject to the same risks as securities crowdfunding. A securities crowdfunding exemption would, therefore, not open investors to new risks, but merely allow entrepreneurs to offer a higher return to offset those risks. The net effect on investors could, therefore, be positive.

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[513] *Id.* at 1006. According to Paredes, now himself an SEC commissioner, securities regulators "have an exaggerated concern over fraud and investor losses and, at least by comparison, a dulled sensitivity to the costs of greater investor protection." *Id.* at 1009. Recently, several of the SEC's rules have been overturned because of the Commission's failure to adequately consider the cost of the rules. *See* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

A. Capital Formation: The Need for a Crowdfunding Exemption

Small businesses face a capital funding gap.[514] Some estimates indicate that the financial markets fall $60 billion short each year "in meeting the demand of small companies for early-stage private equity financing."[515] Equity capital is "widely viewed as less accessible and more costly per dollar raised for small businesses compared with large businesses."[516] Finding funding is particularly difficult for businesses seeking to raise funds in the $100,000 to $5 million range.[517] Many entrepreneurs with promising projects may go unfunded as a result, costing the United States an unknown number of jobs and innovations.[518] Early-stage entrepreneurial activity in the United States is steadily declining, and the United States has lost its lead over other innovation-driven economies.[519]

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[514] *See* Cable, *supra* note 254, at 108; Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 59–64 (1998); Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (2008).

[515] Sjostrom, *supra* note 198, at 3.

[516] GAO Report, *supra* note 200, at 2. *See also* Fisch, *supra* note 514, at 63 (small business funding "is often viewed as inadequate"); Sjostrom, *supra* note 198, at 586 (financing options available to small companies "are generally viewed as inadequate").

[517] Ibrahim, *supra* note 514, at 1417 (amounts above $100,000); GAO Report, *supra* note 200, at 12–13 ($250,000–$5 million); Cable, *supra* note 254, at 108 ($500,000–$5 million).

[518] Curtis J. Milhaupt, *The Small Firm Financing Problem: Private Information and Public Policy*, 2 J. SMALL & EMERGING BUS. L. 177, 178 (1998); Sjostrom, *supra* note 198, at 3.

[519] Abdul Ali et al., *2009 National Entrepreneurial Assessment for the United States of America: Executive Report*, GLOBAL ENTREPRENEURSHIP MONITOR, 2009, at 1, 7, http://www.gemconsortium.org/docs/download/666 [hereinafter National Entrepreneurial Assessment]. The amount of total early-stage entrepreneurial activity in the United States dropped from 10.6% in 2005 to 6.9% in 2009. *Id.* at 7. Nascent entrepreneurial activity declined from 8.7% of the U.S. population in 2005 to 4.9% in 2009. *Id.* at 33.

The small business financing problem has at least two causes. The first cause is informational inefficiency—a failure to match potential sources of capital with potential investment opportunities.[520] Even if money is available, it will not be utilized if the entrepreneur who needs it fails to connect with the investors who have it. Not surprisingly, investments by the major sources of small business capital tend to be concentrated in certain geographical areas, such as Silicon Valley.[521] Crowdfunding allows an entrepreneur to publish her request for funding to the entire world, "mak[ing] it . . . easier to harness spare capital and route it to those who need it most."[522]

The second element of the capital gap is the unavailability of traditional sources of small business financing—bank lending, venture capitalists, and angel investors—to most startups and other very small businesses. Entrepreneurs typically begin new ventures using personal funds, including savings, credit card debt, second mortgages, and money from friends and family.[523] Some entrepreneurs might raise $100,000, or even $500,000, from those personal sources,[524] but many entrepreneurs with good ideas, particularly those who are not in the upper and middle classes, have very little access to funds.

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[520] Sjostrom, *supra* note 198, at 3–4.

[521] *See* GAO Report, *supra* note 200, at 3 (venture capitalists); SIMON C. PARKER, THE ECONOMICS OF ENTREPRENEURSHIP 249–50 (2009) (angel investors).

[522] HOWE, *supra* note 1, at 248. A study of Dutch crowdfunding site Sellaband found that only 13.5% of successful crowdfunders' capital came from investors within fifty kilometers of the entrepreneur. Almost 40% of the amounts received came from investors more than 3,000 kilometers away. Ajay Agrawal, Christian Catalini & Avi Goldfarb, *The Geography of Crowdfunding* 22 tbl. 2a (NET Institute Working Paper No. 10-08, 2011), *available at* http://ssrn.com/abstract=1692661.

[523] Fisch, *supra* note 514, at 60; National Entrepreneurial Assessment, *supra* note 519, at 8; Sjostrom, *supra* note 198, at 5. *See also* PARKER, *supra* note 521, at 250 ("Families are the most commonly used source of business loans in the USA after banks and other financial institutions.").

[524] *See* Cable, *supra* note 254, at 108; Ibrahim, *supra* note 514, at 1417.

Furthermore, when those personal resources are exhausted, funding is difficult to find. Other common sources of business financing are not available to small startups. Bank loans are one possible source of capital, but most small startups do not have the collateral, the cash flow, or the operating history to qualify for bank loans in the amount needed.[525]

Venture capital funds are another possible source of funding,[526] but venture capitalists tend to focus on companies that have passed the initial startup phase and are seeking to grow further.[527] Less than a quarter of venture capital investments are for early-stage funding.[528] Venture capital funding is also not available in the relatively small amounts that new companies need,[529] and the problem is worsening as the average minimum amount invested by venture capital funds increases.[530] A typical venture capital investment averages between $2 million and $10 million.[531] Venture capitalists sometimes provide smaller amounts,[532] but high transaction costs usually make smaller investments impractical.[533] These investments also tend to focus on specific industries[534] and on firms with potential for rapid

[525] *See* Cable, *supra* note 254, at 121; George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L. Q. 1029, 1032 (1992); Fisch, *supra* note 514, at 60; Sjostrom, *supra* note 198, at 5.

[526] For a good, short introduction to the venture capital industry, see Cable, *supra* note 254, at 112–15.

[527] Fisch, *supra* note 514, at 62; Ibrahim, *supra* note 514, at 1416.

[528] GAO Report, *supra* note 200, at 21.

[529] *See id.* at 3. *See also* Cohn & Yadley, *supra* note 11, at 80–81; Ibrahim, *supra* note 514, at 1416.

[530] GAO Report, *supra* note 200, at 13. One source claims that the total amount of venture capital funding has also declined recently, from $106 billion in 2000 to $40 billion in 2001 and $30.5 billion in 2007. PARKER, *supra* note 521, at 238.

[531] Ibrahim, *supra* note 514, at 1416.

[532] *See* GAO Report, *supra* note 200, at 11 (amounts ranging from $250,000 to $5 million).

[533] Dent, *supra* note 525, at 1080.

[534] GAO Report, *supra* note 200, at 3.

growth.[535] Furthermore, venture capitalists are extremely selective, rejecting 99% of the business plans submitted to them.[536]

So-called "angel investors," wealthy individuals with substantial business and entrepreneurial experience,[537] are the other major possibility for initial funding. Angel investors often invest on a smaller scale than venture capital firms,[538] and they are usually more willing to invest in startup companies.[539] A typical financing round for an angel investor ranges from $100,000 to $2 million.[540] Some angel investors may be willing to provide as little as $25,000,[541] but one source indicates that the minimum deal size for most angel investors in the United States is about $1 million.[542] Also, like venture capitalists, angel investors generally look for "high-growth, high-return investment opportunities,"[543] so many small companies would not qualify. Angel investors by themselves are not currently filling the small business funding gap.[544]

Crowdfunding makes new sources of capital available to small businesses.[545] It opens business investment to smaller

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[535] Fisch, *supra* note 514, at 62; GAO Report, *supra* note 200, at 10.

[536] Fisch, *supra* note 514, at 20; GAO Report, *supra* note 200, at 20.

[537] Sjostrom, *supra* note 198, at 5.

[538] Cable, *supra* note 254, at 115; Fisch, *supra* note 514, at 62.

[539] GAO Report, *supra* note 200, at 10; Ibrahim, *supra* note 514, at 1406. According to Amatucci and Sohl, the percentage of angel deals involving the seed and startup stages of business was 45% in 2004, 52% in 2003, and 50% in 2002. F. M. Amatucci & J. E. Sohl, *Business Angels: Investment Processes, Outcomes and Current Trends, in* A. ZACHARAKIS & S. SPINELLI, JR., 2 ENTREPRENEURSHIP: THE ENGINE OF GROWTH 87, 88 (2007).

[540] Ibrahim, *supra* note 514, at 1418; Sjostrom, *supra* note 198, at 6. *See also* Amatucci & Sohl, *supra* note 539, at 88 (average angel investment of $470,000 in 2004).

[541] GAO Report, *supra* note 200, at 10.

[542] PARKER, *supra* note 521, at 249.

[543] GAO Report, *supra* note 200, at 10.

[544] *See generally* Cable, *supra* note 254 (suggesting regulatory changes to enable more angel investing).

[545] *See* Heminway and Hoffman, *supra* note 142, at 931 (arguing that crowdfunding "enables entrepreneurs to more quickly and easily identify

investors who have not traditionally participated in private securities offerings. Those investors have less money to invest, so they would be willing to fund smaller business opportunities that the venture capitalists and angel investors would not touch. Crowdfunding also gives poorer entrepreneurs whose friends and family lack the wealth to provide seed capital somewhere else to turn.

But what about the other benefits that venture capitalists and angel investors provide to small business entrepreneurs? In addition to the capital they invest, venture capitalists and angel investors typically provide companies with managerial and monitoring services.[546] If startups turn to passive, unsophisticated public investors, they will not receive the collateral services provided by sophisticated venture capitalists and angel investors.[547] However, crowdfunding is not a substitute for venture capital or angel investing; it is aimed at entrepreneurs who do not have access to such funding. The entrepreneurs most likely to engage in crowdfunding would not, in any event, have access to the other services that venture capitalists and angel investors provide.

Crowdfunding is not a panacea for small businesses' financing issues. It will not completely eliminate the capital gap. It will, however, open investment to new sources of capital and provide a platform that allows investors with unused capital to connect with entrepreneurs who need it.

B. Investor Protection: The Effects of Crowdfunding on Investors

Crowdfunding sites make it possible for relatively unsophisticated members of the general public to invest in particularly risky ventures. Investor protection is, therefore,

supporter-investors who are willing and able to fund their businesses or projects").

[546] PARKER, *supra* note 521, at 239–40; Fisch, *supra* note 514, at 84; Ibrahim, *supra* note 514, at 1419; GAO Report, *supra* note 200, at 11.

[547] *See* Fisch, *supra* note 514, at 86 (arguing that if angel investor funding were "replaced by dispersed passive public investors, the collateral monitoring and managing services are likely to be eliminated").

an important issue. A crowdfunding exemption, properly structured, can ameliorate some, but not all, of the risk. But investments in small businesses, whether or not those investments are facilitated through crowdfunding, are inherently risky. Crowdfunding possesses no magical properties that prevent investors from losing money just like other investors.

However, at the margin, the cost to investors of a crowdfunding exemption is likely to be low. Investors are already contributing substantial amounts of money to unregulated crowdfunding offerings, although not for securities. Those crowdfunding investments are subject to the same risk of loss as crowdfunded securities, but do not offer the upside potential of a securities investment. Allowing crowdfunding entrepreneurs to sell securities would, therefore, be a net gain to investors, increasing the possibility of gains without any increase in the risk.

1. The Risks of Small Business Investment

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.[548] Losses due to fraud and self-dealing are also much more likely.[549]

Small business investments expose investors to a disproportionate risk of fraud.[550] The abuses in the penny stock market in the 1980s "typify the securities fraud potential associated with direct marketing of microcap securities to individual investors."[551] The SEC's experience when it eased the requirements of the Rule 504 small offering exemption in the 1990s also illustrates the potential fraud associated with unregulated small offerings. The changes freed Rule 504 offerings from federal mandatory disclosure requirements even when those offerings were not

[548] *Id.* at 58. *See also* Sjostrom, *supra* note 198, at 586.

[549] Fisch, *supra* note 514, at 58; Sjostrom, *supra* note 198, at 586.

[550] Fisch, *supra* note 514, at 58; Sjostrom, *supra* note 198, at 586.

[551] Fisch, *supra* note 514, at 82.

registered at the state level. In New York, which has no state registration requirement, "Rule 504 was being used by nefarious promoters to distribute up to $1 million of securities in New York to a select favored group, followed promptly by boiler-room promotions that artificially drove up the secondary market price until such time as the initial purchasers could sell their shares at a handsome profit, leaving the gullible crop of new investors with suddenly deflated shares and irrecoverable losses."[552]

Even absent fraud, investors in small businesses must deal with the potential agency costs and problems of opportunism that arise from uncertainty and information asymmetry.[553] Uncertainty is inherent in startup businesses. At the time of investment, "virtually all of the important decisions bearing on the company's success remain to be made, and most of the significant uncertainties concerning the outcome of the company's efforts remain unresolved."[554] Entrepreneurs typically have a business plan laying out a strategy but, at the startup phase, that plan is little more than a "best guess."[555] At that point, many major strategic decisions remain to be made[556], and they will be made by a management whose quality is unknown to investors.[557] The entrepreneur's intentions and abilities are both "not easily observable by an investor and difficult for an entrepreneur to communicate credibly."[558] In the case of high-technology companies, there may also be uncertainties about the technology itself, including whether the product works and

[552] Cohn & Yadley, *supra* note 11, at 71–72. *See also* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 1999 WL 95490, at *2 (Feb. 25, 1999).

[553] *See* Cable, *supra* note 254, at 121–22 (2010); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076–77 (2003); Ibrahim, *supra* note 514, at 1407.

[554] Gilson, *supra* note 553.

[555] Cable, *supra* note 254, at 121–22.

[556] *Id.* at 122.

[557] Gilson, *supra* note 553, at 1077.

[558] Cable, *supra* note 254, at 122. *See also* Gilson, *supra* note 553, at 1077.

can be viably and widely adopted. The entrepreneur is almost certain to understand those issues better than most investors.[559]

In short, the entrepreneur holds all the cards. Investors have little information about what is to come and little control over what the entrepreneur does. This presents entrepreneurs with opportunities for self-dealing, excessive compensation, misuse of corporate opportunities, and dilution of investors' interests—issues similar to those faced by investors in closely-held corporations.[560]

Sophisticated venture capital funds deal with these problems by negotiating control rights and negative covenants requiring investor approval for certain actions.[561] Staged financing complements these protections.[562] Entrepreneurs and investors "recognize that the company will need additional rounds of financing" requiring the cooperation of the venture capitalists.[563] The need to go back to investors for future funding should constrain self-dealing, opportunistic behavior by the entrepreneur.

Most crowdfunding investors will not have the sophistication to understand the need for or benefits of control rights or protective covenants. Even if they were sophisticated enough to seek such protection, it is unclear how they would negotiate for it, or whether it would be worth their effort. The small amount invested by each crowdfunding investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiations.[564]

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[559] Gilson, *supra* note 553, at 1077.

[560] *See* Dent, *supra* note 525, at 1052–57.

[561] *See* Dent, *supra* note 525, at 1035, 1044–61; Gilson, *supra* note 553, at 1074; Ibrahim, *supra* note 514, at 1407.

[562] Gilson, *supra* note 553, at 1074.

[563] Dent, *supra* note 525, at 1065.

[564] Belleflamme et al., *supra* note 10, at 26–27 ("From a more general perspective, crowdfunding practices raise questions with respect to corporate governance and investor protection issues if most individuals only invest tiny amounts. Crowdfunders are most likely offered very little investor protection. This may lead to corporate governance issues, which in turn may turn into reputation concerns if some cases of fraud or bad governance are uncovered. Crowdfunders have very little scope to

Even in the absence of fraud or self-dealing, many crowdfunded small businesses will fail. The small startups to which crowdfunding appeals pose a disproportionate risk of business failure.[565] Approximately 80% of new businesses "either fail or no longer exist within five to seven years of formation . . . ."[566] Even the small businesses selected for investment by sophisticated venture capital funds are predominantly failures. 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.[567]

Investors in startups also face liquidity risk, because there is no ready public market in which to resell their investments.[568] Crowdfunding sites will not provide such a trading market because, if they did, they would risk having to register as exchanges or alternative trading systems.[569] Therefore, crowdfunding investors may have to wait quite some time to realize any return.[570] Some existing crowdfunding sites require repayment within a few years,[571] which limits the illiquidity problem but may exacerbate the risk of business failure because entrepreneurs could be forced to repay investments before their business has

intervene to protect their interests as stakeholders. Moreover, the fact that their investment is small is likely to create a lack of incentive to intervene.").

[565] *See* Fisch, *supra* note 514, at 58; Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 306 (1994); Sjostrom, *supra* note 198, at 586.

[566] GAO Report, *supra* note 200, at 19.

[567] Dent, *supra* note 525, at 1034. *See also* GAO Report, *supra* note 200, at 19 ("[O]nly about ten percent of venture capital investments meet their expected rate of return.").

[568] Cable, *supra* note 254, at 122; Fisch, *supra* note 514, at 79.

[569] Crowdfunding sites that facilitate resales would bring together multiple buyers and sellers, increasing the likelihood that they would be exchanges. *See supra* Part IV.A.

[570] *See* Cable, *supra* note 254, at 122 (An investor in a startup "can expect to wait more than five years for any return on the investment.").

[571] *See, e.g.*, Prosper Registration Statement, *supra* note 81, at 4 (three-year notes); Lending Club Registration Statement, *supra* note 81, at 3 (three-year notes); Lang, *supra* note 106 (maximum of five years).

developed sufficiently to do so. And, if startups take time to become profitable, such short repayment periods may preclude meaningful profit-sharing.

2. The Financial Sophistication of the Crowd

The risks associated with crowdfunding ventures would be a less significant concern if crowdfunding investors were sophisticated enough to protect themselves. But crowdfunding is open to the general public, and many members of "the crowd" are not that financially well-informed.[572] In one study, 34% of American adults gave themselves a "C" grade or below on their knowledge of personal finance, and only 22% awarded themselves an

[572] Annamaria Lusardi & Olivia Mitchell, *Financial Literacy and Retirement Planning: New Evidence from the Rand American Life Panel* 4 (Michigan Retirement Research Center, Working Paper 2007-157, 2007), *available at* http://ssrn.com/abstract=1095869 ("Financial literacy surveys in many developed nations show that consumers are poorly informed about basic economic and financial concepts."). *See also* B. Douglas Bernheim, *Financial Illiteracy, Education, and Retirement Savings*, *in* LIVING WITH DEFINED CONTRIBUTION PENSIONS: REMAKING RESPONSIBILITY FOR RETIREMENT 38, 42 (Olivia S. Mitchell & Sylvester J. Schieber, eds., 1998) ("Collectively, existing studies paint a rather bleak picture of Americans' economic and financial literacy.").

For specific survey results, see APPLIED RESEARCH & CONSULTING LLC, FINANCIAL CAPABILITY IN THE UNITED STATES: INITIAL REPORT OF RESEARCH FINDINGS FROM THE 2009 NATIONAL SURVEY (Dec. 1, 2009), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf; NAT'L COUNCIL ON ECON. EDUC., WHAT AMERICAN TEENS AND ADULTS KNOW ABOUT ECONOMICS (Apr. 26, 2005), *available at* http://www.councilforeconed.org/cel/WhatAmericansKnowAboutEconomics_042605-3.pdf; NAT'L FOUND. FOR CREDIT COUNSELING, THE 2010 CONSUMER FINANCIAL LITERACY SURVEY: FINAL REPORT (Apr. 2010), *available at* www.nfcc.org/newsroom/FinancialLiteracy/files2010/2010ConsumerFinancialLiteracySurveyFinalReport.pdf; Bernheim, *supra* note 572; Marianne A. Hilgert, Jeanne M. Hogarth & Sondra G. Beverly, *Household Financial Management: The Connection Between Knowledge and Behavior*, Federal Reserve Bulletin 309 (July 2003); Annamaria Lusardi, *Financial Literacy: An Essential Tool for Informed Consumer Choice?*, 26–30 (Paolo Baffi Centre Research Paper No. 2009-35, June 2008), *available at* http://ssrn.com/abstract=1336389; Lusardi & Mitchell, *supra* note 572, at 26–30.

"A."[573] Self-assessment is probably not the best way to measure financial knowledge, but people's self-assessments are strongly correlated with their actual financial knowledge.[574]

Many Americans are not financially literate. In a survey of 3,512 adults and 2,242 high school students in 2005, only 17% of the adults and 3% of the students scored an "A" on a twenty-four-question financial literacy quiz.[575] Sixty-six percent of the adults and 91% of the students had grades of "C" or worse.[576] In 2009, respondents in a survey of American adults answered an average of only 2.72 out of 5 financial literacy questions correctly.[577] Forty-eight percent of those respondents did not understand that investing in a mutual fund generally provides a safer return than investing in a single stock.[578] Thirty-five percent missed a very simple question about calculating compound interest.[579] Seventy-nine percent did not understand the relationship between

[573] NAT'L FOUND. FOR CREDIT COUNSELING, *supra* note 572, at 9. *But see* APPLIED RESEARCH & CONSULTING LLC, *supra* note 572, at 37 (70% of American adults rated their overall financial knowledge in the top three levels on a seven-point scale. Only 13% put themselves in the bottom three levels.)

[574] Bernheim, *supra* note 572, at 48.

[575] NAT'L COUNCIL ON ECON. EDUC., *supra* note 572, at 44.

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

[577] APPLIED RESEARCH & CONSULTING LLC, *supra* note 572, at 41.

[578] *Id.* at 40. *See also* NAT'L COUNCIL ON ECON. EDUC., *supra* note 572, at 42 (only 44% of adults and 15% of high school students understood that diversification was a reason for preferring mutual funds to individual stocks).

[579] APPLIED RESEARCH & CONSULTING LLC, *supra* note 572, at 39. *See also* Bernheim, *supra* note 572, at 44 (In a 1993 survey of American adults aged twenty to forty-seven, nearly one-third indicated that $1,000 left in the bank for thirty years with compound interest of 8% would earn less than $5,000; the correct answer is more than $10,000.); Lusardi & Mitchell, *supra* note 572, at 21 (In a survey of American adults, only 75% correctly answered a multiple-choice question about compound interest.).

interest rates and bond prices.[580] Another survey asked Americans aged fifty or older three questions about compound interest, the relationship between investment return and inflation, and the value of diversification.[581] Only one-third of the respondents were able to answer all three questions correctly.[582]

This financial ignorance extends beyond general principles of finance to more specific questions about economic facts. In a 2001 survey, only 52% of the respondents knew that mutual funds do not pay a guaranteed rate of return; only 33% knew that not all investment products purchased at a bank are federally insured; and only 56% knew that, over the long term, stocks offer the highest rate of return.[583]

Still, the numbers are not totally disheartening. A large percentage of American adults do get many basic financial literacy questions right.[584] In one recent survey, two-thirds of the respondents correctly answered most basic questions about the function of stock markets, mutual funds, diversification, and risk.[585] However, these respondents were relatively highly-educated and wealthy, so the results

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[580] APPLIED RESEARCH & CONSULTING LLC, *supra* note 572, at 38. *See also* Lusardi & Mitchell, *supra* note 572, at 22 (noting that, in a survey of American adults, only 37% knew the relationship between bond prices and interest rate.).

[581] *See* Lusardi, *supra* note 572, at 5. The questions were as follows: (1) Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow: more than $102, exactly $102, less than $102? (2) Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy more than, exactly the same as, or less than today with the money in this account? (3) Do you think that the following statement is true or false? "Buying a single company stock usually provides a safer return than a stock mutual fund."

[582] *Id.* at 6.

[583] Hilgert et al., *supra* note 572, at 313.

[584] *See* Lusardi & Mitchell, *supra* note 572, at 21.

[585] *See* Lusardi, *supra* note 572, at 8–10, 26.

probably "overstate the level of financial literacy in the general population."[586]

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

3. Crowdfunding and Small Business Investment Risk

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

Consider first the effect of crowdfunding on the risk of fraud. No matter how the exemption is structured, there will be fraud. "[N]o amount of technical exemption requirements will hinder the fraud artists from their endeavors."[587] But, of course, registration itself does not completely eliminate fraud. The question is a comparative one: whether Internet-based crowdfunding will increase the incidence of fraud, and, if so, by how much.

Paul Spinrad, who proposed the first crowdfunding exemption, argues that fraudsters will not find crowdfunding appealing because of the small amounts involved and the open, public nature of crowdfunding.[588] It is not clear if that

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[586] Lusardi & Mitchell, *supra* note 572, at 5.

[587] Cohn & Yadley, *supra* note 11, at 72.

[588] Scott Shane, *Let the Crowd Buy Equity in Private Companies*, BLOOMBERG BUSINESSWEEK, May 3, 2011, *available at* http://www.businessweek.com/smallbiz/content/may2011/sb2011052_710243.htm. *See also* SBE Council Proposal, *supra* note 247, at 4 (arguing that the companies that would use its proposed rule "are small enough and transparent enough to prevent fraud").

is true. On the one hand, the Internet allows fraudulent offerings to be distributed widely at low cost,[589] so crowdfunding sites are an obvious target for fraudsters. On the other hand, fraud is "more detectable on the Internet,"[590] especially when it must be mediated through an independent crowdfunding site that is open to the public. The net effect is indeterminate. However, it is important to remember that a crowdfunding exemption would not legitimize fraud or protect fraudulent offerings from the antifraud rules in the securities statutes. The SEC and private parties would still have the usual remedies for any fraud.

The crowdfunding structure does have some features that could help limit some of the risks of investing in small business ventures. First, like venture capital, crowdfunding sometimes involves staged financing.[591] The need to come back for additional funds could moderate entrepreneur behavior, especially if prior-round investors are able to comment publicly on the crowdfunding site about the entrepreneur's behavior. Second, investors could use crowdfunding discussion boards to point out problems with proposed ventures, to coax concessions from entrepreneurs prior to investing, and to monitor investments after they invest. Lenders on peer-to-peer ("P2P") lending sites "show a remarkable propensity to shoulder the burden of monitoring underlying loan debts. Web forums and message boards are replete with the adventures of [a] P2P lender qua detective, ferreting out frauds that have been overlooked by the platform."[592]

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[589] Fisch, *supra* note 514, at 58.

[590] *Id.* at 81.

[591] *See, e.g.*, *Frequently Asked Questions (FAQs)*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Mar. 5, 2012) (indicating that fundraising can be continued after the close of a campaign by starting a new campaign); *Creating a Project,* KICKSTARTER, http://www.kickstarter.com/help/faq/creating%20a%20project#StarAProj (discussing splitting funding for a project into stages). *See also* LAWTON & MAROM, *supra* note 2, at 112 (noting that with crowdfunding, the discrete rounds of financing are being replaced with the "rolling close," which provides continuous funding).

[592] Verstein, *supra* note 12, at 15.

Under the right conditions, crowdfunding could benefit from "the wisdom of crowds,"[593] the notion that "even if most of the people within a group are not especially well-informed or rational . . . [the group] can still reach a collectively wise decision."[594] The knowledge gap that once separated professionals from the general public has shrunk as information has become more readily accessible through the Internet.[595] Moreover, investment expertise does not necessarily translate into success, and experts often make extraordinarily poor judgments.[596] One of the lessons of crowdsourcing is that a diverse group of less-expert decision-makers can often make better choices than an expert working individually.[597] It is at least possible that crowdfunding investors will do a better job compared to venture capitalists and angel investors than their relative lack of sophistication would predict.[598]

Additionally, unsophisticated crowdfunding investors are likely to become more sophisticated over time.[599] A study of

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[593] *See* SUROWIECKI, *supra* note 123.

[594] *Id.* at xiii–xiv.

[595] *See* HOWE, *supra* note 1, at 39–40.

[596] *See* DAN GARDNER, FUTURE BABBLE: WHY EXPERT PREDICTIONS ARE NEXT TO WORTHLESS (2011). James Surowiecki quotes Wharton professor J. Scott Armstrong, who surveyed expert forecasts and analyses in a number of fields and concluded that he "could find no studies that showed an important advantage for expertise." SUROWIECKI, *supra* note 123, at 33.

[597] *See* HOWE, *supra* note 1, at 131–45.

[598] Even so, crowdfunding investors may not necessarily enjoy higher investment returns. Venture capital funds and angel investors are highly selective, and venture capitalists especially tend to focus on larger, high-growth companies that are past the startup phase. *See supra* Part VI.A. Crowdfunding sites appeal to entrepreneurs who cannot otherwise obtain adequate funds—those, in other words, who could not attract funding from venture capitalists and angel investors. Even if crowdfunding investors are better at discriminating among available investments, they are picking from a different, more risky pool than venture capitalists and angel investors.

[599] *See* Seth Freedman & Ginger Zhe Jin, *Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence From Prosper.com* 3 (Net Inst., Working Paper No. 08-43, 2008), *available at* http://ssrn.com/abstract=1304138 ("[M]any Prosper lenders make mistakes

lenders on Prosper.com found that, over the two-year period studied, lenders moved from lower-performing loans to loans with a higher rate of return.[600] However, crowdfunding is still relatively young and has not been exhaustively studied. Only more experience will demonstrate its success in protecting investors from risk.

Critics have argued that a crowdfunding exemption will result in increased fraud and investor losses.[601] This argument is overstated. It supposes a horde of bicephalous con men eager to violate the antifraud rules but unwilling to violate the offering registration requirements. It is unlikely that fraudsters are so selective in their willingness to violate the law.

Nevertheless, the argument that fraud and investors' losses will increase is surely correct. The investors on crowdfunding sites, like other small-business investors, will suffer significant losses.[602] Fraudsters will use crowdfunding sites to deceive investors and take their money. Entrepreneurs will take advantage of their control to benefit themselves at the expense of outside investors. Unsophisticated investors will make ill-advised investments.

But the argument that fraud and investor losses will increase is trivial. More securities offerings of any kind—whether those offerings are registered, pursuant to a crowdfunding exemption, or pursuant to some other exemption—are going to result in more fraud and greater

in loan selection and therefore have a negative rate of return on their portfolios, but they learn vigorously and the learning speeds up over time.").

[600] Freedman & Jin, *supra* note 599, at 25.

[601] *See, e.g.*, Jay Hancock, *Businesses Also Seek "Crowdfunding," so Watch Out*, BALT. SUN, Nov. 14, 2011, *available at* http://articles.baltimoresun.com/2011-11-14/business/bs-bz-hancock-crowdfunding-danger-20111112_1_small-business-crowdfunding-business-plan; Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why any Specially Tailored Exemption Should be Conditioned on Meaningful Disclosure*, N.C. L. REV. (forthcoming 2012) (manuscript at 18–22), *available at* http://ssrn.com/abstract=1954040.

[602] *See* LAWTON & MAROM, *supra* note 2, at 180 (finding that numerous losses will occur, either through fraud, or, more likely, business failure).

investor losses. The real question is whether the benefits of a crowdfunding exemption outweigh these costs.

The structural features mentioned above and the presence of a neutral intermediary will help reduce the risk to investors. In addition, each of the proposed exemptions limits the maximum amount a single investor may contribute and therefore limits each investor's possible loss.[603] Such limits ensure that even if investors do lose money, those losses are unlikely to be catastrophic.

Investors are already investing substantial amounts in non-securities crowdfunding. Those investments are as risky as securities crowdfunding. People who make pure donations to entrepreneurs are guaranteed to "lose" all of their money and receive nothing in return. People who contribute to crowdfunding appeals in return for small rewards or to pre-purchase a product might never receive the promised reward, or the reward or product may not be as valuable as they anticipated. People who make no-interest loans on Kiva may never recover their principal.

Securities crowdfunding increases the potential gains to these investors. Instead of making a donation or settling for some reward, investors in crowdfunded securities can receive interest or a share of the entrepreneur's profits. They may not receive the promised return, but even the possibility of interest or profit is better than no financial return at all.

The risk of fraud or self-dealing is the same in the non-securities crowdfunding context as in the securities crowdfunding context. The gain to the fraudster or the self-dealing entrepreneur depends on the amount invested, not on the type of return offered to investors. A $1,000 contribution provides the same opportunity for diversion whether the offering is for a non-interest loan on Kiva, a pre-purchase on Kickstarter, or a purchase of stock on a securities crowdfunding site. The absence of any serious fraud problem in non-securities crowdfunding (at least as far as we know) is reassuring.

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[603] *See supra* Part V.

VII. A CROWDFUNDING EXEMPTION PROPOSAL

A crowdfunding exemption could be beneficial, but the exemption must minimize investor losses as much as possible without destroying its utility to entrepreneurs raising capital. However, investor protection and capital formation are, to some extent, incompatible goals. It is not possible to maximize both. Adding additional requirements to protect investors will in most cases impose an additional cost on small business issuers using the exemption. Subpart A, below, discusses the requirements an exemption should impose on crowdfunded offerings. Subpart B discusses the requirements an exemption should impose on sites hosting those offerings.

The locus of any regulation should be the crowdfunding sites, not the entrepreneurs making the offerings. The small companies and entrepreneurs most likely to engage in crowdfunding are poorly capitalized and legally unsophisticated. They do not have and cannot afford sophisticated securities counsel to guide them through a labyrinth of complex regulations.[604] Too much complexity at the entrepreneurial level will produce a host of unintended violations and destroy the exemption's utility.

Crowdfunding sites, in contrast, are repeat players. They can spread any regulatory costs over a large number of offerings. They are better capitalized than the entrepreneurs using their sites and can afford securities counsel. Crowdfunding sites are also much more visible to the SEC for regulatory enforcement purposes. Thus, crowdfunding sites are a more desirable locus for any conditions necessary for investor protection.

Conditions may be imposed on the offerings or on the companies making the offerings, but those restrictions should be enforceable at the site level, with the crowdfunding sites acting as gatekeepers to enforce the restrictions. For example, a crowdfunding site can easily monitor and enforce a restriction on the dollar amount of

[604] The cost of securities counsel could easily exceed the amount being raised in smaller offerings.

crowdfunding offerings, since the money flows through the site. But the entrepreneur's off-site activities are not as easily monitored. If, for example, the available amount is affected by fundraising the entrepreneur does off-site, the site has no effective means to enforce the limit.

A. Restrictions on the Offering

The dollar amount of offerings qualifying for the crowdfunding exemption should be limited, as should the amount that any single investor may invest. It is not clear what the exact amounts of those limits should be; there is no magic number. This article proposes an annual offering limit of $250,000 to $500,000, with an annual limit on individual contributions equal to the greater of $500 or 2% of the investor's annual income. Integration and aggregation concepts should not be applied to the offering limit. A limit on the size of companies eligible to engage in crowdfunding offerings is not necessary, but if the SEC believes such a limit is appropriate, limiting the exemption to non-reporting companies would do little damage. Finally, crowdfunding should be exempted only if it occurs on a crowdfunding site that meets the requirements specified in subpart B below.

1. Offering Amount

An absolute, unconditional exemption of smaller offerings from Securities Act registration requirements makes sense.[605] The cost to register a relatively small offering

[605] For a more detailed discussion of this point, see C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. LAW 1 *passim* (2001) [hereinafter Bradford, *Securities Regulation and Small Business*]. The argument for a Securities Act exemption for smaller offerings is just a specific case of the more general economic argument for small business exemptions. *See* C. Steven Bradford, *Does Size Matter? An Economic Analysis of Small Business Exemptions from Regulation*, 8 J. SMALL & EMERGING BUS. LAW 1, 17–20 (2004) [hereinafter Bradford, *Does Size Matter?*].

exceeds any benefit that registration could provide.[606] This is true even if fraud is more likely in smaller offerings. Although the likelihood of fraud affects the dollar amount below which offerings should be exempted, it does not affect the case for such an exemption.[607] Economies of scale make registration inefficient for smaller offerings, even if registration creates a net benefit for larger offerings.[608]

For example, consider an attempt to raise $20,000. The maximum amount investors could lose in that offering is $20,000. Even if registration could reduce the probability of any loss to zero, the maximum possible benefit of registration would only be $20,000. The cost to register an offering is substantially more than $20,000, so requiring registration of the offering costs more than allowing investors to bear the risks of an unregistered offering.

The case for exempting a $20,000 offering is thus fairly obvious, but the exact level at which registration ceases to be cost-effective is less clear. If the exemption is not absolute—if it includes requirements designed to protect investors—a higher limit makes sense.[609] The proposed limits in the various crowdfunding exemption proposals range from $100,000 to $2 million.[610] There is no magic number. Given

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[606] *See* Bradford, *Securities Regulation and Small Business*, *supra* note 605, at 29–33.

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

[608] *See* Bradford, *Securities Regulation and Small Business*, *supra* note 605, at 24–27; Bradford, *Does Size Matter?*, *supra* note 605, at 5–15.

[609] *See* Bradford, *Transaction Exemptions*, *supra* note 509, at 618–22 (explaining the efficiency of intermediate, conditional exemptions).

[610] *See supra* Part V.

the cost of registering an offering,[611] the case for exempting offerings of less than $250,000 to $500,000 is solid. A plausible case can be made for exempting larger offerings, particularly with a strong limit on the amount of each person's investment. But an exemption limit above $500,000 requires stronger assumptions about the cost of registration, the risk of loss, and the extent to which registration reduces that risk.[612]

2. Aggregation/Integration

Any proposal for a Securities Act exemption must deal with the frustrating problem of integration—that is, whether two offerings that are ostensibly separate should be treated as part of the same offering.[613] The integration doctrine was developed by the SEC "to prevent issuers from artificially dividing a single, non-exempt offering into two or more parts in an attempt to obtain an exemption for one or more of the parts."[614] Integrating two offerings could result in the loss of each offering's exemption. Unfortunately, the integration doctrine is an uncertain, confusing mess.[615] Scholars have proposed its elimination[616] or substantial modification,[617] and the SEC itself has created several safe harbors that protect against application of the doctrine.[618]

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[611] *See supra* Part III.B.1.

[612] For a set of hypothetical calculations, see Bradford, *Securities Regulation and Small Business*, *supra* note 605, at 47.

[613] For a general introduction to integration, see Bradford, *Transaction Exemptions*, *supra* note 509, at 649–57.

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

[615] *See* Bradford, *Transaction Exemptions*, *supra* note 509, at 651–52 (discussing the lack of clarity in SEC releases that detail the standard for integrated offerings).

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

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

[618] *See* Bradford, *Transaction Exemptions*, *supra* note 509, at 652–57.

Even if two offerings are not integrated, the related concept of aggregation can pose problems for small issuers. The aggregation provisions in Regulation A and Rules 504 and 505 of Regulation D reduce the maximum amounts available under those exemptions by the amount of certain other offerings.[619] The $1 million limit in Rule 504 would, for example, be reduced if the issuer had completed a Regulation A offering in the previous twelve months.[620]

The dollar limit of any crowdfunding exemption should be applied on an aggregate basis to all crowdfunding within any twelve-month period by the same issuer. If the limit is $500,000, the total an entrepreneur raises through crowdfunding should not exceed $500,000 in a year, even if the entrepreneur conducts multiple, separate rounds of fundraising. Securities sold in non-crowdfunded offerings should not count against the exemption's limit. This is consistent with the SEC's approach in Regulation A. Rule 251(b) limits the offering amount in Regulation A offerings to no more than $5 million in any twelve-month period, but only offerings pursuant to Regulation A are counted against that limit.[621]

The concepts of integration and aggregation should not be applied beyond that. Small business entrepreneurs seeking to raise money through crowdfunding cannot afford the legal expertise needed to navigate the integration doctrine. These entrepreneurs can count how much money they receive

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[619] *See* Securities Act Rule 251(b), 17 C.F.R. §§ 230.251(b) 230.504(b)(2), 230.505(b)(2)(i) (2012). *See generally* Bradford, *Transaction Exemptions*, *supra* note 509, at 657–58 (explaining the concept of aggregation).

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

[621] 17 C.F.R. § 230.251(b). Other exemptions with dollar limits use a similar twelve-month period, although the amounts charged against those limits include other specified offerings. *See* 17 C.F.R. §§ 230.504(b)(2), 230.505(b)(2)(i).

through crowdfunding, but they are not in a position to consider the effect of other fundraising efforts on the availability of crowdfunding—whether, for example, the private solicitation of money from Aunt Agnes will count against the crowdfunding limit.[622] They also cannot anticipate their future capital needs[623] or the potential retroactive application of integration to destroy their crowdfunding exemption. The incorporation of integration concepts into the crowdfunding exemption would function as a trap for unsophisticated, unwary entrepreneurs.

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

Two of the proposed bills have provisions that might be construed as protecting against integration. Both House Bill 2930 and Senate Bill 1970 provide that nothing in the exemption "shall be construed as preventing an issuer from raising capital through methods not described under" the exemption.[624]

3. Individual Investment Cap

All of the crowdfunding exemption proposals limit not only the total amount of the offering, but also the amount that each investor may invest. Such a limit is sensible.

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

[623] *See* Cohn & Yadley, *supra* note 11, at 50 (stating that small companies' capital needs "are often sporadic and immediate").

[624] H.R. 2930, 112th Cong. § 2 (2011); S. 1970, 112th Cong. § 2 (2011).

Small business offerings are very risky and losses are likely.[625] A properly set cap on the amount an individual may invest eliminates the possibility of catastrophic loss and limits losses to what each investor can bear.[626] As with the offering amount, there is no magic number. This article proposes that each investor be able to invest annually in crowdfunding no more than the greater of $500 or 2% of the investor's annual income.

a. The Individual Cap Related to Existing Exemptions

None of the current exemptions limit the amount an individual investor may invest. Many of the exemptions cap the total dollar amount of an offering,[627] but as long as the total offering amount does not exceed the cap, the amount that any single investor purchases does not matter. The exemption would be available even if a single investor purchased the entire offering.

However, some of the existing exemptions do consider an investor's ability to bear losses in a less direct way. Both Rule 506 of Regulation D and Section 4(5) of the Securities Act restrict the purchasers to whom sales may be made.[628] Section 4(5) of the Securities Act limits sales to accredited investors.[629] Rule 506 limits sales to purchasers who either are accredited investors or who have "such knowledge and experience in financial and business matters that . . . [they

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[625] *See supra* Part VI.B.1.

[626] *See* Request for Rulemaking to Exempt Securities Offerings up to $100,000 with $100 Maximum Per Investor from Registration, *supra* note 400, at 7 (arguing that the proposed $100 individual investment limit would prevent investors "from incurring significant financial risk" because "[e]ven a total loss of $100 is unlikely to be financially crippling for anyone").

[627] *See* Securities Act Rule 251(b), 17 C.F.R. § 230.251(b) (2012) (cap of $5 million); 17 C.F.R. § 230.504(b)(2) (cap of $1 million); 17 C.F.R. § 230.505(b)(2)(i) (cap of $5 million).

[628] *See* Securities Act Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii); Securities Act § 4(5), 15 U.S.C. § 77d(5) (2010).

[629] Securities Act of 1933 § 4(5), 15 U.S.C. § 77d(5) (2010).

are] . . . capable of evaluating the merits and risks of the prospective investment . . . ."[630]

Rule 506 is a safe harbor for Section 4(2) of the Securities Act, and the sophistication requirement is consistent with the Supreme Court's analysis of the Section 4(2) exemption in *Ralston Purina*. In *Ralston Purina*, the Court indicated that the availability of the Section 4(2) exemption turns on whether the offerees "need the protection of the Act" or are "able to fend for themselves."[631] But under Rule 506, sales may be made even to unsophisticated investors, as long as they are accredited.[632]

Some of the categories of accredited investors are individuals or institutions who are undoubtedly "sophisticated."[633] In those cases, accredited status is merely a more objective proxy for sophistication. Other parts of the accredited investor definition focus solely on an investor's wealth or income. Any individual whose net worth, either alone or with a spouse, exceeds $1 million is accredited,[634] as are corporations, partnerships, and certain other entities with total assets in excess of $5 million.[635] An individual is also an accredited investor if she has had an income of

[630] 17 C.F.R. § 230.506(b)(2)(ii). Even if a non-accredited investor does not meet the sophistication requirement, the exemption is still available if the investor is represented by someone who meets the requirement or if the issuer reasonably believes that the purchaser meets the sophistication requirement. *Id.*

[631] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). *See also* 1 HAZEN, *supra* note 42, at 565.

[632] *See* 17 C.F.R. § 230.506(b)(2)(ii) (requiring "each purchaser who is not an accredited investor" to meet a sophistication requirement). Moreover, the information requirements that would otherwise apply in a Rule 506 offering do not apply to sales to accredited investors. *See* 17 C.F.R. § 230.502(b).

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

[634] *See* 17 C.F.R. §§ 230.215(e), 230.501(a)(5).

[635] *See* 17 C.F.R. §§ 215(c), 230.215(c), 230.501(a)(3).

$200,000, or a joint income with her spouse of $300,000, over the two previous years, provided she reasonably expects to reach the same income in the year of the offering.[636]

Many people who are accredited investors solely because of wealth or income are unsophisticated investors.[637] Consider, for example, the high school dropout who wins $10 million in a lottery.[638] She would be an accredited investor, even though the way in which she accumulated her wealth does not demonstrate that she is capable of evaluating the merits and risks of investing in the offering.

The SEC's reasons for including wealthy but unsophisticated investors in the definition of "accredited investor" are unclear. One possibility is that wealth and income are just extraordinarily imperfect proxies for sophistication.[639] A more plausible reason, though, is that wealthy investors can afford to lose the money.[640]

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[636] *See* 17 C.F.R. §§ 230.215(f), 230.501(a)(6).

[637] *See* Choi, *supra* note 510, at 311 (stating that the definition of accredited investor may include "financial neophytes"); Friedman, *supra* note 565, at 299 (stating that wealthy investors are "easy prey for securities sales personnel"); Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984) ("Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment.").

[638] This example is derived from a problem in JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 270–71 (6th ed. 2009). *See also* Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 754 (2009).

[639] *See* Finger, *supra* note 638, at 747 (noting that the SEC's goal in Regulation D was to use wealth as a proxy for whether an investor is capable of fending for herself); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1124 (1988) (arguing that "the SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naïve, do not need the protection of the . . . registration provisions"); Friedman, *supra* note 565, at 301; Marvin R. Mohney, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121, 165 (1982) (noting that "the SEC has equated wealth with sophistication and with access to information"); Warren, *supra* note 637, at 381 (noting

If that is the rationale, the existing exemptions do not fit it well. Neither Section 4(5) nor Rule 506 limits the amount that any single investor may invest in the offering.[641] Thus, an individual with a net worth of only $1 million could invest all of his wealth in a single risky offering, and a total loss on that one investment would leave the investor penniless. And an investor whose accredited status is based solely on net income could actually be insolvent at the time of purchase.[642] The crowdfunding exemption proposals focus on the investor's ability to bear the loss in a much more coherent way.

b. How to Structure the Cap

Unfortunately, some of the crowdfunding exemption proposals leave questions about the individual investment limit unanswered. Should the limit be applied on a per-offering basis or applied cumulatively across all of a person's

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that the SEC presumes that these investors can fend for themselves). *See also* Susan E. Satkowski, *Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Businesses*, 23 WM. & MARY L. REV. 73, 81 (1981) (noting that Rule 242, the predecessor to Regulation D, attempted to dispense subjective criteria of sophistication and access to information with more "definitive and objective standards").

[640] *See* Friedman, *supra* note 565, at 299–300 (suggesting that the basis for making wealthy but unsophisticated investors accredited is "the ground that they can afford to lose money"). Edward Fletcher also seems to believe that this basis underlies the accredited investor categories. He asks, "Should the law presume that wealthy investors, *who can bear investment risks*, are sophisticated investors, and treat them as such, no matter how financially naive they may be?" Fletcher, *supra* note 639, at 1123 (emphasis added).

[641] This has not always been the case. When Regulation D was adopted, an investor was accredited if she purchased at least $150,000 of the securities being offered and if the purchase price did not exceed 20% of the purchaser's net worth. *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (Mar. 8, 1982). *See also* Mohney, *supra* note 639, at 135; Warren, *supra* note 637, at 369. Presumably, this 20% floor "assures . . . [investors] . . . are able to bear the risk of the investment." Mahoney, *supra* note 639, at 136.

[642] *See* Warren, *supra* note 637, at 382.

crowdfunding investments? Should it be an annual limit or a cap on the total amount of all outstanding crowdfunding investments? Should the limit be a uniform dollar amount or a percentage of each person's wealth or income? Most importantly, what should the limit be? The proposals range from $100 to $10,000 per person, and some of the proposals add an alternative cap based on the investor's income.[643] This article proposes to limit each investor's annual crowdfunding investments to the greater of $500 or 2% of the investor's annual income.

Consider first whether the investment limit should be the same for all investors or should vary depending on the investor's financial circumstances. A fixed limit of, for example, $500 per person would be simple and easy to apply. But a uniform limit, unless it is very small, does not necessarily limit all investors to an amount they can afford to lose. Many investors have very little savings or uncommitted income.[644] A loss of even $500 could be catastrophic to those investors.

A limit tailored to the particular investor's wealth or income would better fit the policy rationale. For example, an individual investor might be limited to investing no more than 5% of her net worth or annual income. But this type of limit would make the exemption more costly and more difficult to administer. Either the crowdfunding site or the issuer would have to determine the investor's income or net

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[643] *See supra* Part V.

[644] A 2010 survey found that 30% of all adults had no savings (excluding retirement savings). NAT'L FOUND. FOR CREDIT COUNSELING, *supra* note 572, at 5. *See also* Hilgert et al., *supra* note 572, at 310 (earlier survey finding that only 80% of the respondents had a savings account). Another survey found that fewer than half of American adults had an emergency fund that would cover expenses for three months. APPLIED RESEARCH & CONSULTING LLC, *supra* note 572, at 16. Forty-nine percent of those respondents found it difficult merely to pay all of their bills each month. *Id.* at 15. *But see* Hilgert et al., *supra* note 572, at 310 (finding that 63% of the respondents had *some* emergency fund and that 49% of the respondents set aside money out of each paycheck).

worth before allowing the investor to invest.[645] Because crowdfunding depends on small contributions from a large number of investors, the number of such income and wealth determinations could be prohibitively expensive.

There are two ways to incorporate an income- or wealth-based limit without unduly increasing administrative costs. One option, adopted by House Bill 2930, is to allow the issuer (and, presumably, the crowdfunding site as well) to rely on the investor's self-certification of income.[646] The site or the issuer would still have to collect and track income figures for each investor, but no verification would be required. Once the investor stated an income, the site's work would be complete. However, a self-certified income standard is essentially the same as no standard at all. Investors who want to invest more would quickly learn to exaggerate their income.

The second, preferable option is to state the limit per investor in the alternative—as the *greater* of a specified dollar amount or a percentage of the person's income. Senate Bill 1970 takes this approach.[647] Under such a standard, crowdfunding sites would not be required to check or verify anyone's income. Since the limit is the greater of the two, sites could simply limit investments to the specified

[645] Both the Small Business & Entrepreneurship Council petition and the White House proposal provide alternative individual investor limits: either $10,000 or 10% of the investor's income. *See supra* Parts V.B and V.D. Neither proposal indicates how the limit will be applied if an investment is within one of those limits but not the other. In House Bill 2930, the limit is the *lesser* of $10,000 or 10% of the investor's annual income. *See supra* Part V.G.1.

[646] House Bill 2930 provides that "an issuer or intermediary may rely on certifications as to annual income provided by the person to whom the securities are sold to verify the investor's income." H.R. 2930, 112th Cong. § 2 (2011). It is unclear what would happen under this proposal if the issuer knows or reasonably should know that the investor's self-certification is false. What if, for instance, the investor states one income, then changes it when she wants to invest more money?

[647] S. 1970, 112th Cong. § 2 (2011).

dollar amount.[648] An income determination would be required on a case-by-case basis only if the site chose to allow a particular investor to contribute more than that dollar limit. It would, therefore, be left to the site to decide whether to incur the additional costs of determining an investor's income.[649]

Both the dollar amount and the income percentage should be low enough that most people could afford to lose that amount. Neither theory nor empirical analysis can specify the precise amount, but an investment limit of around $500 per person seems reasonable.[650] This amount is more than

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

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

[650] *See* Heminway & Hoffman, *supra* note 142, at 948 (proposing an individual limit of $100 to $250 per offering); Shane, *supra* note 588 (arguing that allowing people to invest only $100 "doesn't seem to impose a significant risk of financial loss on individuals").

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

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

some investors could afford to lose, but, at some point, potential investors must be trusted to decide for themselves what they can afford. The $10,000 individual limit in some of the proposals seems excessive; it is doubtful whether most investors could afford an annual loss of that magnitude.[651]

The alternative limit in the exemption proposals varies from 1% to 10% of the investor's annual income.[652] Again, there is no magic number. How much an investor can afford to lose depends on a number of factors other than annual income. An investor whose wealth is tied up in illiquid assets and who has little free income can afford to lose very little of her income. A cap of 10% seems too high for most people. A more cautious cap of 2% makes more sense, at least until investors have some experience with the exemption. Thus, an investor should be able to invest no more than the greater of $500 or 2% of the investor's annual income.[653]

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increase the number of purchasers, increasing the cost of making an offering under the exemption.

[651] Pope proposes a limit of $1,000 per investor, arguing that "many consumers already spend [that much] on items such as laptop computers and tablets, designer footwear and high-definition televisions." Pope, *supra* note 99, at 997. That may be true of some people, but $1,000 would be a catastrophic loss to some investors, particularly when considered on an annual basis.

[652] *See supra* Part V.

[653] Heminway and Hoffman suggest limiting the cap to investors who are not accredited or sophisticated, and allowing accredited and sophisticated investors to invest without any limit. *See* Heminway & Hoffman, *supra* note 142, at 953. Issuers can already offer securities to accredited and sophisticated investors using Rule 506 of Regulation D. The author's proposal would preclude integration of any Rule 506 offerings with offerings pursuant to the crowdfunding exemption. *See infra* Part VII.A.2. Therefore, the only thing that would preclude simultaneous, side-by-side Rule 506 and crowdfunding exemption offerings on the same web site is Regulation D's general solicitation restriction. *See supra* text accompanying notes 225–27. The author would prefer that the SEC eliminate the general solicitation restrictions for all Rule 506 offerings rather than carve out an exception in the crowdfunding exemption for sales to accredited and sophisticated investors.

Whatever the limit, it should be applied to all of an individual's crowdfunding investments in any given year, not on a per-offering basis. Otherwise, an investor could quickly invest more than she could afford to lose by investing the maximum amount in a large number of offerings—$500 in offering A, $500 in offering B, $500 in offering C, and so on. An investment limit fits the policy argument only if it is applied on an aggregate basis.[654]

Only crowdfunding investments should be considered in applying this annual cap. Other investments, even other securities investments, should not count. People have numerous other investments with various levels of financial risk—mutual funds, houses, cars, friends' businesses. All of a person's assets and liabilities are relevant in assessing the risk that a particular investment adds to the person's portfolio, but the SEC has to draw a line somewhere. The SEC is not a general risk protection agency, and going outside the crowdfunding exemption to calculate the limit would make the exemption unworkable.[655]

Finally, the limit should be an annual one. An investor who invests $500 in 2012 should be free to invest another $500 in 2013, even if she still holds the 2012 investment. The amount of the cap obviously should be lower for an annual limit than it would be for a cumulative limit, but an annual limit is much easier to administer. A cumulative cap would have to account for withdrawals of money, dividends, and bankruptcies, and could pose difficult computational issues.[656]

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[654] The only proposal that clearly takes this approach is Senate Bill 1970. It imposes investor limits both for each offering and for all offerings collectively. *See supra* Part V.

[655] *See also supra* Part VII.A.2 (rejecting application of integration and aggregation concepts).

[656] If, for example, an investor loses her entire $500 investment, would or should she be forever barred from again investing in crowdfunding? She has, after all, lost the total amount it was determined she could afford to lose. One might want to bar her on the theory that she is a bad investor, but given the high percentage of startup failures, a total loss does not necessarily reflect negatively on that person's capabilities as an investor.

4. Should There Be Company Size Limits?

The proposed crowdfunding exemption is designed to help very small businesses raise capital. Should larger businesses therefore be excluded from using it? The SEC already limits the use of the Regulation A and Rule 504 exemptions to non-reporting companies.[657] Heminway and Hoffman suggest that any crowdfunding exemption should be similarly limited.[658] However, the justification for small offering exemptions depends on the size of the offering, not on the size of the company making the offering.[659] There is no reason to prevent larger companies from using the exemption, but such a limit, if imposed, would be relatively easy to administer and would have no dramatic effect on the use of the crowdfunding exemption.[660]

Larger businesses are unlikely to use the exemption even if they are allowed to. Most large businesses are unlikely to seek external funding for such small amounts, particularly given the cost of raising money through investments of $500 or less. Big companies usually have enough cash to meet small funding requirements internally. Apple Computer, for instance, had $11.2 billion in cash and cash equivalents at the end of its 2010 fiscal year.[661] The Buckle, Inc., a much smaller company, reported over $116 million in cash and cash equivalents at the end of its most recent fiscal year.[662]

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[657] *See* Securities Act Rule 251(a)(2), 17 C.F.R. §§ 230.251(a)(2), 230.504(a)(2) (2012).

[658] *See* Heminway & Hoffman, *supra* note 142, at 948. They also propose to exclude foreign issuers and investment companies. *Id.*

[659] *See supra* text accompanying notes 592–95.

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

[661] Apple Inc., Annual Report (Form 10-K), at 47 (Oct. 27, 2010), *available at* http://www.sec.gov/Archives/edgar/data/320193/000119312510238044/d10k.htm#tx37397_2.

[662] The Buckle, Inc., Annual Report (Form 10-K), at 31 (Mar. 30, 2011), *available at* http://www.sec.gov/Archives/edgar/data/885245/000115752311001807/a6663779.htm#statements.

These companies are not going to be using a crowdfunding exemption.

Larger non-reporting companies have another reason to avoid the crowdfunding exemption. Companies in the United States with more than $10 million in total assets and a class of equity security held of record by 500 or more people must register with the SEC under the Exchange Act.[663] Selling equity to a large number of investors in small amounts would increase the number of equity holders and could trigger Exchange Act reporting requirements.

B. Restrictions on Crowdfunding Sites

Offerings that fall within the limitations discussed above should be exempted only if they are sold through crowdfunding sites that meet standards designed to protect investors. Crowdfunding sites should be open to the general public and should provide publicly accessible communications portals that allow potential investors to communicate about each offering. Investors should be allowed to invest on those sites only after viewing a brief investor education video or taking a short quiz. Entrepreneurs posting on those sites should be required to specify a funding goal and should be allowed to close an offering only if that goal is reached. Until then, investors should be free to withdraw their commitments. Crowdfunding sites should not be allowed to recommend or rate investment opportunities, or to advise investors about those opportunities, unless they are willing to register as brokers or investment advisers. Neither the crowdfunding sites nor their employees should be able to invest in any of the offerings that appear on the site.

Crowdfunding sites that meet these standards and notify the SEC that they are engaged in crowdfunding should not be required to register as brokers or investment advisers

[663] *See* Securities Exchange Act of 1934 § 12(g)(1)(B), 15 U.S.C. § 78l(g)(1)(B) (2010) (requiring the registration of companies with more than $1 million in total assets and 500 or more record holders of a class of equity security); Rule 12g-1 (raising the asset amount to $10 million).

unless they also engage in activities other than their crowdfunding activities that would make them such.

1. Open Sites, Open Communication

Crowdfunding sites that want to take advantage of the proposed exemption should be open to the general public and should be required to provide some means, such as an electronic bulletin board, that allows investors to communicate freely and openly about each offering. These requirements will allow crowdfunding sites to take advantage of "the wisdom of crowds" that is the foundation of crowdsourcing, including crowdfunding.[664]

An open communications platform will help to prevent fraud by allowing investors with particular knowledge about an offering or an issuer to communicate it to other investors. Investors who are aware of a particular entrepreneur's shady business background can communicate that knowledge to others. Investors with local knowledge of facts inconsistent with the entrepreneur's claims can inform others. For example, if the entrepreneur falsely claims to own a facility in North Platte, Nebraska, people in North Platte can expose the fraud.

In addition to preventing fraud, open communication will lead to better-informed investors. Investors with knowledge of the particular industry or type of product can share that knowledge with other potential investors. Investors who are also potential customers can explain why the proposed product or service will or will not succeed and can suggest modifications of the product or service. Investors with business or accounting expertise can point out problems in the entrepreneur's business plan or projections. Investors with legal expertise can point out regulatory issues the

[664] *See* SUROWIECKI, *supra* note 123, at 230 (Peer monitoring is a fundamental part of the virtual world.); Schwienbacher & Larralde, *supra* note 14, at 12 (Although crowdfunders might not have any special knowledge about the industry in which they are investing, they can be more efficient as a crowd than a few equity investors alone.). *See also* Freedman & Jin, *supra* note 599, at 2.

entrepreneur has not considered. Not only would these communications provide investors with more and better information, they might even help the entrepreneur refine her business plan.

Openness like this can also lead to better monitoring after an investment is made. From a purely economic standpoint, it makes little sense for someone who has invested a couple hundred dollars to devote a substantial amount of time and effort to monitoring. But the social aspects of crowdfunding and other crowdsourcing applications often lead people to contribute inordinate amounts of time and effort to the enterprise.[665] A crowdfunding site that facilitates open communication allows these monitors to share their findings with other investors.

Open communication is not an unmitigated positive. It can also lead to group-think. Deliberative discussion "is the enemy of collective intelligence because it reduces diversity."[666] James Surowiecki, promoter of "the wisdom of crowds," notes that group judgment is most likely to be accurate if each person's opinion is not determined by the opinions of those around them.[667] According to Surowiecki, "The more influence a group's members exert on each other, and the more personal contact they have with each other, the less likely it is that the group's decisions will be wise ones."[668] If people can see what others have done before they act, they tend to follow the actions of others, creating an "information cascade" problem.[669]

There is also a risk that these open forums will be the target of spammers or advertisements, or that users will post fraudulent comments. Crowdfunding sites should not be

[665] "In many cases, the financial return seems to be of secondary concern for those who provide funds. This suggests that crowdfunders care about social reputation and/or enjoy private benefits from participating in the success of the initiative." Belleflamme et al., *supra* note 10, at 27.

[666] HOWE, *supra* note 1, at 175.

[667] SUROWIECKI, *supra* note 123, at 10.

[668] *Id.* at 42.

[669] *Id.* at 63–64.

liable for the content of the comments and should be free to remove irrelevant or fraudulent material.

2. No Investment Advice or Recommendations

A key determinant of whether a person is a broker or an investment adviser is whether she offers recommendations or investment advice to investors.[670] Unless crowdfunding sites are willing to register as brokers or investment advisers, they should not recommend or rate the offerings that appear on the sites and should not advise investors about the merits or risks of those offerings. Without this restriction, a crowdfunding exemption could become a way to circumvent the regulation applicable to ordinary brokers and investment advisers. If crowdfunding sites act as anything other than a neutral intermediary, they should have to face the regulatory consequences. Similarly, if crowdfunding sites set up a secondary trading market for crowdfunded securities, the crowdfunding exemption should not free them from having to register as exchanges or alternative trading systems if such registration would otherwise be required.

3. Prohibition on Conflicts of Interests

Crowdfunding sites and their employees should not be allowed to invest in the offerings on their sites, or to have any financial interest in the companies posting offerings on the site. Some of the SEC no-action letters involving matching services condition relief on the non-participation of the site and its employees in any of the posted offerings.[671] Although typically unstated by the SEC staff, its concern is presumably conflicts of interest. If the site and its employees participate in advertised offerings, they will have a financial interest in favoring or promoting particular offerings.[672] If

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[670] *See supra* Parts IV.B.2.c.i and IV.C.4.

[671] *See, e.g.*, Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094, at *1 (Oct. 25, 1996); Atlanta Econ. Dev. Corp., SEC No-Action Letter, 1987 WL 107835, at *1 (Feb. 17, 1987).

[672] The receipt of transaction-based compensation already gives crowdfunding sites a financial incentive to promote all of the offerings

recommendations and other investment advice are prohibited, the potential dangers of such conflicts are reduced. Nevertheless, a conflict-of-interest prohibition would eliminate any remaining incentives to manipulate the system to promote or favor particular offerings. Such a condition would also prevent an issuer from setting up a sham site to promote the issuer's own securities. Whether or not it is necessary, a conflict-of-interest prohibition like this could enhance the public reputation of crowdfunding sites.[673] Such restrictions seem relatively harmless, and the cost to the site of imposing such a policy would be small.[674]

4. Notification to the SEC

Crowdfunding sites that meet the requirements of the exemption should not have to register as brokers, investment advisers, or exchanges, and no other special registration should be required. However, sites should have to notify the SEC that they are acting as crowdfunding sites pursuant to the exemption. The SEC, understandably, will want to monitor how the crowdfunding exemption is being used and whether sites are in compliance. It can do that only if it knows where crowdfunding is occurring. A simple notice containing the site's name and URL would be sufficient to make the SEC aware of sites that are engaged in crowdfunding under the exemption. Since the sites will be open to the public, including the SEC, the SEC will have access to all of the information being provided to investors.

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collectively. The concern here is the incentive to promote particular offerings in which the site's operators have invested or plan to invest.

[673] Of course, if that is the case, individual sites have a competitive incentive to impose and promote such policies, whether or not the SEC requires them.

[674] No employer can guarantee that its employees will abide by any conflict-of-interest policy. If the crowdfunding site has a conflict-of-interest policy, informs its employees of its policy, and makes a good faith effort to enforce the policy, it should qualify for the exemption. The site should not be liable if an employee, without its knowledge or complicity, invests in one of the site's offerings—for example, through a false identity.

This notice should not trigger any other regulatory requirements. The more the SEC requires from these sites, the greater the cost that will be passed along to crowdfunding entrepreneurs, and the less effective the crowdfunding exemption will be.

5. Investor Education

Many of the investors on crowdfunding sites will be unsophisticated.[675] The participation of so many unsophisticated investors offers a rare investor-education opportunity. Before she is given access to any offerings, each crowdfunding investor should be required to complete a brief investor-education video or quiz prepared by the SEC.[676]

This article is not suggesting that the SEC certify whether investors are qualified to invest or that the education be in the form of a full course on investment.[677] Such requirements would unduly burden crowdfunding and chill its development. This article merely suggests the use of a brief educational film or quiz with feedback that would take no more than five or ten minutes to complete. Such a short presentation would not make crowdfunding investors sophisticated, but it would allow the SEC to warn them of the potential pitfalls and risks associated with small business investments.

The mechanics would be relatively simple. When investors first register with the crowdfunding site, they could be linked to the SEC material; they would be returned to the crowdfunding site when the educational video or quiz is

[675] *See supra* Part VI.B.2.

[676] *See* SBE Council Proposal, *supra* note 405 (proposing that investors be required to take an online test prior to investing).

[677] Others have suggested certification of investors. *See, e.g.*, Choi, *supra* note 510, at 310–11 (proposing that investors be licensed); Finger, *supra* note 638, at 759–62 (2009) (proposing that investors be licensed). *See also* Hass, *supra* note 198, at 112 (arguing that unseasoned issuers should have to make a suitability determination before selling securities to unsophisticated retail investors).

completed.[678] There is no easy way to guarantee that investors actually pay attention—or, in the case of a video, even watch it. However, this requirement would at least give unsophisticated investors an *opportunity* to learn something. Those who choose not to take advantage of this opportunity have only themselves to blame.

Heminway and Hoffman propose to accomplish the same objective in a slightly different way—by requiring each crowdfunding web site to include cautionary language and certain other limited disclosures.[679] This is a plausible alternative, but the proposal set forth above has two advantages. First, it allows a disinterested party—the SEC—to control the disclosure and the context in which it is presented. Second, cautionary language and mandatory disclosures tend to be ignored, as anyone who has dealt with the detailed scroll-down licenses on the Internet can attest. Under this proposal, investors would be forced to engage on some level with a non-graded quiz, even if they breeze through it.

6. Funding Goals and Withdrawal Rights

Entrepreneurs should be required to include a funding goal in their online proposals and should not be allowed to close offerings unless and until investors have pledged at least that amount. Until then, investors should be free to change their minds and withdraw their pledges.

These requirements allow the social networking aspect of crowdfunding to work fully. Investors can communicate with each other while the offering is open and withdraw their bids

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[678] Crowdfunding sites would not be required to present the SEC material to investors or to endorse the SEC educational materials as their own, only to limit access to investors who have viewed such material. Therefore, any claim that the exemption compels speech in violation of the First Amendment seems weak. *See generally* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 1001–02 (4th ed. 2011) (discussing the compelled speech issue under the First Amendment); RONALD ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE 63–64 (4th ed. 2008) (same).

[679] *See* Heminway & Hoffman, *supra* note 142, at 957–59.

if they conclude, based on the information shared, that the offering is not a suitable investment. The all-or-nothing condition also protects the most optimistic and foolhardy investors from their own improvidence. Unless the entrepreneur can convince other, more rational, investors to participate, the foolhardy are not at risk.[680]

The all-or-nothing condition also forces the entrepreneur to carefully consider her financing needs before posting her proposal. Since overreaching could cause the offering to fail, the entrepreneur has an incentive to request only the true minimum amount needed to fund the project. This should lead to more careful budgeting before the funding request is posted.

Some of the existing crowdfunding sites already impose all-or-nothing requirements,[681] and such requirements are common in other areas of securities regulation. Some securities offerings include minimum sales conditions.[682] Completing an offering when that minimum is not met

[680] This all-or-nothing restriction "'imposes a lot of market discipline . . . You can see whether an artist or organizer can get sufficient attention to a project.'" Tina Rosenberg, *On the Web, A Revolution in Giving*, N.Y. TIMES (Mar. 31, 2011), http://opinionator.blogs.nytimes.com/2011/03/31/on-the-web-a-revolution-in-giving/ (quoting Ethan Zuckerman, senior researcher at Harvard's Berkman Center for Internet and Society).

[681] *See, e.g.*, *Kickstarter Basics*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter%20basics#AlloFund (last visited Mar. 5, 2012); *Company Terms and Conditions for Services*, PROFOUNDER, *supra* note 112 ("If the aggregate value of pledges that Company receives in its Raise does not meet Company's Raise Goal within the time period allotted, ProFounder will no longer continue to support the making or collection of pledges for that particular Raise, pledges will not be converted to Investments and funds distributed to Company, and no money will change hands on the Website."). *But cf. Frequently Asked Questions*, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Mar. 5, 2012) (follow "Creating a Campaign" hyperlink) ("With Flexible Funding you still keep the money you raise with your campaign. You will be charged a 9% fee on the money you raise, despite the unmet funding goal. With Fixed Funding, IndieGoGo will refund all your campaign's contributions if your goal is unmet, and you will not be charged any fees.").

[682] *See* Regulation S-K, Item 501(a)(8)(ii), Example B, 17 C.F.R. § 229.501(a)(8)(ii) (2012) (requiring that any such conditions be disclosed on the front cover of the registration statement).

constitutes securities fraud.[683] Since no contract of sale is allowed before a registration statement is effective,[684] investors who express interest before that time are free to change their minds and withdraw their offers. Similarly, shareholders whose shares are subject to a tender offer are free to withdraw their tenders at any time prior to closing of the offer.[685] Crowdfunding investors should receive similar protection.[686]

C. Other Possible Requirements

1. Non-Profit Versus Profit Status

Crowdfunding sites should not be required to have non-profit status. The SEC no-action letters applying the definitions of broker and investment adviser to Internet matching sites have often focused on the provider's non-profit status.[687] A for-profit provider obviously has a stronger incentive to push investors and entrepreneurs to complete the proposed transactions, even if those transactions are not in the investors' best interests.[688] This is especially true

[683] Exchange Act Rule 10b-9(a)(2), 17 C.F.R. § 240.10b-9(a)(2) (2012). *See also* In the Matter of Richard H. Morrow, Exchange Act Release No. 40,392 (Sept. 2, 1998) (violation to sell securities after the deadline set in the offering document for raising the required minimum amount).

[684] *See* Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2010).

[685] Exchange Act Rule 14d-7(a)(1), 17 C.F.R. § 240.14d-7(a)(1) (2012).

[686] Another possibility would be to impose a minimum time period that offerings must be open before they may close, similar to the minimum offering period the SEC requires for tender offers. *See* 17 C.F.R. § 240.143-1(a). In many cases, it will take time for the entrepreneur to convince sufficient investors to meet the entrepreneur's funding goal; no regulatory minimum is needed in such cases. But a regulatory minimum would insure that investors have time to consider the offering and communicate with each other even in the most popular offerings. The author does not advocate such a minimum limit, but, if it is sufficiently short, it would not substantially burden issuers using the exemption.

[687] *See supra* Part IV.B.2.e and text accompanying note 363.

[688] *See* Verstein, *supra* note 12, at 18 (arguing that peer-to-peer lending platforms "have an incentive to encourage lending . . . while lenders bear the brunt of the loss if the lending is imprudent").

when the site operator's compensation depends on completion of the transaction, as in the case of many existing crowdfunding sites.

But that profit motive also gives companies incentives to establish crowdfunding sites in the first place and to develop and improve those sites.[689] With the exception of Kiva (admittedly a big exception), for-profit sites have driven business-related crowdfunding. Limiting crowdfunding to non-profits would seriously restrict its development. Some of the proposed restrictions on crowdfunding sites, such as the prohibition of investment advice and the conflicts-of-interest bar, should temper some of the adverse effects of the profit motive. Reputational constraints should also moderate a site's interest in pushing investors toward inappropriate investments; a site that develops a reputation for losing investments will suffer a loss of customers as investors move to more reputable sites.[690]

2. Mandatory Disclosure by Entrepreneurs

Senate Bill 1970 imposes extensive mandatory disclosure requirements as a condition of the exemption. It would require detailed standardized disclosure about the issuer, its business and business plan, its ownership and capital structure, the offering, the rights of the securities being sold, and even financial statements prepared by independent accountants and audited in some cases. Mandatory disclosure requirements like those will unduly increase the cost of crowdfunding.[691] Entrepreneurs will need to hire

[689] *See* Olivia L. Walker, *The Future of Microlending in the United States: A Shift from Charity to Profits?*, 6 OHIO ST. BUS. L.J. 383, 393–95 (2011) (arguing that, for microlending to succeed in the United States, it needs to be transformed into a for-profit industry).

[690] *See* Verstein, *supra* note 12, at 14 (arguing that peer-to-peer lending platforms "have long-term incentives to cultivate impressive returns to gain customers").

[691] Heminway and Hoffman concede that one of "[t]he major disadvantage[s] of this type of disclosure requirement [is] its cost." Heminway & Hoffman, *supra* note 142, at 959. Broad, ambiguous disclosure requirements are equally dangerous. Senate Bill 1791, for

attorneys and accountants to comply, and the increased cost will drive away small, marginal entrepreneurs. Crowdfunding site operators might help entrepreneurs to complete the required disclosure, but that does not eliminate the cost, and such advice increases the likelihood that the site operator will be treated as a broker or investment adviser.[692] A better option for crowdfunding filings would be the very simple notice filing required by House Bill 2930.[693]

The proponents of strong mandatory disclosure requirements are missing one of the important facets of the argument for small business exemptions. For offerings below a certain size, the cost of *any* regulatory requirements—even a minimal disclosure requirement—exceeds the benefit. For those small offerings, an *unconditional* exemption makes sense.[694] No matter how attractive registration and standardized disclosure seem in the abstract, they make no economic sense for the very small offerings that crowdfunding facilitates.

Although it allows easier comparisons among investment opportunities and therefore has some value to investors,[695] standardization of disclosure is a bad idea for another reason. Crowdfunding is still in a very early stage of development. Standardization of what appears on crowdfunding sites could discourage experimentation and

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instance, requires issuers to disclose "all rights of investors, including complete information about the risks, obligations, benefits, history, and costs of offering." S. 1791, 112th Cong. § 2(b)(1)(A) (2011). What does it mean to provide "complete" information about all the risks of the offering? This uncertain requirement merely provides fodder for subsequent investor lawsuits against issuers who were not advised by sophisticated securities counsel.

[692] See *supra* Parts IV.B.2.c.i and IV.C.4.

[693] *See* H.R. 2930, 112th Cong. § 2(b) (2011) (requiring information about the issuer, its principals, the purpose of the offering, the target offering amount, and the deadline for reaching that target).

[694] The author explains this point in much greater detail elsewhere. *See* Bradford, *Securities Regulation and Small* Business, *supra* note 605, at 29–33; Bradford, *Transaction Exemptions*, *supra* note 509, at 614–22.

[695] *See* Heminway & Hoffman, *supra* note 142, at 938–39 (arguing that standardization promotes efficiency).

freeze its development. Instead of forcing all crowdfunding sites into a federally mandated standard disclosure model, regulators should allow them to search for the format that investors find most useful.

3. Restrictions on Resale

The three bills outstanding in Congress all restrict the resale of crowdfunded securities.[696] Heminway and Hoffman argue that such restrictions are necessary because a resale market may not provide new investors with direct access to the information available on the crowdfunding site itself, so resales are more conducive to fraud.[697]

Restrictions on resale are neither necessary nor desirable, although their presence will not unduly chill use of the exemption. The existing crowdfunding sites do not maintain trading markets, and they cannot easily establish such markets without registering as exchanges or alternative trading systems.[698] If crowdfunding platforms do establish their own trading platforms, information about the entrepreneur and the offering is available on-site. Given the small amounts invested, active trading markets are unlikely to develop outside the crowdfunding site.[699]

Resale restrictions are likely to serve only as a trap for the unwary. Unsophisticated investors, who are unlikely to understand or even be aware of such restrictions, would be exposed to liability whenever they sell their crowdfunded securities to Uncle Ernie or Aunt Emma. And, if resale restrictions are given any teeth, such resales could cause

[696] *See supra* Part V.G.

[697] *See* Heminway & Hoffman, *supra* note 142, at 954.

[698] *See supra* Part IV.A.

[699] However, the notes offered by Prosper and Lending Club are traded on a platform maintained by FOLIOIfn, a registered broker-dealer. *See* Prosper Registration Statement, *supra* note 81, at 11; Lending Club Registration Statement, *supra* note 81, at 11. It is not clear how actively those notes are traded.

issuers to lose their exemptions.[700] Given the limited danger, resale restrictions are undesirable.

D. Preemption of State Law

Securities regulation in the United States is a polycentric combination of federal and state regulation. Issuers offering securities must deal not only with the registration requirements of the federal Securities Act, but also with the registration requirements in all of the states in which they offer the securities. Congress has preempted state registration requirements for the offering of certain securities,[701] but the securities sold by small issuers on crowdfunding sites do not fall within the preempted categories. Even if the SEC adopts a crowdfunding exemption, the states would remain free to regulate crowdfunding.[702]

State securities laws also require the registration of brokers and other agents engaged in securities activities.[703] Exempting crowdfunding sites from federal regulation as brokers or investment advisers would not protect them from similar state regulation. The Exchange Act limits the power of states to regulate brokers and their associated persons,[704] but, as explained earlier, crowdfunding sites would *not* be brokers under the proposed crowdfunding exemption. The

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[700] Heminway and Hoffman recognize this issue. They note that "any regulatory solution should address the manner in which investor violations of any resale prohibition impact the issuer's exemption." Heminway & Hoffman, *supra* note 142, at 954 n.367.

[701] *See* Securities Act of 1933 § 18, 15 U.S.C. § 77r(a), (b) (2010).

[702] Cohn & Yadley, *supra* note 11, at 13 ("Even when the issuer is able to qualify for exemption from the 1933 Securities Act, there is no guarantee, other than Rule 506, that the offering will be exempt from state securities regulation."). A crowdfunding site could avoid the application of a *particular* state's securities law by not selling in that state. Most states have adopted an exemption for Internet offerings when (1) the offer specifically indicates it is not being offered to the residents of that state; (2) no offer is specifically directed to anyone in that state; and (3) no securities are sold in that state. *See* Sjostrom, *supra* note 198, at 30.

[703] *See generally* 12A LONG, *supra* note 148, at 8-3–8-6.

[704] Securities Exchange Act of 1934 § 15(i), 15 U.S.C. § 78o(i).

states would be free to construe the term "broker" more broadly than under federal law. However, the SEC probably could effectively preclude state regulation of crowdfunding sites as investment advisers. The Investment Advisers Act provides that states may not require the registration, licensing or qualification of advisers excepted from the federal definition in Section 202(a)(11) of the Act,[705] and one of the exceptions in 202(a)(11) is for advisers designated by the SEC.[706]

States could develop coordinated exemptions that would also free crowdfunded offerings from state regulatory requirements. This would not be unprecedented. Many states, for example, have adopted a Uniform Limited Offering Exemption ("ULOE") that coordinates with Rule 505 of Regulation D.[707] However, states have been unwilling to extend the ULOE to Rule 504,[708] and it is unlikely they will extend it to any other exemption for offerings to unaccredited, unsophisticated investors.[709] The North American Securities Administrators Association is working on a model crowdfunding rule, but it has not yet been

[705] Investment Advisers Act of 1940 § 203A(b)(1)(B), 15 U.S.C. § 80b-3a(b)(1)(B) (2010).

[706] Investment Advisers Act of 1940 § 202(a)(11)(G), 15 U.S.C. § 80b-2(a)(11)(G) (2010).

[707] There are actually two versions of the Uniform Limited Offering Exemption. *See* 12B LONG, *supra* note 148, apps. C, C-1. For a general discussion of the ULOE, *see* 12 LONG, *supra* note 148, 7-85–7-107.

[708] Only four states have exemptions for offerings under Rule 504, and at no time has there been any serious effort to coordinate the ULOE with Rule 504. 12 LONG, *supra* note 148, at 7-199.

[709] Most states have adopted a uniform private offering exemption that exempts offerings to no more than a few people in the state. *See* 12 LONG, *supra* note 148. That exemption is unlikely to work for most crowdfunded offerings. It focuses on the number of offerees in the state, not the number of purchasers, effectively precluding publicly advertised offerings. *Id.* Some states have altered their versions of the exemption to focus on the number of purchasers, but even some of those states still put an outside limit on the number of offerees. *Id.* Other states read a sophistication requirement into the exemption, which would preclude public offerings. *Id.*

publicly released.[710] Even if a model rule is developed, its success would depend on uniform adoption by all the states, and the history of other state-coordinated exemptions is not encouraging.

Because of state securities law, a federal crowdfunding exemption would not by itself allow entrepreneurs to avoid the cost of regulation. Unless state law was preempted, a federal exemption would merely shift the cost to another level in the federal system. Absent corresponding state exemptions, a federal exemption would therefore accomplish little.[711] Compliance with state regulation alone is "prohibitively costly if companies are seeking to raise only small amounts of money."[712] Therefore, states should be preempted from requiring the registration of offerings that comply with the proposed crowdfunding exemption.[713]

The most effective way to preempt state law is through congressional action.[714] Congress could simply add crowdfunded securities to the existing list of preempted offerings.[715] This is precisely what House Bill 2930 proposes

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[710] See *NASAA Completes Draft of Model Crowdfunding Rule*, Sec. L. Daily (BNA) (Dec. 5, 2011). The model rule apparently would not exempt issuers from filing a state disclosure document. *Id.*

[711] Rutheford Campbell argues that requiring federally exempted small business offerings to comply with state registration requirements is inconsistent with the SEC's reckoning of the appropriate balance between investor protection and capital formation and imposes an "unwarranted drag on capital formation." Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 208 (1997) [hereinafter Campbell, *Blue Sky Laws*]. More recently, Campbell has called for the complete preemption of all state registration requirements. *See* Rutheford B. Campbell, Jr., *Federalism Gone Amuck: The Case for Reallocating Governmental Authority Over the Capital Formation Activities of Businesses*, 50 WASHBURN L.J. 573 (2011).

[712] Shane, *supra* note 588.

[713] Others agree that any crowdfunding exemption should preempt state law. *See* Heminway & Hoffman, *supra* note 142, at 960; Pope, *supra* note 99, at 1000.

[714] *See* Cohn & Yadley, *supra* note 11, at 82 (calling for congressional action to preempt state registration requirements for all federally exempted offerings except the intrastate exemption).

[715] *See* Securities Act of 1933 § 18, 15 U.S.C. § 77r (2010).

to do. However, even House Bill 2930 preempts only state offering registration requirements.[716] It leaves the states free to regulate crowdfunding intermediaries as brokers.

Another possibility is intriguing, but it is less likely. Section 18(b)(3) of the Securities Act preempts state securities requirements "with respect to the offer or sale . . . [of securities] . . . to qualified purchasers, as defined by the Commission by rule."[717] The statute itself does not define "qualified purchaser;" instead, it says that the SEC "may define the term . . . differently with respect to different categories of securities, consistent with the public interest and the protection of investors."[718] The SEC could define the term "qualified purchaser" to include everyone who purchases in a federally exempted crowdfunding offering, thereby exempting crowdfunding offerings from state registration requirements.[719] This would not solve the "broker" or "investment adviser" issues under state law, but it would exempt the offerings themselves from registration.

However, it is reasonably clear that when Congress added this provision to the Securities Act, in the National Securities Market Improvement Act of 1996, it intended "qualified purchaser" to encompass only "sophisticated investors, capable of protecting themselves in a manner that

[716] Senate Bill 1791 takes a slightly more conservative approach. It preempts state offering registration requirements, but allows the issuer's home state, and any state in which the purchasers of more than 50% of the offering amount reside, to require notice filings and charge fees. *See supra* Part V.G.2.

[717] Securities Act of 1933 § 18(b)(3), 15 U.S.C. § 77r(b)(3) (2010).

[718] *Id.*

[719] Others have made similar suggestions. Shortly after these preemption provisions were added by the National Securities Markets Improvement Act of 1996, Campbell proposed that the SEC define "qualified purchaser" to include all purchasers in offerings pursuant to the Rules 504, 505, 147, and Regulation A exemptions. Campbell, *Blue Sky Laws*, *supra* note 711, at 207. *See also* Sjostrom, *supra* note 198, at 587–88 (noting this as a possible solution to the problem state regulation poses to Internet offerings).

renders regulation by State authorities unnecessary."[720] Rutheford Campbell argues that this legislative history should not limit the SEC,[721] but the SEC proposal to implement Section 18(b)(3), still not adopted, equates the term qualified purchaser with the term "accredited investor" in Regulation D.[722] Because most crowdfunding investors are not accredited investors, the SEC is unlikely to include them within the definition of "qualified purchaser" for purposes of preemption.

VIII. CONCLUSION

The SEC should adopt an exemption to facilitate crowdfunded securities offerings. That exemption should include the basic features outlined above. Issuers should be able to raise a maximum of $250,000–$500,000 each year without registration or other information requirements, provided that each investor invests annually no more than either $500 or 2% of the investor's annual income, whichever is greater. Those crowdfunded offerings should include a funding goal and should not close until that goal is met. Until then, investors should be free to withdraw from the offering.

The exemption should also require that the offering be made on a crowdfunding site that:

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[720] H.R. Rep. No. 622-104, pt. 1, at 31 (1996). *See also* S. Rep. No. 293-104, at 10 (1996).

[721] Campbell, *Blue Sky Laws, supra* note 711, at 207–08. Campbell notes that the statute itself contains no such restriction and states that the legislative history is "so disjointed and confusing as to be essentially worthless." *Id.* at 208. Section 18 requires the SEC to define the term "consistent with the public interest." Securities Act of 1933 § 18(b)(3), 15 U.S.C. § 77r(b)(3) (2010). Campbell also points out that, in considering what is in "the public interest," the SEC must consider not only investor protection, but also "whether the action will promote efficiency, competition, and capital formation." Campbell, *Blue Sky Laws*, *supra* note 711, at 207.

[722] *See* Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Securities Act Release No. 33-8041, SEC Docket S7-23-01 (Dec. 19, 2001).

> (1) notifies the SEC that it is facilitating crowdfunding offerings under the exemption;
>
> (2) is open to the general public;
>
> (3) provides a communication portal that allows investors to communicate about each offering;
>
> (4) requires investors to fulfill a simple education requirement before investing;
>
> (5) does not invest, and does not allow its employees to invest, in the site's offerings; and
>
> (6) does not offer investment advice.

The enactment of a crowdfunding exemption would be no panacea. None of the requirements that this article proposes will guarantee that investors receive their expected returns. None of these requirements will protect investors from the losses often incurred by investors in small businesses. None of these requirements will prevent fraud. That is not the point of the proposed crowdfunding exemption.

Instead, the proposed crowdfunding exemption is an attempt to promote small business capital formation by exempting offerings where the cost of registration clearly exceeds any possible benefits. The proposed exemption allows smaller, unsophisticated investors to act as capitalists and to learn by doing, while protecting those investors from catastrophic losses they cannot bear. Finally, the proposed exemption attempts to bring securities regulation into the modern world of social networking and the Internet—to reconcile the regulatory requirements of 1933 with the realities of the twenty-first century.