

Proceed at Your Peril: Crowdfunding and the Securities Act of 1933

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Funding small business firms while, at the same time, complying with applicable securities laws and regulations is tricky. Businesses need money to commence and sustain operations; however, most interests in the firm that non-bank funders request in return are deemed securities, invoking the possibility that the financing transaction is regulated by federal or state securities laws (or both). Under U.S. law, an offer or sale of securities must be registered unless the security or the transaction is exempt.³

For many small businesses, the cost of compliance with the applicable regulatory requirements outweighs the benefits associated with the proposed financing method. Small firms—even those with good ideas and business plans that are sustainable for the long term—either never get their fair shake in obtaining start-up funds or fail because they cannot finance the continued operation or growth of the business. There must be a better way

A promising Web-based funding model for small business firms (and, potentially, for larger enterprises) has emerged over the past few years. Crowdfunding, as this model has come to be known, has been defined in various ways.⁴ A recent article explains crowdfunding as follows:

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³ See 15 U.S.C. § 77e (2006).

⁴ See, e.g., JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING BUSINESS 281 (2008) (“Crowdfunding taps the collective pocketbook, allowing large groups of people to replace banks and other institutions as a source of funds.”); Kristina Dell, *Crowdfunding*,

The concept of crowdfunding finds its root in the broader concept of crowdsourcing, which uses the “crowd” to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment; this is generally done by using social networks, in particular through the Internet (Twitter, Facebook, LinkedIn and different other specialized blogs). The crowd-funders (those who provide the money) can at times also participate in strategic decisions or even have voting right. In other words, instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the “crowd”), where each individual will provide a very small amount.⁵

Crowdfunding includes a variety of business financing models using the Internet.⁶ As we use the term in this article, crowdfunding involves the use of a Web-based business enterprise to seek and obtain incremental venture funds from the public using a Web site (which we refer to as a “crowdfunding Web site”) to connect promoters of businesses or

TIME.COM, Sept. 4, 2008,

<http://www.time.com/time/magazine/article/0,9171,1838768,00.html> (describing crowdfunding as “[o]ne part social networking and one part capital accumulation”). Some define crowdfunding to exclude Web sites that promise to pay profit sharing to the funders. See Kieran Masterton, *How to Crowdfund Your Startup*, THINK VITAMIN, <http://thinkvitamin.com/web-industry/how-to-crowdfund-your-startup/> (“[R]ule number one of Crowdfunding is that you don't offer a percentage of your venture as a reward.”). Crowdfunding is sometimes confused or conflated with crowdsourcing, which also is a poorly defined term. But Jeff Howe, the apparent originator of the term, defines it broadly to include online business collaborative ventures of many kinds, where the power of the Internet is harnessed to substitute the public for employees, creating a new type of labor market. See Jeff Howe, *The Rise of Crowdsourcing*, WIRED, June 2006, <http://www.wired.com/wired/archive/14.06/crowds.html>. One commentator connects the two terms by offering that “[t]he term crowdfunding derives from another neologism: crowdsourcing, i.e., outsourcing to the public jobs typically performed by employees.” Dell, *supra*. Yet another includes a crowdfunding Web site, Aswarmofangels.com, in his list of crowdsourcing “efforts,” implying that crowdfunding is a type of crowdsourcing. Jessi Hempel, *Tapping the Wisdom of the Crowd*, BLOOMBERG BUSINESSWEEK, Jan. 2007, http://www.businessweek.com/innovate/content/jan2007/id20070118_768179.htm. Jeff Howe agrees, noting that “crowdfunding has more in common with other forms of crowdsourcing than is immediately apparent.” HOWE, *supra*, at 247.

⁵ Thomas Lambert & Armin Schwienbacher, *An Empirical Analysis of Crowdfunding*, Mar. 24, 2010, <http://ssrn.com/abstract=1578175>.

⁶ See KEVIN LAWTON & DAN MAROM, *THE CROWDFUNDING REVOLUTION 1* (2010) (“[T]he true social vibrance of crowdfunding is difficult to capture in a definition. The crowdfunding space is quite diverse, comprised of many niches, and shares a lot of social networking’s energy.”); C. Steven Bradford, *Crowdfunding and the Federal Securities Laws* 8-18 (Aug. 5, 2011) (unpublished manuscript) (on file with Tennessee Law Review) (describing various different models).

projects needing funding (which we refer to as “crowdfunded ventures”) with potential funders.⁷ Some crowdfunding Web sites specialize in a particular crowdfunded venture or type of crowdfunded venture; others are more general. A chart identifying and describing a number of crowdfunding Web sites in existence on the date work on this article was completed is included as Table 1.

We became interested in this venture finance model because it has huge appeal in a number of obvious respects, yet we could not understand how some of the crowdfunding Web sites and crowdfunded ventures (especially those offering profit-sharing interests to funders) were complying with federal securities laws.⁸ Our study of these firms in that context has resulted in, among other things, this article. The article includes both descriptive and normative observations. It is clear that some (but not all) manifestations of the crowdfunding model result in the offer and sale of interests that are securities under the Securities Act of 1933, as amended (the “Securities Act”),⁹ and that these offers and sales are neither registered nor exempt from registration as required under the Securities Act. These crowdfunded ventures are at risk. They are the focus of the analysis and prescriptions we offer here.

We are not alone in our engagement with the federal securities law aspects of crowdfunding. Among others, the U.S. Securities and Exchange Commission (“SEC”) has taken an interest in crowdfunding. In an April letter to the Chairman of the Committee on Oversight and Government Reform of the U.S. House of Representatives, SEC Chairman Mary Schapiro expressly mentions crowdfunding as a new capital-raising strategy and indicates that the SEC has been engaged with industry participants and is focusing on how

⁷ This definition is not vastly different from the one constructed by the authors of the article cited *supra* note 5. These authors define crowdfunding, based on the 51 examples they reviewed, as involving “an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes.” *Id.* at 6.

⁸ We focus in this article on the federal laws and regulations governing securities offerings—and most specifically the Securities Act and rules adopted by the SEC under it, but we note here the potential applicability of aspects of broker-dealer, investment advisory, or exchange regulation and state securities (or “blue sky”) laws and regulations. See Bradford, *supra* note 6, at 30-51; C. Steven Bradford, *Peer-to-Peer Lending, Crowd-funding, and Securities Law*, June 17, 2011,

http://lawprofessors.typepad.com/business_law/2011/06/peer-to-peer-lending-crowd-funding-and-securities-law.html [hereinafter Bradford, *Peer-to-Peer Lending*]. We also note that the possibilities and perils of crowdfunding cross state borders internationally. While this is extremely important, it is part of a larger issue in international (and especially Internet) securities offerings that this article does not attempt to resolve. At various points throughout, however, as relevant to our analysis, we reference crossover issues under state and international law. And finally, although we note in several places the possibility that other regulatory schemes (notably, the regulation of gambling and charitable solicitations), this article does not address these other potential source of regulation.

⁹ 15 U.S.C. § 77a – aa (2006).

to address regulatory concerns relating to crowdfunding.¹⁰ In addition, in testimony before that House Committee later in the month, Chairman Schapiro echoed many of the same themes from the letter, without expressly mentioning crowdfunding.¹¹

I recently asked the staff to take a fresh look at our offering rules in light of changes in the operation of the markets, advances in technology and the acceleration in the pace of communications. I also requested that the staff think creatively about what the SEC can do to encourage capital formation, particularly for small businesses, while maintaining important investor protections. Areas of focus for the staff will include:

- the restrictions on communications in initial public offerings;
- whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends and our mandates to protect investors and facilitate capital formation;
- the number of shareholders that trigger public reporting, including questions surrounding the use of special purpose vehicles that hold securities of a private company for groups of investors; and
- regulatory questions posed by new capital raising strategies.

In conducting this review, we will solicit input and data from multiple sources, including small businesses, investor groups and the public-at-large. The review will include evaluating the recommendations of our annual SEC Government-Business Forum on Small Business Capital Formation, as well as suggestions we receive through an e-mail box we recently created on our website. In addition, I expect our efforts to benefit from the input of the new Advisory Committee on Small and Emerging Companies the Commission is in the process of forming, which will provide a formal mechanism for the Commission to receive advice and recommendations about regulatory programs that affect privately held small businesses and small publicly traded companies.¹²

The SEC's current focus on crowdfunding and related capital formation strategies and business models is an important and necessary step in defining the SEC's reach in

¹⁰ Letter from Mary L. Schapiro to The Honorable Darrell E. Issa, dated April 6, 2011, at 22-24, available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf> [hereinafter Issa Letter]. See also C. Steven Bradford, *Crowdfunding and the SEC*, Apr. 18, 2011, http://lawprofessors.typepad.com/business_law/2011/04/crowdfunding-and-the-sec.html [hereinafter Bradford, *Crowdfunding*].

¹¹ Mary L. Schapiro, Testimony on the Future of Capital Formation, May 10, 2011, available at <http://www.sec.gov/news/testimony/2011/ts051011mls.htm> [hereinafter Schapiro Testimony].

¹² *Id.* The email box referenced in Chairman Schapiro's testimony is available at <http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml>.

regulating crowdfunding and other innovative capital markets.¹³ Moreover, with the right approach, the SEC can take a leading role (working with industry) in defining responsible parameters for crowdfunding on a going-forward basis. This article is designed to contribute to the regulatory conversation.

In our view, investor protection and the maintenance of market integrity—the two principal policies underlying the federal securities laws—do not clearly compel registration of interests offered and sold through crowdfunding Web sites, even if those interests are securities within the meaning of the Securities Act.¹⁴ This article supports our contention in several ways. First, it explores both the foundational definitional question—whether, and if so, when crowdfunding interests are securities—and the implications of the answer to that question as a matter of positive law and underlying policy. The article then addresses the advantages and disadvantages of the crowdfunding venture finance model and concludes by proposing the principles, processes, and substantive components of an exemption from registration that is designed to enable survival of the crowdsourcing model as an investment vehicle and, at the same time, appropriately protect those investors who cannot fend for themselves.

To accomplish these objectives, the article proceeds in four additional parts. Part I analyzes the circumstances under which crowdfunding interests are securities under the definition provided in Section 2(a)(1) of the Securities Act.¹⁵ After situating crowdfunding interests as potential investment contracts governed by the *Howey* test,¹⁶ this Part of the article explains the elements of an investment contract and compares and contrasts them, in pertinent part, to the attributes of crowdfunding interests. This analysis reveals that some crowdfunding interests are likely classifiable as securities. Given that some crowdfunding interests may be securities, Part II of the article then focuses on the consequences of that legal conclusion. Part II first describes the regulatory ramifications of security status under the Securities Act's key operative provisions (which require, in significant part, that the offer and sale of a security must be registered or exempt from registration¹⁷) and the policies underlying both the registration requirement and relevant exemptions. Part III explains why the offer and sale of crowdfunding interests under certain conditions should not require registration and offers a possible solution in the form

¹³ Another Internet-based market for small business finance that also has attracted SEC attention is the peer-to-peer lending market. See Angus Loten, *Peer-to-Peer Loans Grow*, WALL ST. J., June 16, 2011, at B10.

¹⁴ This question is, of course, of paramount importance to the SEC as it contemplates the appropriate level of regulation of crowdfunding. "In considering whether an exemption from the registration requirements of the Securities Act is appropriate for capital formation strategies like crowdfunding, the Commission will be mindful of its dual responsibilities of facilitating capital formation and protecting investors." See Issa Letter, *supra* note 10.

¹⁵ 15 U.S.C. § 77b(a)(1) (2006).

¹⁶ See *infra* note 21 and accompanying text.

¹⁷ See 15 U.S.C. at § 77c – e.

of the means of developing a new registration exemption adopted by the SEC under Section 3(b) of the Securities Act.¹⁸ Part IV offers a summary conclusion.

I. ARE CROWDFUNDING INTERESTS SECURITIES UNDER THE SECURITIES ACT?

Our concern about the application of the Securities Act in the context of crowdfunding Web sites is misplaced if crowdfunding interests are not securities. Accordingly, this Part addresses the threshold question of whether crowdfunding interests are securities under the Securities Act.

The Securities Act contains a statutory definition of the term “security,” which states that, “unless the context otherwise requires,” the term “security” includes a variety of listed financial instruments. The list comprises (among other, more typical financial interests, like stock, bonds, debentures, evidence of indebtedness, and options) an “investment contract.”¹⁹ In cases involving instruments other than standard equity, debt, and derivative instruments, the application of Section 5’s registration mandate often depends on whether or not the particular financing device is an investment contract and, therefore (unless the context otherwise requires), a security.²⁰ Consequently, the U.S. Supreme Court developed a common law test, known as the *Howey* test, for determining whether or not a financial instrument is an investment contract.²¹ Under the *Howey* test, “an investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party. . . .”²² *Howey* involved the solicitation of purchasers of real property interests and related service contracts that together represented profit-sharing interests in Florida citrus groves.²³ The court found that these

¹⁸ *Id.* at § 77c(b).

¹⁹ 15 U.S.C. at § 77b(a)(1).

²⁰ *See, e.g.,* SEC v. Edwards, 540 U.S. 389 (2004) (holding a sale and leaseback arrangement of payphones on the promoter’s property was an investment contract); Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967) (holding that a program for breeding beavers was an investment contract); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (holding that a program in which investors raised chinchillas and sold the offspring to the owners for resale at inflated prices constituted an investment contract).

²¹ *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (determining that an arrangement to sell profit-sharing interests in a citrus grove was an investment contract).

²² *Id.* at 298-99. *See also* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975) (“The touchstone [of an investment contract] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”).

²³ The investment interests offered in the *Howey* case included a land sales contract for a citrus grove by W. J. Howey Company and an accompanying service contract with W. J. Howey Company’s affiliate, Howey-in-the Hills Service Inc., giving Howey-in-the-Hills a leasehold interest that allowed the company to cultivate the crops on the land. *Id.* at 295-96.

combined transactions constituted investment contracts (and, given the context, securities).

A. *Howey* Explained and Interpreted

The various parts of the *Howey* test have been illuminated in meaningful ways in subsequent federal court opinions, including a number of Supreme Court opinions. In *United Housing Foundation, Inc. v. Forman*,²⁴ for example, the Supreme Court better identified when an arrangement constitutes an “investment.” The *Forman* Court focused on differentiating “consumption” and “use” from “investment” and determined that the latter occurs when “the investor is ‘attracted solely by the prospects of a return on his investment.’”²⁵ Thus, the existence of an investment depends on whether profits motivated the potential investor’s decision to provide funds. We say more about profits below, since the expectation of profits is a component of the *Howey* test.

The U.S. Supreme Court has not defined a “common enterprise,” and federal circuit courts of appeal have taken different approaches to determining whether one exists.²⁶ A business venture may be a common enterprise under *Howey*’s progeny if it meets one of three judicially ordained tests (with the applicable test determined by the federal circuit in which the case is brought). Two principal types of commonality exist, one of which has two different forms.

The first type of commonality recognized in these court cases is horizontal commonality. “A horizontal common enterprise is a pool of assets . . . , not separate accounts”²⁷ The horizontal commonality approach focuses on the relationship among the investors and requires that there be a pooling of investors’ funds for the purpose of generating financial returns based on the success of the venture (and, in some cases, a sharing of profits and losses on a pro-rata basis among investors).²⁸ In the *Howey* case itself, for example, the

²⁴ 421 U.S. at 837.

²⁵ *Id.* at 852-53 (citations omitted) (quoting from *Howey*, 328 U.S. 293). *Forman* and other federal cases typically do not focus on the word “solely” as a part of this analysis, preferring instead to look at degrees of significance. *See, e.g.,* *Timmreck v. Munn*, 433 F. Supp. 396, 402 (N.D. Ill. 1977) (“The court must therefore consider the nature of the promotion to determine whether the emphasis of the developers and their sales agents was on the ‘investment’ or the ‘consumption’ side of the real estate duality.”). The issue in *Forman* was whether the mandatory acquisition of shares of stock by tenants who wished to lease an apartment in a cooperative housing project involved the purchase of securities. *Id.* at 840. The Court concluded that because the tenants “purchase[d] a commodity for personal consumption or living quarters for personal use,” the interests in the co-op were not securities. *Id.* at 858.

²⁶ Christopher L. Borsani, *A “Common” Problem: Examining the Need for Common Ground in the “Common Enterprise” Element of the Howey Test*, 10 DUQ. BUS. L.J. 1, 7 (2008).

²⁷ *Schofield v. First Commodity Corp.*, 638 F. Supp. 4, 7 (D. Mass. 1985).

²⁸ *Id.* at 8 (citations omitted). This approach, as required by the Third, Sixth, and Seventh Circuits, depends on “whether [investors’] risks were pooled for a single investment

purchasers were offered “an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise.”²⁹ The *Howey* Court noted that purchasers of the land and management contracts have “no right of entry to market the crop; thus, there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking.”³⁰

Vertical commonality, the other principal type of commonality for purposes of *Howey*’s investment contract definition, focuses on the relationship between the promoter and the investor or investors, eliminating the requirement that investors pool their funds.³¹ The U.S. Court of Appeals for the Ninth Circuit has stated that “[a] common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those promoting the investment or of third parties.”³² Thus, strict vertical commonality (as the Ninth Circuit standard has been labeled) describes a venture in which the principals or promoters do not make a profit until the investors make a profit. In other words, strict vertical commonality requires a link between investment performance and promoter remuneration.³³ The promoter must have a financial stake in the investment, and the “fortunes of the investor [are] commingled with, and dependent upon the success of the promoter.”³⁴

Other courts have rejected this narrow definition of a common enterprise in favor of a more open inquiry. The resultant broad vertical commonality test merely recognizes the

purpose.” *Id.* (citing *Deckebach v. La Vida Charters, Inc. of Florida*, 867 F.2d 278 (6th Cir. 1989)).

²⁹ SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946). At least one commentator, however, believes that the investment scheme in *Howey* is not characterized by a pooling of investor funds. See James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 73 (2011) (“[H]orizontal commonality was not present in *Howey* itself because each investor individually owned a separate tract of land.”). We disagree. Although each investor purchased separate real estate, the profit-generating scheme to which each investor was contributing in that purchase involved the aggregation of their funds and lands, maintained and harvested collectively, with profits doled out from the aggregate enterprise based on the number of tracts owned. In this regard, the purchaser’s interests in the separate tracts of land (represented by deeds and service contracts) are the equivalent of a stock certificate in corporate equity investments—a tangible representation of each investor’s profit-sharing interest. *Howey*, 328 U.S. at 300 (“Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors’ allocable shares of the profits. The resulting transfer of rights in land is purely incidental.”).

³⁰ *Id.* at 296.

³¹ Borsani, *supra* note 26, at 9 (citations omitted).

³² SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

³³ Borsani, *supra* note 26, at 9 (citation omitted).

³⁴ *Id.* at 9-10 (citation omitted). The Ninth Circuit is the only circuit that follows this approach. *Id.*

existence of a relationship between the promoter's efforts and the investor's profits. "[T]he requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the [promoter's efforts]." ³⁵ Accordingly, broad vertical commonality requires a relationship between investor and promoter, but does not require that the promoter actually benefit in a manner consistent with the benefit promised to the investors (*i.e.*, the promoter's remuneration need not be dependent upon the success of the venture, but the profits of the investor must be dependent upon the promoter's expertise and efforts). ³⁶ Although the circuits differ on the exact scope of the "common enterprise" requirement, horizontal commonality (which often, but not always, exists regardless of the nature of any vertical commonality in a potential investment contract arrangement) is sufficient to satisfy this prong of the *Howey* test in most circuits. ³⁷

Finally, federal courts have illuminated the last two parts of the *Howey* test—the parts relating to expectations of profits from the efforts of others. The *Forman* Court defined "profits" as either "capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds" ³⁸ In a subsequent case, the Court announced that fixed returns may constitute profits under the *Howey* test. ³⁹

With respect to the "solely from the efforts of a promoter or a third party" prong in *Howey* (commonly shortened to "solely from the efforts of others" ⁴⁰), federal circuit court decisions have established that the proper analysis is not whether the efforts of others are the exclusive determinants of the investors' profits, but rather "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." ⁴¹ Although the Court has not directly endorsed this relaxed interpretation, it appears to have acquiesced in this formulation. ⁴² As a result, the definition of broad vertical commonality is effectively

³⁵ SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974).

³⁶ Borsani, *supra* note 26, at 10 (citing SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974)).

³⁷ *Id.* at 12.

³⁸ United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852-53 (1975).

³⁹ SEC v. Edwards, 540 U.S. 389, 394 (2004).

⁴⁰ *Howey* itself used this terminology. SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946) ("The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.").

⁴¹ SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974) ("[A] close reading of the language employed in *Howey* and the authority upon which the Court relied suggests that . . . we need not feel compelled to follow the 'solely from the efforts of others' test literally.").

⁴² MARC I. STEINBERG, UNDERSTANDING SECURITIES LAWS 18 (5th ed. 2009). As dictum, the *Forman* Court acknowledged the Ninth Circuit's decision in *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), which "held that 'the word 'solely' should not be read as a strict or literal limitation on the definition of an

synonymous with the “efforts of others” test, conflating two of the *Howey* test prongs—the existence of a common enterprise and the generation of profits from the efforts of others—in those jurisdictions adopting broad vertical commonality.⁴³

B. *Howey* Applied in Context

Although the attributes of crowdfunding ventures differ within a range (as illustrated in Table 1), the interests offered by some crowdfunding Web sites and crowdfunded ventures are equity interests that afford the owners some revenue or profit-sharing rights. Our analysis in this article (and our application of the *Howey* test) concentrates on these equity-type interests.

However, as an aside (and before applying *Howey* to crowdfunding interests), we note that some crowdfunding interests are styled as debt instruments. This type of instrument (separately listed under the “security” definition in Section 2 of the Securities Act as a “note, . . . bond, debenture, [or] evidence of indebtedness”⁴⁴) likely would be analyzed under the *Reves* Court’s “family resemblance” test (which determines when “notes,” as debt instruments listed in the both the Securities Act and the Exchange Act, are securities), rather than the *Howey* test.⁴⁵ The *Reves* analysis begins with a “presumption that every note is a security.”⁴⁶ The presumption may be rebutted by reference to a Second Circuit “list of instruments commonly denominated ‘notes’ that nonetheless fall without the ‘security’ category.”⁴⁷ If, however, the instrument is not among those listed,

[m]ore guidance . . . is needed. . . . [A]s the Second Circuit itself has noted, its list is “not graven in stone,” and is therefore capable of expansion. Thus, some standards must be developed for determining when an item should be added to the list.

An examination of the list itself makes clear what those standards should be. In creating its list, the Second Circuit was applying the same factors that this Court has held apply in deciding whether a transaction involves a “security.” First, we examine

investment contract.” *Forman*, 421 U.S. at 852 n. 16. Since this issue was not presented in *Forman*, the Court expressed no view on this matter in its holding. *Id.*

⁴³ See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994) (noting that under broad vertical commonality, “two separate questions posed by *Howey* -- whether a common enterprise exists and whether the investors' profits are to be derived solely from the efforts of others -- are effectively merged into a single inquiry”); James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 76 (2011) (“Broad vertical commonality is present whenever the first, third, and fourth prongs of the *Howey* test are met—i.e., when there is an investment of money with an expectation of profits solely from the efforts of others. Thus, the broad vertical commonality test eliminates the common enterprise prong of the *Howey* test.”).

⁴⁴ 15 U.S.C. § 77b(a)(1) (2006).

⁴⁵ See *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

⁴⁶ *Id.* at 65.

⁴⁷ *Id.*

the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument . . . to determine whether it is an instrument in which there is "common trading for speculation or investment" Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine 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.⁴⁸

Crowdfunding interests structured in the form of interest-bearing notes or similar debt instruments are likely to be classified as securities under the *Reves* test.⁴⁹ Although crowdfunding interests do not typically trade in a secondary market and the *Howey* test does not require an assessment of the applicability of alternative risk-reduction regulatory schemes, the same essential issues and tensions exist in the application of both the *Howey* and *Reves* tests.

Crowdfunding interests styled as equity instruments with profit-sharing components (our focus here) are best seen as investment contracts (and, given their context, securities) under Section 2(a)(1) of the Securities Act⁵⁰ as interpreted by *Howey* and its progeny. Our analysis breaks the *Howey* test into five parts or prongs (rather than the more standard framework for analysis used by jurists and commentators, which separates the investment contract definition into three or four elements⁵¹). We add to that analysis a brief

⁴⁸ *Id.* at 65-67 (citations and footnotes omitted).

⁴⁹ See Bradford, *supra* note 6, at 21-25 (engaging in an analysis of whether crowdfunding interests styled as debt instruments are securities and concluding that "[t]he *Reves* analysis supports the characterization of interest-bearing crowdfunding notes as securities, especially given the underlying presumption that notes are securities. interest-bearing notes.").

⁵⁰ 15 U.S.C. § 77(b)(a)(1) (2006).

⁵¹ See, e.g., *Warfield v. Alaniz*, 569 F.3d 1015, 1020 (9th Cir. 2009) (applying *Howey* in three parts but acknowledging that others use a four-part test); *United American Bank v. Gunter*, 620 F.2d 1108, 1116 (5th Cir. 1980) (referring to "application of the four-pronged *Howey-Forman* test"); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (stating that the *Howey* test "subsumes within it three elements: first, that there is an investment of money; second, that the scheme in which an investment is made functions as a common enterprise; and third, that under the scheme, profits are derived solely from the efforts of

discussion of context. To illustrate our analysis, we use one of the crowdfunding Web sites featured in Table 1, 33needs, as our primary example.⁵² Except as otherwise noted in the analysis set forth below, we assume that U.S. law is applicable to the purchase of the subject crowdfunding interests.⁵³

1. Contract, Transaction, or Scheme

Beginning with the first prong of the *Howey* test, the language, “contract, transaction or scheme” is seemingly broad enough to cover all crowdfunding business operations. We have found no court decision defining these terms in this context. Jurists and legal scholars easily pass over this component of the *Howey* test (considering it satisfied) because of its ostensible breadth.⁵⁴ The *Howey* Court notes that it is “immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”⁵⁵ The *Howey* Court also notes that the overall investment contract definition it propounds comes from earlier state law opinions.⁵⁶ These opinions provide important background and context but offer little in the way of content that is not embodied in the *Howey* opinion. A unitary legal contract is not required (as the *Howey* case itself illustrates⁵⁷), and the words “transaction” and “scheme” do not have an

individuals other than the investors.”).

⁵² See 33NEEDS.COM, <http://www.33needs.com/>. We chose this site as our example because it allows for a more detailed treatment of the “investment of money” part of the *Howey* test. In the interest of full disclosure, it must be noted here that one of us (Professor Heminway) has been in communication with the founder of 33needs since January 2010.

⁵³ Having assumed this, we note that the jurisdictional reach of the U.S. securities laws in this context is an unclear matter. Rule 901 of Regulation S under the Securities Act provides that “for the purposes only of Section 5 of the Act, the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not include offers and sales that occur outside the United States. 17 C.F.R. § 230.901. Under Regulation S, an offer or sale occurs outside the United States when it is made in an offshore transaction, which requires (among other things) that the offer not be made to a person in the United States and that any sale transaction meet other specified requirements. 17 C.F.R. § 230.903. This may not be as simple as it sounds. Moreover, despite a recent Supreme Court case, *Morrison v. Nat’l Australia Bank*, 130 S.Ct. 2869 (2010), attempting to clarify the extraterritorial reach of the key antifraud provision applicable to purchases and sales of securities, Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78j(b) (2006), questions also remain as to the application of the *Morrison* rule in specific cases.

⁵⁴ See, e.g., C. Edward Fletcher, III, *Sophisticated Investors under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1131 (noting that “over time, courts have refined the *Howey* test into three elements: (1) an investment of money (2) in a common enterprise with (3) an expectation of profits that will be derived from others’ efforts.”).

⁵⁵ SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946).

⁵⁶ *Id.* at 298.

⁵⁷ *Id.* at 300 (noting that the plaintiffs’ “respective shares in this enterprise are evidenced by land sales contracts and warranty deeds.”) See also SEC v. Edwards, 540 U.S. 389, 391

accepted legal meaning. In common American English usage, the word “transaction” means “something transacted; *especially*: an exchange or transfer of goods, services, or funds”⁵⁸ and the word “scheme,” in this context, means “a plan or program of action; *especially*: a crafty or secret one.”⁵⁹ These terms have expansive meanings, and the Court tacitly embraced them in the *Howey* opinion when it noted that its overall investment contract definition

permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of “the many types of instruments that in our commercial world fall within the ordinary concept of a security.” It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.⁶⁰

While some crowdfunding business models may not involve the execution of a formal written contract, the sale of an interest in the funded venture typically does involve an offer, an acceptance, mutual obligation, the transfer of consideration and other elements of a legally valid, binding, and enforceable contract under U.S. law.⁶¹ For example, 33needs

(2004) (involving the sale of payphones “packaged with a site lease, a 5-year leaseback and management agreement, and a buyback agreement.”); *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989) (involving the purchase of a condominium packaged with several rental agreements).

⁵⁸ “Transaction,” MERRIAM-WEBSTER DICTIONARY, at <http://www.merriam-webster.com/dictionary/transaction>. Similarly, *Black’s Law Dictionary* defines a “transaction” as: “(1) The act or an instance of conducting business or other dealings. (2) Something performed or carried out; a business agreement or exchange. (3) Any activity involving two or more persons.” BLACK’S LAW DICTIONARY 728 (3rd pocket ed. 2006).

⁵⁹ “Scheme,” MERRIAM-WEBSTER DICTIONARY, at <http://www.merriam-webster.com/dictionary/scheme>. *Black’s Law Dictionary* defines a “scheme” as: “(1) A systematic plan; a connected or orderly arrangement, esp. of related concepts” BLACK’S LAW DICTIONARY, *supra* note 58, at 634.

⁶⁰ *Howey*, 328 U.S. at 299 (citation omitted).

⁶¹ The five primary requirements of a valid contract are:

one or more promisors and one or more promisees having legal capacity to enter into the contract; at least one promisor or one promisee who is an individual party on but one side of the contract, as distinguished from membership in an entity which may be a party on the other side; a manifestation of mutual assent by the parties who form the contract, to the terms of the contract and by each promisor to the consideration for a promise, with limited exceptions; sufficient consideration, again with limited exceptions; and a requirement that the transaction must not be one declared void by statute or by special rules of the common law.

RICHARD A. LORD, WILLISTON ON CONTRACTS § 3:2 (4th ed. 2011) (citations omitted); *see also* AM. JUR. 2D *Contracts* § 19 (“The elements of a valid contract have been stated as . . . an offer, acceptance, contractual capacity, consideration, a manifestation of mutual assent, and legality of the object of consideration . . .”).

describes the investment⁶² process as follows in the FAQ (frequently asked questions) part of its Web site:

How do I invest?

So simple: just click the big invest button on any company page. You'll be asked to select your investment amount. From there, you will go through Amazon.com's secure and uber simple checkout process.⁶³

Accordingly, the investment is made in the form of a standard ecommerce purchase and sale accomplished by the payment of funds through checking account debits or the use of a debit or credit card. Internet purchases are generally acknowledged to be valid, binding, and enforceable contracts (under general U.S. legal principles) if made by persons having legal capacity.⁶⁴ Interestingly, the 33needs Web site expressly raises questions about both extraterritoriality and the legal capacity of investors.⁶⁵

Can I invest if I'm not in the US?

Absolutely. You can invest (or list your company) if you live on a remote island off the coast of Kenya or live in the heart of New York City.

...

Do investors need to be a certain age?

Investors who participate can be any age.

Do investors need to be in the U.S.?

Not at all.⁶⁶

Regardless of whether the purchase of crowdfunding interests is a valid, binding, and enforceable contract, the purchase by funders of a crowdfunding interest qualifies as a

⁶² The use of this word is not meant to convey a legal conclusion for purposes of the *Howey* test or otherwise. Rather, it is the term used for purchases of interests on the 33needs Web site. See FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq> (noting in particular the response to "I'm confused. Why do you call this an investment?").

⁶³ FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

⁶⁴ See JEFFREY H. MATSUURA, SECURITY, RIGHTS, AND LIABILITIES IN E-COMMERCE 185 (2001). See generally U.C.C. § 2-204(4) (2004) ("A contract may be formed by the interaction of an electronic agent and an individual acting on the individual's own behalf or for another person. ...").

⁶⁵ Again, "investors" is the word used on the 33needs Web site and its use is not intended to convey a legal conclusion. See *supra* note 62.

⁶⁶ FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

transaction or scheme—a plan or program to finance a business or project through the exchange of funds for profit-sharing interests. Even before *Howey*, the Court noted that the inclusion of terms such as “investment contract” in the Securities Act evidence a legislative intent to bring “novel, uncommon, or irregular devices” under the coverage of the Securities Act in some circumstances.⁶⁷ While crowdfunding is a fairly distinctive and new phenomenon, it is hard to fathom how a financing plan or program that involves the exchange of funds for profit-sharing interests in a third-party’s venture over the Internet would not qualify as a contract, transaction, or scheme under the *Howey* test.

2. Investment of Money

A number of crowdfunding business models involve people spending money with the prospect of getting more money back, seemingly satisfying the second prong of the *Howey* test. As shown in Table 1, many crowdfunding Web sites offer funders a financial return on the interests purchased.⁶⁸ When such a return is offered, it is usually in the form of a revenue-sharing or profit-sharing arrangement.⁶⁹ Viewing this bargain in isolation, there appears to be a clear income-seeking intent and motive on the part of funders.

However, *dicta* in the *Howey* case, cited to and applied by the Court in *Forman*, raises a question as to whether all exchanges of money made in the hopes of getting a return are

⁶⁷ SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (“By including an investment contract within the scope of [Section] 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by . . . prior judicial interpretation,” under which state courts had construed the term broadly “so as to afford the investing public a full measure of protection.”).

⁶⁸ There are, however, many crowdfunding Web sites that do not offer traditional financial returns (in the form of capital appreciation or a participation in earnings) to funders. For example, Kiva is a microfinancing venture that secures loans for start-up businesses in lesser developed countries. *See How it Works*, KIVA, <http://www.kiva.org/about/how>. The funders receive repayments of the principal of their loans with no interest. *Id.* VenCorps provides \$50,000 in start-up capital and enables funders to earn points for their contributions, which can be redeemed for various non-financial goods and services (for example, the VenCorps store might offer an iPad to be auctioned off to funders who bid points for the product). *See FAQ*, VENCORPS, <http://www.vencorps.com/Page/FAQ#funder>. This type of funding model is less likely to be an investment contract under *Howey*. We question, however, whether the regulation of crowdfunding should turn on this difference.

⁶⁹ We believe that it is inconsequential for purposes of the *Howey* test whether the current return on a crowdfunding interest represents a share of revenues or profits. The *Forman* Court referred to “a participation in earnings,” *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975), and the *Edwards* Court found that a fixed rate of return could support investment contract status under *Howey*. *See* SEC v. Edwards, 540 U.S. 389, 394 (2004) (“There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income”).

investments of money for the purpose of determining the existence of an investment contract. Specifically, the *Howey* Court noted that the purchasers of the land and contracts were “attracted solely by the prospects of a return on their investment.”⁷⁰ Many crowdfunding Web sites raise funds to support the production of goods and services by artists and others, and these crowdfunded ventures may reward funders with free or discounted products or services created or sold by the funded business.⁷¹ For example, in May 2011, 33needs featured a business venture, More than Me, Inc., a corporation that “funds the education of girls in Liberia by selling laptop covers, which are made by local Liberian women.”⁷² The return promised to investors by More than Me on the 33needs Web site is “5% of our revenue for 1 year with investors on 33needs. . . . If you invest \$100 or more, you'll get one of the first 100 laptop slip covers.”⁷³ 33needs also plans to offer other benefits to investors based on the number of “impact points” investors earn in funding featured businesses.⁷⁴ The hybrid nature of the benefits offered on some crowdfunding Web sites blurs the line between investment and consumption as set forth in *Forman*.⁷⁵

The 33needs venture raises additional concerns about the investment of money under *Howey* and *Forman*. 33needs focuses on social enterprise funding and markets itself as a financing venture for social entrepreneurs.⁷⁶

Just so I'm clear, who raises money on 33needs?

Social entrepreneurs. They lead companies solving the world's biggest needs, also known as social enterprises. You've heard of them, right? If not, just Google it.⁷⁷

As a result, 33needs encourages funders to finance the ventures it features based on more than a classic investment or consumption interest. It markets and sells altruism (funding a

⁷⁰ SEC v. W. J. Howey Co., 328 U.S. 293, 300 (1946). *See also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (citing the same language).

⁷¹ For example, Sellaband is a crowdfunding site that supports music artists and entitles funders to “[r]eceive free downloads and other goodies artists might offer like exclusive CDs, t-shirts, free lunches etc.” *How it Works*, SELLABAND https://www.sellaband.com/en/pages/how_it_works. Peerbackers is another website that funds start-up businesses where the funders receive various “rewards” at the entrepreneurs’ discretion (usually in the form of products created by the enterprise), but financial rewards are strictly prohibited. *See FAQ*, PEERBACKERS, <http://peerbackers.com/faq>.

⁷² *More Than Me*, 33NEEDS.COM, <http://www.33needs.com/ventures/more-than-me> (last visited May 21, 2011).

⁷³ *Id.*

⁷⁴ *FAQ*, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

⁷⁵ *See supra* note 25 and accompanying text.

⁷⁶ *See, e.g., Mission*, 33NEEDS.COM, <http://www.33needs.com/pages/mission>.

⁷⁷ *FAQ*, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

better world) and meaningfulness (the emotional satisfaction of having an individual impact).

This is just about the money, then?

Not at all. We also believe 33needs powers something as -- or even more -- important than money: it powers community. And particularly in the world of social good, where people feel an emotional attachment to your company, building a community of passionate supporters (that means you) can often drive change. And that, after all, is what it's all about.

What's the larger point, though?

Put simply: it's all about maximizing social and environmental impact. Nothing else matters. Thousands of entrepreneurs need a disruptive financial innovation: a way to connect with the vast pool of capital in the hands of our friends, our family, and the growing number of people who believe business-led solutions allow for a deeper, more sustained impact than old models. We think impact investing can play a crucial role in solving our world's biggest needs. That's why we're here.⁷⁸

This mixed-motivation solicitation likely encourages investors to invest in businesses featured on the 33needs Web site for one or more reasons—financial return, preferential access to goods or services, emotional satisfaction, or contribution to the public good.

The hybrid nature of the motivation of purchasers of crowdfunding interests is, however, unlikely to change the conclusion that crowdfunding interests represent an investment of money. As a general matter, federal courts have given little effect to the language in *Howey* referencing investors attracted “solely by the prospects of a return on their investment”⁷⁹ in deciding subsequent investment contract cases. For example, in a case involving “approximately 160,000 individuals who purchased ‘Lifetime Partnerships’ from an entity known as ‘PTL’ entitling them to a short stay annually in a hotel at a vacation retreat constructed by PTL,”⁸⁰ the court did not give dispositive weight to testimony from some purchasers that their motivation was personal use of the hotel rather than profit.

It would make little sense for the existence of a “security” to turn solely on whether those who actually invest do so without regard to profit. Such a rule would be highly impractical. Would the existence of a “security” change according to each purchaser? If not, how many, or what percentage of, purchasers would have to have made their investments with an eye toward profits in order for there to be “securities”? Finally, how could the SEC be expected to regulate effectively where the existence of a “security” turns not on how and to whom an investment opportunity is offered, but only on those who ultimately undertake such an

⁷⁸ *Id.*

⁷⁹ *SEC v. W. J. Howey Co.*, 328 U.S. 293, 300 (1946) (emphasis added).

⁸⁰ *Teague v. Bakker*, 35 F.3d 978, 981 (4th Cir. 1994).

investment?⁸¹

In that case, the court relied on the promotional materials used to solicit the purchases to find that the Lifetime Partnerships may represent an investment of money with the expectation of profit.⁸² Interestingly, the *Howey* Court offered a similar analysis, noting that its determination as to the existence of an investment contract

is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents. The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.⁸³

Crowdfunding Web sites that offer returns to their funders do promote the revenue-sharing or profit-sharing components of that return. For example, each of the featured businesses on 33needs has its own page on the 33needs site that includes an “Offer” to the investors. This is where the return on investment is described. In addition, the FAQ page on the 33needs Web site clearly distinguishes the capital investments it seeks from donations and loans, noting that financial rewards are an essential part of the bargain.

We’re turning the focus of crowdfunding entirely on companies with a social mission, and allowing ordinary people to invest, make a social impact, and *earn financial rewards*.

We’re the only platform in the world that enables ordinary people – you, neighbor Joe, Aunt Sally, and even your dog Jake (fine, maybe not Jake) – to invest in do-good companies (called social enterprises) and earn financial rewards. For example: 20,000 people could invest, not donate, \$50 each in More than Me, Inc., one of the companies raising money on 33needs.⁸⁴

This type of marketing supports a conclusion that the purchase of the subject crowdfunding interests constitutes an investment of money.

Some cases analyzing investment contracts have focused on whether the primary (as opposed to exclusive) purpose of the arrangement is to provide a return to funders.⁸⁵

⁸¹ *Id.* at 989 n.12.

⁸² *Id.* at 988-89.

⁸³ SEC v. W. J. Howey Co., 328 U.S. 293, 300-301 (1946) (footnote omitted).

⁸⁴ FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq> (emphasis added).

⁸⁵ See *Int’l Bhd. Of Teamsters v. Daniel*, 439 U.S. 551, 560 (1979) (holding that involvement in a mandatory pension plan was not an investment contract). The Court stated, “Looking at the economic realities, it seems clear that an employee is selling his labor *primarily* to obtain a livelihood, not making an investment.” *Id.* See also *Aschenbach v. Covenant Living Centers-North, Inc.*, 482 F. Supp. 1241, 1244 (E.D. Wis. 1980) (“[R]esidency contracts, which are not transferrable or assignable, are entered into for the primary purpose of

Accordingly, in the case of crowdfunding Web sites that offer non-financial benefits along with financial return, the satisfaction of the *Howey* test may depend upon whether the primary purpose of the arrangement is affording funders preferential access to goods or services, emotional satisfaction, or contribution to the public good or, in the alternative, a financial return on the amount paid for their crowdfunding interests. Although there are variations among the financing arrangements on crowdfunding Web sites we have reviewed, the potential financial return on the crowdfunding interests described in Table 1 as offering hybrid returns (i.e., more than just a financial return) may have a significantly higher potential value than the non-financial interest offered.⁸⁶ This value disparity may influence funders to purchase crowdfunding interests rather than, for example, buy goods or services from a traditional brick-and-mortar or online retailer (where a consumption interest also is involved) or contribute to a charity that funds a social project (where altruism or the public good is an objective). In other words, the higher potential value of the financial rewards promised on a crowdfunding Web site supports a conclusion that the site is primarily offering a revenue-sharing or profit-sharing arrangement. Under these circumstances, it is hard to argue that the funder's primary purpose in purchasing crowdfunding interests on these Web sites is not the investment of money.

Finally, in determining whether a contract, transaction, or scheme represents an investment of money, some courts focus on whether the arrangement subjects the funder to a loss.⁸⁷ Under this analysis (sometimes seen as the equivalent of a risk capital analysis⁸⁸), crowdfunding interests may represent the financing of a business that subjects

acquiring low cost living space, with the added feature of low cost maintenance and health care, and not for 'profit' in the sense intended by the Supreme Court in *Howey* and *Forman*.").

⁸⁶ For example, Sellaband offers a revenue-sharing arrangement (at the artist's discretion) and also offers the funder music downloads, CDs, and t-shirts signed by or promoting the artist. However, there is no limit on the amount contributed by an individual funder. This creates the potential for huge differences between the monetary values of the financial and non-financial interests received by funders. For example, as a result of a large contribution, a funder on Sellaband could be entitled to a large percentage of revenue, which would be much greater in value than the non-financial interests (music downloads, CD, t-shirts, etc.).

⁸⁷ See, e.g., *Becks v. Emery-Richardson, Inc.*, 1990 U.S. Dist. LEXIS 21066 (S.D. Fla. July 6, 1990) ("Generally, an 'investment' in this context means that the investor commits his assets to an enterprise or venture in such a manner as to subject himself to financial loss.").

⁸⁸ See, e.g., *Underhill v. Royal*, 769 F.2d 1426, 1431 (9th Cir. 1985) (outlining a risk capital test applied in the U.S. Court of Appeals for the Ninth Circuit that was used to determine whether notes are securities before the Court's opinion in *Reves v. Ernst & Young*, 494 U.S. 56 (1990)). When used in the investment contract context, the risk capital test typically is used to assess the combination of the second, fourth, and fifth prongs of the *Howey* test under our framework—the investment of money with an expectation of profits from the efforts of others. *First Citizens Federal Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, 919 F.2d 510, 516 (9th Cir. 1990). Given its substantial overlap with key parts of the *Howey* test, the risk capital test sometimes is seen as an alternative to the *Howey* test. See, e.g., *Martin v. T. V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980) ("Plaintiffs urge that the

the funder to a loss—the loss of his or her initial investment. The purchasers of crowdfunding interests typically have little or no control over the success of the business they fund and, unless funds are conveyed in the form of a debt instrument, have no right to a return of their capital (although many equity-type crowdfunding business models provide that capital will be returned if a stated funding threshold is not met⁸⁹).

Based on the promotion of a money-making potential, crowdfunding interests that offer financial returns to funders likely satisfy the second prong of our five-pronged *Howey* test.

3. Common Enterprise

Turning to the “common enterprise” part of the *Howey* test, we begin with horizontal commonality, noting that the pooling of funds obtained from the crowd is seemingly the essence of crowdfunding.⁹⁰ Funders purchase interests in a particular crowdfunded venture featured on a crowdfunding Web site, and typically earn financial returns (through revenue-sharing or profit-sharing) based on the amount of their investment as a percentage of the aggregate funding target for the business. Their ability to benefit financially arises from the success of the overall venture. The investor’s funds are locked in once the funding target for the venture is reached. 33needs calls this aspect of its operations “all or nothing funding.”

What if the company doesn't hit its funding target?

It's all or nothing funding. For example, if a company attempts to raise \$20,000 and falls short of their target, then all the investors will get their money back.

Is that "all for nothing" model fair to these good companies?

district court erred in failing to analyze the franchise agreement under the so-called “risk capital” approach. We previously have taken note of this alternative to the *Howey* test”). In its modern formulation,

The “risk capital” test requires a consideration of the following factors: (1) whether funds are being raised for a business venture or enterprise; (2) whether the transaction is offered indiscriminately to the public at large; (3) whether the investors are substantially powerless to effect the success of the enterprise; and (4) whether the investors’ money is substantially at risk because it is inadequately secured.

Moreland v. Department of Corporations, 194 Cal. App. 3d 506, 519 (Cal. App. 5th Dist. 1987) (decided under California State law).

⁸⁹ See *infra* note 91 and accompanying text.

⁹⁰ See *supra* notes 4 & 5 and accompanying text. The 33needs Web site references the pooling of funds, classifying crowdfunding as “the collective cooperation by people who network and pool their money together.” *Mission*, 33NEEDS.COM, <http://www.33needs.com/pages/mission>.

We just think it's less risky for everyone. We want you, the investor, to have confidence that the company has raised enough to completely follow-through on their commitments.⁹¹

This basic financing arrangement, common to many of the crowdfunding Web sites we have reviewed, satisfies the requirements of horizontal commonality.

With respect to vertical commonality, only broad vertical commonality exists in the typical crowdfunding model. The success of investors generally is dependent on the combined efforts of the crowdfunding Web site and crowdfunded venture. In most cases, a crowdfunding Web site (one that is unaffiliated with the crowdfunded ventures it promotes) takes a fee or commission once the featured venture's funding target is achieved and has no ongoing interest in the success of that venture parallel to that of the funders.⁹² If a crowdfunding Web site takes a percentage of the featured business's revenues or profits along the same lines that the funders do, however, strict vertical commonality may exist.

The 33needs Web site is silent on the nature of the compensation or financial benefit, if any, that it receives in promoting the featured ventures, but the principal of 33needs confirmed that 33needs takes a 5% fee from any venture that is successful in reaching its funding target.⁹³ The FAQ portion of the site is clear, however, about the fact that 33needs does not take an ownership or intellectual property interest in these enterprises.⁹⁴ Accordingly, 33needs exhibits broad vertical commonality only.

Although a case-by-case analysis of individual crowdfunding sites would yield different results with respect to the existence of broad or strict vertical commonality, the fact that almost every crowdfunding site that we examined satisfies the horizontal commonality test, which is sufficient to establish a common enterprise in many jurisdictions,⁹⁵ leads to the conclusion that most crowdfunding business models constitute common enterprises for purposes of the *Howey* test.

⁹¹ FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

⁹² For example, IndieGoGo provides funding for various entrepreneurial projects and causes for which it takes 4% of the funded amount, but retains no on-going interest in the funded venture. FAQs, INDIEGOGO, www.indiegogo.com/about/faqs. Similarly, Kickstarter provides funding for artists' projects and charges 5% of the funded amount, but the success of the project is entirely in the hands of the artist. FAQs, KICKSTARTER, www.kickstarter.com/help/faq.

⁹³ Email message from Josh Tetrack to Joan Heminway, May 23, 2011 2:08 PM (on file with authors).

⁹⁴ FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq> ("Does 33needs or investors on 33needs take some percentage of ownership or intellectual property in the social enterprises? Absolutely not.").

⁹⁵ See *supra* notes 90 & 91 and accompanying text.

4. Expectation of Profits

In analyzing the second part of the *Howey* test under our taxonomy—the investment of money prong—we necessarily engaged some of the analysis relevant to this fourth attribute of an investment contract, the expectation of profits. An investor of money is one who is motivated by financial return in making an expenditure of funds. As noted in the description and analysis *supra* Part I.B.2., the financial benefit that funders expect (and are led to expect) from ventures promoted through crowdfunding Web sites is a participation in the venture’s revenues or profits.

There are some crowdfunding Web sites (typically sites offering debt-type interests) that offer a fixed return to funders.⁹⁶ This type of benefit arrangement offered by a crowdfunded venture (e.g., in lieu of revenue-sharing or profit-sharing), is sufficient to satisfy the expectation of profits prong of the *Howey* test.⁹⁷

Crowdfunding Web sites do not typically allow funders to benefit through capital appreciation (the other type of financial return recognized as profit under the *Forman* case⁹⁸), however. Although most sites do not address the issue, there is no apparent mechanism for transferring crowdfunding interests to others. The interests, however, constitute personal property and therefore should be assignable. Moreover, with minor exception, there is no evidence that a market exists for the transfer or assignment of all or some rights in crowdfunding interests.⁹⁹ However, if a market were to develop, the expectation of profits from capital appreciation also would be possible.

Those who purchase crowdfunding interests that promise them a current return or capital appreciation expect profits under *Howey*.

5. Solely from the Efforts of Others

The “solely from the efforts of others” prong also is met with respect to almost every crowdfunding business. Under many crowdfunding business models, the funder serves the roll of a passive funder while the crowdfunded venture, with some marketing or logistical support from the crowdfunding Web site, is responsible for the success or failure of the

⁹⁶ Microplace is a microfinancing operation that allows funders to contribute money, in the form of a loan to entrepreneurs in lesser developed countries. *How It Works: Overview*, MICROPLACE. www.microplace.com/howitworks. The funder is entitled to a return of the funded amount plus interest. *Id.* Similarly, 40Billion provides start-up funds for businesses, on an invite-only basis, and the funder is entitled to repayment of the principal plus interest. *How It Works*, 40BILLION, www.40billion.com/how_it_works.asp.

⁹⁷ See *supra* note 39 and accompanying text.

⁹⁸ See *supra* note 38 and accompanying text.

⁹⁹ One site that aims to facilitate a market for crowdfunding shares is Cinema Shares, which plans to allow for the purchase of fully listed, publicly traded shares on NASDAQ. *About Cinema Shares*, CINEMA SHARES, www.cinemashares.com/aboutCS.html.

venture.¹⁰⁰ In a few instances we have observed, the funder plays a minor role in the selection of the crowdfunded venture by the crowdfunding Web site or the promotion or conduct of the operations of the crowdfunded venture.¹⁰¹ Regardless of the exact level of involvement by the funders in a crowdfunded venture, the bulk of the efforts contributing to the success of the venture come from the principals of the funded venture, with some support (typically administrative and ministerial) from the crowdfunding Web site.

The engagement of crowdfunding Web sites in the operations of the crowdfunded venture very. 33 needs, for example, pre-screens the businesses that are featured on the site. The FAQ notes that

[t]o date, 33needs has received over 900 applications from entrepreneurs around the world. We have a 4-person investment committee that reviews, interviews, and selects companies. Sometimes we select them individually, sometimes collectively. We look at the strength of the business model, integrity of the team, and the nature of the need being addressed. We tend to focus on urgent needs.¹⁰²

In addition, while 33needs states that the funded ventures are responsible for meeting the commitments (“Offers”) they make to investors (noting that the ventures, themselves, are “responsible for making sure [they] deliver on what they promise”), it also promises that it will “be working closely with them to make sure all is right.”¹⁰³

In any case, funder expectation of profits on the crowdfunding Web sites we reviewed would be from the efforts of the promoters (including the crowdfunding Web sites and crowdfunded ventures), not from the efforts of the funders themselves. Thus, the fifth and last prong of the *Howey* test, like the other four, is likely satisfied by most crowdfunded ventures, making it probable that a court would find that crowdfunding interests that include a financial return are investment contracts.

¹⁰⁰ See Lambert & Schwienbacher, *supra* note 5, at 3 (“The major fraction are passive investments; i.e., investments with a promise of compensation but no direct involvement in the decision-making process or provision of time or expertise for the initiative.”).

¹⁰¹ For example, funders who choose to participate as “believers” on SellaBand also can support the artists of their choice in other ways:

On SellaBand you can support your favorite artists by buying a part and helping them to raise the funds for a new music project (a new album, tour or the promotion of their music). . . .

Join your favorite artists on their way to reach their funding goal. Promote them, stay in touch with them and help them.

How it works, SELLABAND.COM, https://www.sellaband.com/en/pages/how_it_works.

¹⁰² FAQ, 33NEEDS.COM, <http://www.33needs.com/pages/faq>.

¹⁰³ *Id.*

C. The Question of Context

Under Section 2(a)(1) of the Securities Act, an investment contract is a security “unless the context otherwise requires.”¹⁰⁴ Section 2’s introductory limitation regarding context is not frequently used to disqualify an instrument listed in Section 2(a)(1) from being a security. However,

courts have held that the definition of what constitutes a security need not be read literally, thereby giving meaning to the introductory language of the definition, “unless the context otherwise requires.” Stressing that the Acts were aimed at preventing fraud in the securities market, the Supreme Court has stated that “[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.” This is the examination which must be made “in searching for the meaning and scope of the word ‘security’” -- “form should be disregarded for substance and the emphasis should be on economic reality.”¹⁰⁵

“The test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. . . . [I]t is not inappropriate that promoters’ offerings be judged as being what they were represented to be.”¹⁰⁶ For example, court opinions assessing the status of “notes” under Section 2(a)(1) have used the context limitation to find that certain notes are not securities for purposes of the Securities Act.¹⁰⁷ The determinative factor in these cases is whether the note is a commercial instrument or an investment instrument.¹⁰⁸ In the same vein, the Supreme Court in *United Housing Foundation v. Forman*¹⁰⁹ elevated substance over terminology, deciding that interests in a housing cooperative were not securities, despite the fact that the interests were labeled as “stock.” One of the instruments listed in the security definition.¹¹⁰

¹⁰⁴ 15 U.S.C. § 77b(a)(2006).

¹⁰⁵ *Ayala v. Jamaica Sav. Bank*, 1981 U.S. Dist. LEXIS 17994 (E.D.N.Y. June 15, 1981) (citations omitted).

¹⁰⁶ *SEC v. C. M. Joiner Leasing Corp.*, 64 S. Ct. 120, 124 (1943).

¹⁰⁷ *See Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484, 487 (7th Cir. 1984) (“[T]his as well as other Circuits have relied upon the prefatory phrase ‘unless the context otherwise requires’ to exclude certain notes from the protection of the federal securities acts.”). *See also* *Lincoln Nat’l Bank v. Herber*, 604 F.2d 1038 (7th Cir. 1979).

¹⁰⁸ *Hunssinger*, 745 F.2d at 488.

¹⁰⁹ 421 U.S. 837 (1975).

¹¹⁰ *Id.* at 851.

Despite their name, [the interests at issue] lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive “dividends contingent upon an apportionment of profits.” . . . Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they

The key to an analysis of context hinges on whether the financial instrument at issue represents an investment vehicle. In this regard, the Supreme Court offered in *Reves* that “[a] commitment to an examination of the economic realities of a transaction does not necessarily entail a case-by-case analysis of every instrument, however. Some instruments are obviously within the class Congress intended to regulate because they are by their nature investments.”¹¹¹ Given that the *Howey* test, as applied, includes an evaluation of a contract, transaction, or scheme as an investment of money, our analysis *supra* Part I.B.2. already establishes the necessary context. Crowdfunding interests that include revenue-sharing or profit-sharing benefits do appear to be equity-type capital investment vehicles, despite the potential (and actual) multiple benefits they may offer (e.g., consumption interests and altruistic and emotional satisfaction).¹¹² In saying this, we recognize that crowdfunding interests are unique and flexible devices. But

the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as “investment contracts,” or as “any interest or instrument commonly known as a ‘security.’”¹¹³

II. FEDERAL REGULATION OF OFFERINGS OF CROWDFUNDING INTERESTS AS SECURITIES

The analysis *supra* Part I.B. indicates that the interests offered to funders by many crowdfunding Web sites (and especially those that offer a revenue-sharing or profit-sharing arrangement) likely satisfy all five elements of the *Howey* test and therefore are investment contracts. Given that the context in which crowdfunding interests are offered and sold to funders does not otherwise require a different categorization (as discussed *supra* Part I.C.), we assume for the remainder of this article that these crowdfunding interests are securities within the meaning of Section 2(a)(1) of the Securities Act. The status of these interests as securities exposes crowdfunding Web sites and crowdfunded ventures to regulation—including the expensive and time-consuming process of registering offers and sales of securities—under the Securities Act. This Part describes both the current regulatory framework and the underlying policy objectives of that landscape (in each case, as applied to crowdfunding interests) and, based on that environment, concludes by questioning whether crowdfunding interests that are securities should be subject to the registration requirements of the Securities Act.

cannot be pledged or hypothecated; they confer no voting rights in proportion to the numbers of shares owned; and they cannot appreciate in value.

Id. (citation omitted).

¹¹¹ *Reves*, 494 U.S. at 62.

¹¹² See *supra* notes 71-84 and accompanying text.

¹¹³ *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

A. Applicable Regulation

A full-blown description of regulation under the U.S federal securities laws is beyond the scope of this article (and, indeed, is the subject of three-credit-hour-plus courses in Securities Regulation in U.S. law schools). However, even a brief summary of key applicable provisions of the federal securities laws (which is what we provide here) illustrates the weight of regulation they impose—a transaction cost that is impossible for small businesses to bear.

1. Registration and Related Liability and Costs

Section 5 of the Securities Act regulates the offer and sale of securities.¹¹⁴ In sum, Section 5 prohibits the offer or sale of securities without registration, unless an applicable exemption is available.¹¹⁵ An “offer for sale” or “sale” includes “every attempt or offer to dispose of, or solicitation of an offer to buy, a security . . .”¹¹⁶ These terms are interpreted very broadly, making it quite easy for an offeror or seller of securities to inadvertently violate Section 5 by, for example, communicating with potential investors before the filing of a registration statement.¹¹⁷ If interests in crowdfunded ventures are securities, then the offer and sale of those interests on or through a crowdfunding Web site must be registered with the U.S. Securities and Exchange Commission (the “SEC”) absent the availability of an applicable exemption.

If securities are offered or sold in violation of Section 5, Section 12(a)(1) provides the purchaser of the securities with a private cause of action against the seller, allowing for rescission of the sale of the securities (or the recovery of rescissory damages if the purchaser no longer owns the securities).¹¹⁸ False and misleading registration statements are actionable under Section 11 of the Securities Act,¹¹⁹ false and misleading prospectuses or oral communications may result in liability under Section 12(a)(2) of the Securities Act,¹²⁰ and fraudulent conduct in connection with the offer and sale of securities may be enforced (at least by the SEC) under Section 17(a) of the Securities Act.¹²¹ Further, those

¹¹⁴ 15 U.S.C. § 77e (2006).

¹¹⁵ *Id.*

¹¹⁶ 15 U.S.C. at § 77b(3).

¹¹⁷ See Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 606 (1997) (“Section 5 sweeps broadly, regulating every offer and sale of a security.”); Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U.L. REV. 561, 568 (2007) (“Section 5(c) of the Securities Act specifically made it unlawful for any person to offer to sell or buy securities before a registration statement had been filed with the SEC. Section 2(a)(3) of the Securities Act defined “offer” as broadly as it could.”).

¹¹⁸ 15 U.S.C. at § 77l(a)(1).

¹¹⁹ 15 U.S.C. at § 77k.

¹²⁰ 15 U.S.C. at § 77l(a)(2).

¹²¹ 15 U.S.C. at § 77q(a); *In re Washington Public Power Supply System Sec. Litigation*, 823 F.2d 1349 (9th Cir. 1987).

who offer and sale of securities are exposed to potential liability for securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”),¹²² and under Rule 10b-5 under the Exchange Act.¹²³

Registration of the offer and sale of securities under the Securities Act is an expensive and time-consuming proposition. An issuer must file a registration statement that includes operating and financial disclosures about the issuer, information about the securities being offered and sold, and details about the plan of distribution of those securities.¹²⁴ The costs of an initial SEC registration typically include underwriting compensation (in the form of discounts or commissions), a registration fee (paid to the SEC), legal and accounting fees and expenses, and (as needed) printing and engraving costs, a Financial Industry Regulatory Authority filing fee (when filing is required because of underwriter compensation), electronic filing fees (when a service is used for filing), stock exchange listing fees (if the subject securities are to be listed for trading on a stock exchange), Blue Sky filing fees (payable when federal regulation of the offering does not preempt state securities regulation of the offering), and transfer agent and registrar fees (when the issuer retains the services of a third party to handle its stock records).¹²⁵ Although there are offerings that cost somewhat less (because of the nature of the issuer or the offering), an initial public offering for even a small business issuer will cost the issuer over \$100,000—and most times multiples of that—in fees for third-party services alone (i.e., not including the value of the time spent by senior management in preparing for and marketing the offering).¹²⁶ Small business issuers may have lower costs in some regards, but the overall relative costs are high.

¹²² 15 U.S.C. at § 78j(b). Although the Exchange Act has its own definition of the term “security,” the definitions under the Securities Act and the Exchange Act are substantially similar and result in only small differences in application. *See* JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 19 (6th ed. 2009) (“The ’33 Act and the ’34 Act have substantially similar definitions of a *security*.”). The regulatory schemes of the two acts are integrated, with the Securities Act regulating offers and sales of securities generally and the Exchange Act largely governing trading transactions on and through securities markets and market professionals. *See* COX ET AL., *supra*, at 7 (“Whereas the Securities Act grapples with the protection of investors in primary distributions of securities, the Exchange Act’s concern is trading markets and their participants.”).

¹²³ 17 C.F.R. § 240.10b-5 (2011).

¹²⁴ *See* 15 U.S.C. at § 77g; COX ET AL., *supra* note 122, at 143-47.

¹²⁵ *See* COX ET AL., *supra* note 122, at 156 (setting forth in Note 4 various external and internal costs of going public); 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, 8-9 (2007) (“Moreover, regardless of the outcome of the offering, the costs of the registration process are heavily front-loaded. Accounting fees, attorney retainers, SEC filing fees, broker-dealer expenses, printing and road show costs are all incurred and become payable prior to the effective date of the registration statement.”).

¹²⁶ One commentator accurately sums up the cost situation when he states:

[O]ne should appreciate that it is relative, not absolute, offering expenses that are important. To use an extreme example, \$ 500,000 in offering costs on a \$ 50 million offering will certainly not kill the transaction, while \$ 500,000 in offering expenses on a \$ 500,000 deal will kill the transaction.

Accounting, legal and other expenses on small deals can easily exceed \$ 50,000, and such amounts bulk large relative to the total yield from a small offering. When added to the costs due to the lack of financial intermediation services, one is able to appreciate the extreme structural and economic disadvantages that small entrepreneurs encounter when attempting to access external capital.¹²⁷

Add to these expenses the ongoing costs of being public (which, depending on the issuer's assets and equity ownership, may be a long-term proposition),¹²⁸ and the costs of a registered public offering typically are not worth the benefits for small business issuers.¹²⁹

Registration involves legal fees, accounting fees, printing costs, filing fees, and other miscellaneous costs, along with a significant discount paid to the underwriters. The total expense is hundreds of thousands of dollars. These external costs are in addition to the time consumed by the company's own employees in preparation for registration.

C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 24 (2001). See also COX ET AL., *supra* note 122 ("The estimated 2007 costs for a significant IPO are \$600,000-\$800,000 in fees to counsel, \$400,000-\$600,000 for the auditor, underwriter commissions of typically 7 percent of the offering amount, \$150,000-\$200,000 in printing costs, plus various filing fees . . ."); Marvin E. Rooks, *It Is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees*, 11 WAKE FOREST L. REV. 55, 66 (2010) ("The SEC's initial public offering . . . process for even a small company (less than \$20 million in revenue) takes six to nine months and costs at least \$100,000 in fees for legal, accounting, audit, printing, filing fees, and underwriter commissions.") (citations omitted).

¹²⁷ Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search For "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 90 (2006).

¹²⁸ See COX ET AL., *supra* note 122, at 156 ("The publicly traded company incurs the burden of complying with the periodic reporting requirements of the '34 Act. While out-of-pocket costs may be trivial in relation to the registrant's assets or income, the more significant costs are those associated with the consciousness of operating in the public eye."); Cohn & Yadley, *supra* note 125, at 9 ("Once public, the company is now subject to the periodic reporting obligations of the . . . Exchange Act . . . for at least the remainder of the first year. . . . These reporting and regulatory burdens weigh extraordinarily heavily on public-traded small businesses, prompting both administrative and legislative efforts to modify such requirements for small business issuers.").

¹²⁹ See Campbell, *supra* note 127, at 91-92 ("Registration has never been a viable way for small businesses to raise capital. High transaction costs associated with registered

Registration also takes time (several months, at a minimum, in most cases) because of the length and complexity of the registration statement, the regulatory filing and review process, and the marketing and sales activities.¹³⁰ This means that issuers may miss important financing opportunities because favorable market conditions for an offering (so-called “market windows”) will pass unutilized because the registration statement for the offering has not yet been declared effective. Missing a market window can be especially devastating to small business issuers who can ill-afford to lose the sunk costs spent in initiating and carrying through the registration process.

The costliness and slow pace of the registration process are unfortunate, since the registration process has a number of advantages for small businesses (as well as other issuers).

If registration were an economically viable alternative for small issuers, it would produce a number of attractive benefits. It would ameliorate problems of inadvertent loss of an exemption through the impact of the integration doctrine . . . or failure to meet the technical requirements of a particular exemption. It would eliminate all resale restrictions that often adversely impact the attractiveness of exemptions. Finally, it would provide some help and comfort regarding antifraud compliance. Scheduled disclosure requirements in registration forms provide a prepackaged checklist regarding matters and events that may be material and thus subject to disclosure obligation under antifraud rules, such as Rule 10b-5. Compliance with the registration form, therefore, effectively reduces the risk of a material omission of fact that would generate liability under federal antifraud rules.¹³¹

In addition, with the SEC’s recent approval of the proposal of Nasdaq OMX BX to establish a new listings market, the “BX Venture Market,”¹³² registration may afford some small business issuers the prospects of access to a public trading market.

offerings inevitably put registration out of the range of small businesses in search of capital. Thus, the data show that small offerings are very rarely made through SEC registration.” (footnotes omitted)); Cohn & Yadley, *supra* note 125, at 10 (“The combined effect of the costs imposed by the registration process and the post-registration reporting system is generally more than sufficient to convince small businesses that financing through a registered public offering is a most undesirable course.”).

¹³⁰ See Bradford, *supra* note 6, at 26-27.

¹³¹ Campbell, *supra* note 127, at 92 n.55 (citations omitted). See also Stuart R. Cohn, *The Impact Of Securities Laws On Developing Companies: Would The Wright Brothers Have Gotten Off The Ground?*, 3 J. SMALL & EMERGING BUS. L. 315, 361 (1998) (“The SEC finds two principal benefits from registration - disclosure and the ability to resell securities.”). But see Bradford, *supra* note 126, at 28-29 (describing inconclusive benefits of registration).

¹³² Sec’s & Exch. Comm’n, Release No. 34-64437, Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Create a Listing Market on the Exchange (May 6, 2011),

2. Exemptions from Registration

Given its expense—and despite its regulatory and potential practical advantages, the registration process is a nonstarter for most crowdfunding Web sites and crowdfunded ventures. For crowdfunding Web sites and crowdfunded ventures, as with many other small businesses, the costs and time required to register a securities offering most often prohibit the offering from occurring.¹³³ Therefore, under the current regime, the only hope for crowdfunding Web sites and crowdfunded ventures offering or selling securities is to find an applicable exemption for each security or offering. Securities may be exempt under Section 3(a) of the Securities Act.¹³⁴ Examples generally include, e.g., securities issued by states and municipalities, charitable organizations, and savings and loan associations.¹³⁵ Section 3(a) does not provide an exemption for crowdfunding interests.

The few possible transactional registration exemptions under the Securities Act that one would consider in connection with the primary offering of interests in crowdfunded businesses include: the private offering exemption under Section 4(2),¹³⁶ Rules 504, 505, and 506 of Regulation D (authorized under Sections 3(b) and 4(2)),¹³⁷ and Regulation A (authorized under Section 3(b)).¹³⁸ None of these exemptions provides a feasible path for a crowdfunding Web site or crowdfunded venture to avoid registration of the offer or sale of profit-sharing interests in the crowdfunded venture.¹³⁹ This Part II.A.2. outlines the key

<http://www.sec.gov/rules/sro/bx/2011/34-64437.pdf>.

¹³³ See generally Cohn & Yadley, *supra* note 125 (discussing how the current regulatory regime fails to adequately provide opportunities for small businesses); Schapiro Testimony, *supra* note 11 (“Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations.”). We note, however, that at least one crowdfunded business has pursued the registration of a crowdfunded offering. See Audience Productions, Inc., Amendment No. 7 to Form S-1 Registration Statement (filed April 21, 2010),

<http://www.sec.gov/Archives/edgar/data/1474227/000147422710000015/ds1a.htm>.

Ultimately, despite extensions of the originally established offering period, this offering was not successful. In a post-effective amendment filed in August 2011, Audience Productions requested deregistration of the shares offered. See Audience Productions, Inc., Post-Effective Amendment No. 6 to Form S-1 Registration Statement (filed Aug. 11, 2010), <http://www.sec.gov/Archives/edgar/data/1474227/000147422711000018/dposam.htm>.

¹³⁴ 15 U.S.C. § 77c(a) (2006).

¹³⁵ *Id.* § 77c(a)(2), (4) & (5).

¹³⁶ *Id.* § 77d(2).

¹³⁷ 17 C.F.R. §§ 230.501-508 (2011).

¹³⁸ 17 C.F.R. at §§ 230.251-263.

¹³⁹ While the intrastate offering exemption, 15 U.S.C. § 77c(a)(11), may be applicable in some situations involving crowdfunding, most crowdfunded ventures seek to raise capital from investors residing in a variety of states. Because of its unlikely applicability in this

attributes of each possible exemption and comments on the unsuitability of each for primary offerings of crowdfunding interests.

a. Private Offering Exemption under Section 4(2) of the Securities Act

Section 4(2) of the Securities Act exempts from registration “transactions by an issuer not involving a public offering.”¹⁴⁰ Interestingly, the term “public offering” is not defined in the Securities Act or in SEC rules under the statute.¹⁴¹ However, it is generally acknowledged that the exemption “was designed to apply to specific or isolated sales as well as offerings to a very small number of securities holders so that the public interest is not involved.”¹⁴²

Soon after the Securities Act was signed into law, the SEC’s General Counsel set forth five attributes of offerings that provide guidance on whether the offer or sale of securities is a transaction not involving a public offering under Section 4(2): the number of offerees, the relationship of offerees to each other and to the issuer, the number of units offered, the size of the offering, and the manner of the offering.¹⁴³ The overall message? An offering

- to the many (rather than the few),
- to those with no or little preexisting association to each other or the issuer,
- of a large number of shares or other investment units (especially if in smaller denominations),
- that is large in aggregate size, and
- that is conducted through a broad-based advertising

is more likely to be characterized as a public offering.¹⁴⁴ This guidance gave transaction-planners and litigators some foundation for assessing whether particular offerings required registration or were exempt. Decisional law began to develop under Section 4(2), but 18 years passed before the Supreme Court took on the issue of clarifying the nature of a public offering.

It was then, in 1953, that the Court decided the seminal case involving the availability of the private offering exemption, *SEC v. Ralston Purina Co.*¹⁴⁵ In *Ralston Purina*, the Court refused

context, the possible application of the intrastate offering exemption in the crowdfunding context will not be further analyzed in this article.

¹⁴⁰ 15 U.S.C. at § 77d(2).

¹⁴¹ See Stephen D. Bohrer, *The Application of U.S. Securities Laws to Overseas Business Transactions*, 11 STAN. J.L. BUS. & FIN. 126, 153 (2005) (“The term ‘public offering’ is not defined under the Securities Act.”); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 71 (1989) (“The term ‘public offering’ is not defined by statute”) (citation omitted).

¹⁴² THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.24 (5th ed. 2005).

¹⁴³ Securities Act Release No. 285, 1 CCH Fed. Sec. L. Rep. ¶ 2740 (Jan. 24, 1935) [hereinafter SEC General Counsel Letter].

¹⁴⁴ *Id.*

¹⁴⁵ 346 U.S. 119 (1953).

to impose a numerical limitation as a litmus test for determining whether or not a public offering has occurred.¹⁴⁶ Although the number of offerees is a relevant consideration to the finding of a public offering, this number is not dispositive.¹⁴⁷ Instead, “the exemption question turns on the knowledge of the offerees.”¹⁴⁸ According to the Court, “the applicability of § [4(2)] should turn on whether the particular class of persons affected needs the protection of the Act.”¹⁴⁹ The Court determined that where the offerees “are shown to be able to fend for themselves,” they do not need the protection of the Securities Act’s registration requirement and, therefore, the offering should not be characterized as a public offering for purposes of Section 4(2) of the Securities Act.¹⁵⁰

Ralston Purina and its progeny have established two overarching factors that indicate whether offerees are able to fend for themselves. The first factor is the “sophistication” of the solicited investors. Offerees possessing financial and business knowledge that allows them to appreciate the risks of the investment have been considered sophisticated for these purposes.¹⁵¹ Sophisticated investors can fend for themselves—at least if they have the right information—or access to it. Accordingly, the second factor is the information (or access to information) provided to offerees. Sophisticated offerees provided with

¹⁴⁶ *Id.* at 125. In this case, *Ralston Purina* claimed that an offering of treasury stock to its “key employees” (a group that actually included any employee who wanted to participate in the offering) was not a public offering. *Id.* at 121. Although the Court recognized that some offerings to employees may constitute non-public offerings, the Court determined that, absent special circumstances (such as an offering to certain corporate executives), “employees are just as much members of the ‘investing public’ as any of their neighbors in the community.” *Id.* at 125-26.

¹⁴⁷ *Id.* at 125 (“It may well be that offerings to a substantial number of persons would rarely be exempt.”).

¹⁴⁸ *Id.* at 126.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ See *S.E.C. v. Murphy*, 626 F.2d 633, 646 (9th Cir. 1980) (issuer failed to show that the investors were sophisticated where the only evidence offered was the fact that 60% of the investors were represented by purchaser representatives, which suggested “at least that the majority of the purchasers, if not the majority of offerees, lacked the sort of business acumen necessary to qualify as sophisticated investors.”); *Hill York Corp. v. American Int’l Franchises, Inc.*, 448 F.2d 680, 690 (1971) (recognizing that the sophistication requirement was met where the offering was made “only to sophisticated businessmen and lawyers”); *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971) (The Supreme Court in its description of a possible “private” group in *Ralston Purina* includes only persons of exceptional business experience . . .). As these and other cases illustrate, the concept of sophistication is a bit fluid. See C. Howard Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws* 1988 DUKE L.J. 1081, 1084-85 (1988) (“[T]he federal courts’ treatment of investor sophistication reflects a doctrine in disarray . . . [as] the courts’ treatment of sophisticated investors shows little coherence or, if you will, reflects little cross-fertilization among the different settings in which the sophistication issue arises.”).

substantially the same information (or meaningful access to substantially the same information) as that provided in a registration statement can fend for themselves.¹⁵²

As developed in the decisional law, if an offeree is not actually provided information akin to that provided in a registration statement, the offeree must have access to that level of information and a relationship with the issuer that reasonably enables the offeree to take advantage of the access to ascertain the necessary or desired information.¹⁵³ Therefore, if the issuer does not disclose the requisite information to the offerees, the issuer must prove that its relationship with each offeree was such that it satisfied the access requirement.¹⁵⁴ The private offering exemption is not available unless both sophistication and information (or meaningful access to information) exist because “[s]ophistication is not a substitute for access to the information that registration would disclose,”¹⁵⁵ and disclosure of or access to important information is an empty promise without the ability to ascertain and appreciate the risks involved with the investment.¹⁵⁶

¹⁵² The *Ralston Purina* Court only references access to information. 346 U.S. at 127. See also *Hill York*, 448 F.2d at 690 (“[T]he relationship between the promoters and the purchasers and the ‘access to the kind of information which registration would disclose’ become highly relevant factors.” (citation omitted)). The offerees in *Hill York* had no previous relationship with the issuer at the time of the offering and were only given a few brochures with minimal information about the issuer. *Id.* The court concluded that the offerees “could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest” in the venture because they did not possess the “information requisite for a registration statement.” *Id.*

¹⁵³ See *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977). In *Doran*, the issuer tried to use the private placement exemption to prevent an investor from rescinding an agreement for an oil-drilling venture. *Id.* at 897. The court concluded that the investor, who had a degree in petroleum engineering and a net worth of over \$1,000,000 (including holdings of 26 oil and gas platforms worth over \$850,000), was sophisticated. *Id.* at 902. The court concluded, however, that a sophisticated investor cannot use his knowledge of business affairs to make a prudent investment decision without the information that would be contained in a registration statement. *Id.* Focusing on the information requirement, the court pointed out that where disclosure is shown, “the absence of a privileged relationship between the offeree and issuer would not preclude a finding that the offering was private.” *Id.* at 904. However, when an issuer claims the offeree had access to information, “the relationship between offeree and issuer now becomes critical, for it must be shown that the offeree could realistically have been expected to take advantage of his access to ascertain the relevant information.” *Id.*

¹⁵⁴ *Id.* (“Such access might be afforded merely by the position of the offeree or by the issuer’s promise to open appropriate files and records to the offeree as well as to answer inquiries regarding material information.”).

¹⁵⁵ *Doran*, 545 F.2d at 893 (citing *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 678 (4th Cir. 1967)).

¹⁵⁶ *Id.* at 904-05.

By moving away from numerical limitations and focusing on the concepts of sophistication and disclosure of (or meaningful access to) a prescribed level of information, the opinions in *Ralston Purina* and its progeny have created “doubts and ambiguities . . . by varying Section 4(2) interpretations.”¹⁵⁷ In order to clarify some of the uncertainty surrounding the application of the Section 4(2) exemption, the SEC adopted Rule 506 as part of Regulation D under the Securities Act, a safe harbor under Section 4(2).¹⁵⁸ Looking solely at Section 4(2) and relevant decisional law, however, the twin concepts of sophistication and information (or meaningful access to information) would require crowdfunded ventures to ensure that all individuals who visit crowdfunding Web sites (who would then be offerees) meet the sophistication requirements and have (or have meaningful access to) the information that would be found in a Securities Act registration statement. This is impractical because the costs associated with providing that level of information are high in relation to the benefit sought (in most cases, a relatively small amount of funding). Further, “the SEC has indicated that any ‘public advertising is inconsistent with a claim of private offering.’”¹⁵⁹ This prohibition eliminates any hope for the crowdfunding business model under the private offering exemption.¹⁶⁰

b. Rules 504, 505, and 506 of Regulation D

Regulation D is a set of rules adopted by the SEC to provide exemptions principally for small issues and small issuers.¹⁶¹ The main operative provisions are Rules 504 and 505,¹⁶² which were adopted under the SEC’s exemptive authority in Section 3(b) of the Securities Act,¹⁶³ and Rule 506,¹⁶⁴ which was adopted under Section 4(2) of the Securities Act.¹⁶⁵ Each exemptive rule has unique attributes, but there is some overlap in the requirements. Common to all three rules, however, are three unifying principles: offerings made within six months of each other may be integrated with each other and considered to be a single offering if they have certain specified common characteristics;¹⁶⁶ securities acquired in

¹⁵⁷ Cohn & Yadley, *supra* note 125, at 22.

¹⁵⁸ See *infra* Part II.A.2.b.

¹⁵⁹ HAZEN, *supra* note 142 (quoting Non-Public Offering Exemption Sec. Act Rel. No. 33-4552, 1962 WL 69540, 1 Fed.Sec.L. Rep. (CCH) ¶ 2781 (Nov. 6, 1962)).

¹⁶⁰ See *infra* Part II.A.2.b. (discussing the prohibition of general advertising).

¹⁶¹ HAZEN, *supra* note 142, § 4.19[1].

¹⁶² 17 C.F.R. §§ 230.504 & 505 (2011).

¹⁶³ 15 U.S.C. § 77c(b) (2006). Section 3(b) allows the SEC to pass rules or regulations exempting “any class of securities . . . if it finds that the enforcement of [the Securities Act] 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. . . .” *Id.* The maximum aggregate amount of any offering exempted under Section 3(b) is \$5,000,000. *Id.*

¹⁶⁴ 17 C.F.R. at § 230.506.

¹⁶⁵ 15 U.S.C. at § 77d(2). Section 4(5) of the Securities Act, 15 U.S.C. § 77d(5) (formerly Section 4(6) of the Securities Act), which allows for limited offerings to accredited investors, is also a foundation for the exemptions in Rules 505 and 506 of Regulation D. See HAZEN, *supra* note 142, §§ 418-19.

¹⁶⁶ 17 C.F.R. at § 230.502(a) (commonly referred to as “integration”).

Regulation D offerings are considered restricted securities for purposes of the Securities Act and cannot be resold absent registration or the availability of an applicable exemption;¹⁶⁷ and (except in limited circumstances under Rule 504) issuers and their agents may not offer or sell securities under Regulation D using “any form of general solicitation or general advertising.”¹⁶⁸

Rule 504 provides an exemption for certain offerings not exceeding an aggregate of \$1,000,000 within a 12-month period.¹⁶⁹ This exemption places no limits on the number of offerees, and it does not require specific affirmative disclosure on the part of the issuer.¹⁷⁰

Rule 505 provides an exemption for offerings with a maximum aggregate offering price of \$5,000,000 within a 12-month period.¹⁷¹ The rule limits the number of purchasers to 35, not including “accredited investors,” a term that generally refers to institutional investors and high-net-worth individuals—entities and individuals who are presumed to be able to bear the risk of the total loss of their investment.¹⁷² Additionally, Rule 505 requires disclosure of specific financial and non-financial information to any securities purchasers who are not accredited investors.¹⁷³

Rule 506 is a Section 4(2) safe harbor that was included in Regulation D.¹⁷⁴ Because it is not based on the SEC’s authority to grant exemptions under Section 3(b), Rule 506 does not

¹⁶⁷ 17 C.F.R. at § 230.502(d).

¹⁶⁸ 17 C.F.R. at § 230.502(c).

¹⁶⁹ 17 C.F.R. at § 230.504(b)(2) (commonly referred to as “aggregation”).

¹⁷⁰ See 17 C.F.R. at § 230.504(b) (apart from the exclusion of public companies, investment companies, and specified development stage companies, the only conditions that must be satisfied under this rule—other than the applicable conditions under Rule 502—relate to the previously mentioned \$1,000,000 aggregate limitation on offering size).

¹⁷¹ 17 C.F.R. at § 230.505(b)(2)(i). Like Rule 504, Rule 505 is not available for offerings by investment companies. *Id.* § 230.505(a).

¹⁷² 17 C.F.R. at § 230.505(b)(2)(ii). See Rule 501, 17 C.F.R. § 230.501(a) (defining “accredited investor” to generally include: banks; savings and loan associations; insurance companies; employee benefit plans; private business development companies; insiders of the issuer of the securities; any individuals whose individual net worth, or joint net worth with that person’s spouse, at the time of the purchase exceeds \$1,000,000; and any person with individual income of greater than \$200,000, or \$300,000 joint income with a spouse, in each of the two previous years).

¹⁷³ 17 C.F.R. at §§ 230.502(b)(1) & 230.505(b)(1). Rule 505(b)(1) incorporates by reference the requirements of Rule 502, and Rule 502(b)(1) mandates the disclosure to non-accredited investors of various financial statement and non-financial statement information for offerings made pursuant to Rules 505 and 506. *Id.*

¹⁷⁴ HAZEN, *supra* note 142, § 4.20[1]. Section 4(5) (formerly denominated Section 4(6)) of the Securities Act also covers offerings of the kind exempted under Rule 506, but became outdated and superfluous when the more detailed safe harbor provisions of Rule 506 were adopted. See COX ET AL., *supra* note 122, at 286 (“Section 4(6) reflected congressional dissatisfaction with the state of limited offering exemptions in the early 1980s. The SEC

limit the maximum aggregate size of an offering that is exempt under its provisions.¹⁷⁵ Like Rule 505, Rule 506 specifies that no more than 35 non-accredited investors may purchase the securities¹⁷⁶ and requires the same affirmative disclosures to all non-accredited investors.¹⁷⁷ Further, because the exemption is based on Section 4(2), Rule 506 requires that each non-accredited investor (or the non-accredited investor's "purchaser representative") meet a minimum sophistication requirement or that the issuer "reasonably believes" immediately prior to making a sale that each non-accredited purchaser or purchaser representative meets that sophistication requirement.¹⁷⁸

As is evident from the foregoing descriptions of the exemptions available under Regulation D, 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.¹⁷⁹ In fact, "[t]here is no greater impediment to the ability of small companies to raise capital under the securities laws than the SEC rules against general solicitation and advertising."¹⁸⁰ The ban on general solicitation and general advertising is a substantial obstacle because the SEC has interpreted this restriction very broadly, construing "'general solicitation' to include offers to any person with whom the issuer, or the issuer's agent, has not had a prior relationship."¹⁸¹ Under Rules 505 and 506, neither

responded with the adoption of Regulation D, rendering the statutory exemption of little, if any, use today."); Gary M. Brown, *Securities Act Registration Exemptions*, 175 PLI/Corp 209, 217 (2009) ("Among other things, Regulation D incorporates the accredited investor concept of section 4(6) into a more useful exemption, making the free-standing statutory section largely superfluous.").

¹⁷⁵ See *supra* note 171 and accompanying text.

¹⁷⁶ 17 C.F.R. at § 230.506(b)(2)(i); see also *supra* note 172 and accompanying text (regarding the parallel requirement in Rule 505).

¹⁷⁷ 17 C.F.R. at §§ 230.502(b) & 230.506(b)(1); see also *supra* note 173 and accompanying text (regarding the parallel requirement in Rule 505).

¹⁷⁸ 17 C.F.R. at § 230.506(b)(2)(ii) (requiring that each non-accredited investor or his or her purchaser representative have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" or that the issuer "reasonably believes" that the purchaser meet that requirement).

¹⁷⁹ See Cohn & Yadley, *supra* note 125, at 11 ("The SEC's ban on general advertising and general solicitation in private offerings . . . eliminates the potential of the internet to attract investors").

¹⁸⁰ *Id.* at 36. See also sources cited *infra* note 309 (arguing for dismantlement of the ban on general solicitation and general advertising.). This prohibition also applies to the private offering exemption under Section 4(2), discussed *supra* Part II.A.2.a. The only transactional exemptions that are not subject to this restriction are the intrastate offering exemption under Section 3(a)(11), 15 U.S.C. § 77c(a)(11) (2006), and Rule 147, 17 C.F.R. § 230.147 (2011), and Regulation A, 17 C.F.R. at §§ 230.251-263, discussed *infra* Part II.A.2.c.

¹⁸¹ Cohn & Yadley, *supra* note 125, at 41 (citations omitted). In examining a case where offerors engaged in a general solicitation by sending materials to an unknown number of people with whom the offerors did not have a pre-existing relationship, the SEC stated:

general solicitation nor general advertising is permitted.¹⁸² Rule 504 permits this manner of offering only if the issuer complies with applicable state law that provides adequate investor protection.¹⁸³

In almost all cases,¹⁸⁴ crowdfunding Web sites exist to invite the general public—the crowd—to help fund small business ventures.¹⁸⁵ The whole point is to allow ventures to access capital that they would not be able to access without the use of the crowdfunding Web site. If the ventures seeking the funding were able to raise the capital they need from those with whom they have a prior relationship, they would have no need for crowdfunding. Thus, the nature of crowdfunding *requires* the use of general solicitation and general advertising and often rules out the use of screening devices (including, e.g., password-protected access to the crowdfunding Web site), making Rules 505 and 506 unavailable. Rule 504 may be available, but only if the issuer's offering meets the state law exemption requirements set forth in Rule 504(b)(1).¹⁸⁶ Assuring compliance with Rule 504 for a crowdfunded venture is not straightforward. It may be difficult to determine the states in which crowdfunding interests are offered and sold. Moreover, the cost of complying with multiple (if not all) state laws—even assuming applicable state laws meet the proper threshold level of investor protection—would be high (if not prohibitive).

These persons were selected only because their names were on lists that were purchased or created by Kenman. Although the make-up of the lists may indicate that the persons themselves have some degree of sophistication or financial well-being, utilization of lists of thousands of persons with no pre-existing relationship to the offeror clearly does not comply with the limitations of Rule 502(c) on the manner of solicitation.

In re Kenman Corp., Exchange Act Release No. 21962 (April 19, 1985).

¹⁸² 17 C.F.R. §§ 230.502(c), 505(b)(1) & 506(b)(1).

¹⁸³ 17 C.F.R. § 230.504(b)(1). Rule 504(b)(1) requires that the issuer comply with state laws compelling public filing or delivery of disclosure documents before the sale of securities or that the securities be sold exclusively according to state law exemptions that allow for general solicitation to accredited investors. *Id.*

¹⁸⁴ One crowdfunding Web site, Profinder, only allows investors who are invited by the small business owner seeking the funding. In that case, the crowdfunding Web site's primary function is to market the small business's products and performing administrative work. Although the Web site facilitates the fundraising by giving the small business owner a platform from which to promote the business, Profinder's fundraising strategy is not based on allowing the small business owner to access more sources of capital; it is based on giving the small business owner a more effective strategy for tapping those resources. *For Entrepreneurs: FAQs*, ProFinder, www.profinder.com/entrepreneurs/faqs.

¹⁸⁵ See Lambert & Schwienbacher, *supra* note 5, at 4 ("Raising funds by tapping a general public (or the crowd) is the most important element of crowdfunding. This means that consumers can volunteer to provide input to the development of the product, in this case in form of financial help.").

¹⁸⁶ See 17 C.F.R. § 230.504(b)(1).

The prohibitions on general solicitation and general advertising are veritable showstoppers for ventures contemplating the use of a Regulation D exemption for crowdfunding or other Internet offers and sales.¹⁸⁷ But they are not the only obstacles that issuers face in exempting crowdfunded offerings from registration using Regulation D. The 35-purchaser limit under Rules 505 and 506 also is an impediment. Information available on crowdfunding Web sites leaves open the possibility that each venture will be funded through the purchase of interests by more than 35 entities and individuals.¹⁸⁸ We can safely assume that many (if not most) purchasers of crowdfunding interests are not institutional investors or high-net-worth individuals (which or who would qualify as accredited investors). If more than 35 distinct non-accredited investors purchase crowdfunding interests in a particular crowdfunding venture, the offering of those interests would not qualify for an exemption under Rule 505 or Rule 506. Even if fewer than 35 non-accredited investors acquired crowdfunding interests in a crowdfunded offering meeting the general solicitation and general advertising requirements, the preparation of the disclosure documents required for non-accredited investors under Rules 505 and 506 may be costly to produce, increasing the overall transaction costs of the offering to prohibitive levels.¹⁸⁹

An additional hurdle exists with respect to compliance with the sophisticated investor requirements in Rule 506. It is unlikely that all purchasers of crowdfunding interests—as members of an undifferentiated Internet-based crowd—would meet the sophistication standards or have access to a qualified purchaser’s representative. For these many reasons, Regulation D fails to provide a viable exemption option for crowdfunded businesses.

¹⁸⁷ See, e.g., U. S. Sec’s & Exch. Comm’n, *SEC Enters Cease and Desist Order in Connection with Online Campaign to Buy Beer Company*, June 8, 2011 (describing alleged violations of Section 5(c) of the Securities Act in connection with the online solicitation of pledges for up to \$300 million to purchase the Pabst Brewing Company).

¹⁸⁸ For example, LiveProud is a project listed on 33needs that has a goal of “removing thousands of tons of garbage from landfills across the country by making great looking, high performance sportswear.” *Venture Profile: LiveProud*, 33needs.com, <http://www.33needs.com/ventures/liveproud>. This project, which has a target goal of \$15,000, provides information on rewards for contributions in the following increments: \$10, \$30, \$50, and \$100. *Id.* If one was to assume that these amounts were the limits on individuals’ contributions (which they may not be), this means that the project will require anywhere from 150 to 1,500 investors to reach the funding target. If an individual was allowed to contribute less than \$10 (for example, if the minimum contribution is \$1), it is possible that there could be as many as 15,000 investors for the project.

¹⁸⁹ See 17 C.F.R. § 230.502(b)(2) (which requires, in some instances, the same kind of non-financial information that is contained in a registration statement along with audited financial statements).

c. Regulation A

Regulation A exempts offerings not exceeding \$5,000,000 within a 12-month period, provided that the issuer offers the securities using an offering statement on Form 1-A, a filing like a limited registration statement, and an offering circular, a disclosure and selling document that is similar to the traditional Section 10 prospectus that forms a part of the registration statement in offerings registered under the Securities Act.¹⁹⁰ The offering circular is a “rather full disclosure document . . . complete with financial statements prepared in accordance with generally accepted accounting principles, filed and reviewed by the SEC in a manner similar to the filing and review of registration statements.”¹⁹¹ Absent from Regulation A, however, are the prohibitions against general solicitation and advertising, limitations on the number of investors, and investor qualification standards.¹⁹² Although Regulation A alleviates many of the burdens imposed by Regulation D (and was used for an early internet-based direct public offering¹⁹³), the expense of producing the offering circular, in addition to the costs associated with state securities law compliance, makes this exemption too costly for many crowdfunded ventures.¹⁹⁴ Therefore, Regulation A, like other current exemptions to Section 5’s registration requirement, fails to provide a practical solution that enables crowdfunded ventures to comply with federal securities laws.

¹⁹⁰ 17 C.F.R. §§ 230.252 & 253; HAZEN, *supra* note 142, § 4.17[1].

¹⁹¹ Cohn & Yadley, *supra* note 125, at 28 (internal citations omitted). *See also* Campbell, *supra* note 127, at 105 (“Although less extensive than the corresponding disclosures required in a prospectus in a registered offering, the narrative disclosures in an offering circular are substantial.” (footnote omitted)).

¹⁹² 17 C.F.R. at § 230.251. Rule 251 acknowledges that the exempted offering is a “public offer or sale of securities.” *Id.* Therefore, there is no need to limit general solicitation and general advertising, count purchasers (or assess accredited investor status), or examine the sophistication of the investors because the exemption presupposes a public offering.

¹⁹³ *See* Nikki D. Pope, Crowdfunding Microstartups: *It’s Time For The Securities And Exchange Commission To Approve A Small Offering Exemption*, 13 U. PENN. J. BUS. L. [106-07] (forthcoming 2011).

¹⁹⁴ *See* Campbell, *supra* note 127, at 105-110. In 1997, the average cost of a Regulation A offering was \$40,000 to \$60,000 and the average cost of a registered offering using Form S-1 was between \$400,000 and \$1,000,000. HAZEN, *supra* note 142, § 4.17[1]. Although mini-registration under Regulation A costs less than a registered offering, that lower cost will still often be more than the amount of capital that the crowdfunding venture is seeking to raise. Thus, “the Regulation A procedure ‘has for the most part become too cumbersome and expensive for small financing in an enterprise’s early years.’” Cohn & Yadley, *supra* note 125, at 28 (quoting Julian M. Meer, *The Private Offering Exemption Under the Federal Securities Act – A Study in Administrative and Judicial Contraction*, 20 Sw. L.J. 503, 504 (1966)).

3. Whose Conduct is Regulated?

The analysis in the preceding two subparts of this Part II.A. does not address directly the question of who, in a crowdfunded offering, is subject to the registration requirements of Section 5 of the Securities Act (or applicable liability provisions under the Securities Act and the Exchange Act, for that matter). It is important to address this part of the regulatory equation as a predicate to an evaluation of both the benefits and burdens of U.S. securities regulation in the crowdfunding context and the desirability and efficacy of any adjustments that may be made to the existing regulatory framework to better serve the policy objectives applicable to securities offerings under the Securities Act. This subpart engages that analysis as it relates to the registration requirement under the Securities Act.¹⁹⁵

Section 5 regulates the offer and sale of a security.¹⁹⁶ Different categories of persons with different roles in securities transactions are recognized under the 1933 Act as persons who may offer or sell securities. Paramount among them is the issuer. As a general matter, it is the issuer who must register securities for offer and sale.¹⁹⁷ Section 2 of the 1933 Act defines an issuer as “every person who issues or proposes to issue any security”¹⁹⁸ Under this vague definition, either a crowdfunding Web site (where one exists) that promotes a crowdfunded venture or the crowdfunded venture could be an issuer. In *SEC v. Murphy*,¹⁹⁹ the U.S. Court of Appeals for the Ninth Circuit offered that, for purposes of determining the issuer of securities in a limited partnership, the issuer was the “entity about which the investors needed information.”²⁰⁰ The court limited its holding in *Murphy* to situations involving limited partnerships, and left for another day the issue of whether additional individuals or entities with information material to the investment decision would be an issuer of securities.²⁰¹ This definitional guidance may best support labeling the specific crowdfunded venture as the issuer. That result seems intuitively correct, since a profit-seeking crowdfunder needs information about the venture being funded in order to assess the desirability and financial promise of an investment in that venture.

¹⁹⁵ In limiting our analysis here to matters under the Securities Act, we recognize that we fail to address the possible application of other important potential roles that crowdfunding Web sites may be deemed to occupy in securities transactions. See Bradford, *supra* note 6, at 30-51 (analyzing crowdfunding Web sites as potential exchanges, brokers, or investment advisors); Bradford, *Peer-to-Peer Lending*, *supra* note 8 (“If the sites are offering securities, the sites themselves could be brokers, or even exchanges, within the meaning of the Securities Exchange Act. Alternatively, it is at least possible that crowdfunding sites are investment advisers subject to regulation under the Investment Advisers Act.”).

¹⁹⁶ 15 U.S.C. § 77e (2006).

¹⁹⁷ 15 U.S.C. at § 77f(a) (“Any security may be registered with the Commission . . . by filing a registration statement in triplicate, at least one of which shall be signed by *each issuer*”) (emphasis added).

¹⁹⁸ 15 U.S.C. at § 77b(a)(4).

¹⁹⁹ 626 F.2d 633 (9th Cir. 1980).

²⁰⁰ *Id.* at 643-44.

²⁰¹ *Id.* at 644.

The conclusion that specific crowdfunded ventures are Securities Act issuers, however, does not foreclose the conclusion that crowdfunding Web sites also may be issuers. In fact, decisional law explicitly recognizes the possibility that multiple entities may act as “co-issuers.”²⁰² The concept of co-issuers was also implicitly recognized in *Howey*, where the Court found that two affiliated companies, who together offered a land sales contract and a related service agreement for that land, were liable for violating Section 5.²⁰³ Co-issuer status among affiliates was also implicitly recognized in *SEC v. Edwards*, involving a corporation and its subsidiary that sold payphones and offered in conjunction with the sales a five-year leaseback and management agreement.²⁰⁴ Thus, where affiliated companies act together to offer or sell an investment contract that is a security (i.e., in circumstances in which more than one entity is promoting and selling interests that are securities), the likely result is that both entities will be held to be co-issuers of those securities.

However, in many (but not all) crowdfunding arrangements, the crowdfunded venture and the crowdfunding Web site are not affiliated. This should not make a difference in whether the two are offering and selling securities for purposes of the Securities Act. The D.C. Circuit’s opinion in *SEC v. Life Partners, Inc.*,²⁰⁵ provides some (albeit limited) support for the proposition that two unaffiliated entities working together to offer a potential security will be similarly regulated for purposes of the registration requirements of the Securities Act. In *Life Partners*, Life Partners, Inc. (“LPI”) offered viatical settlements²⁰⁶ to investors and, along with Sterling Trust Company, an independent escrow agent acting for LPI, performed post-purchase administrative functions to ensure that investors collected on the settlements.²⁰⁷ The court determined that all prongs of the *Howey* test other than the “efforts of others” prong were satisfied in this case.²⁰⁸ An important aspect of this decision as it relates to those regulated under the Securities Act is that the court analyzed the efforts

²⁰² *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250, 254 (4th Cir. 1973), *cert. denied*, 416 U.S. 937 (1974). Datronics was an engineering company that spun off unregistered shares of nine corporations into new merger-corporations. *Id.* at 252-53. The court determined that “[c]learly, in these transactions the merger-corporation was an issuer; Datronics was a purchaser as well as a co-issuer . . .” *Id.* at 254. In fact, the 1933 Act definition expressly recognizes the possibility of more than one issuer. *See supra* note 198 and accompanying text..

²⁰³ *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946). *See supra* note 23 and accompanying text.

²⁰⁴ *SEC v. Edwards*, 540 U.S. 389, 391 (2004).

²⁰⁵ *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996).

²⁰⁶ Viatical settlements are arrangements where an investor purchases an interest in the life insurance policy of a terminally ill individual (typically an AIDS patient) at a discount of 20 to 40 percent. *Id.* at 537. This arrangement provides the patient with instant cash, and the investor’s profit is the difference between the discounted price paid for the policy and the death benefit collected from the insurer. *Id.*

²⁰⁷ *Id.* at 540.

²⁰⁸ *Id.* at 542-45.

of two unaffiliated entities together. Specifically, the court recognized that two separate entities can work together in such a way that it makes their functions inseparable for determining whether a security is being offered. Because investors would need information about both parties, each must comply with the Securities Act's registration requirements. Both parties, even if unaffiliated, should be treated as co-issuers where their efforts are inseparable and integral to the offering or sale of the contract, transaction, or scheme that constitutes a security under the Securities Act. Accordingly, in some circumstances, crowdfunded ventures and crowdfunding Web sites may be acting in concert in a manner that makes them co-issuers.

An alternative to characterizing the crowdfunded venture and the crowdfunding Web site as co-issuers is to treat the crowdfunded venture as an issuer and the crowdfunding Web site as an underwriter. "Underwriter status subjects applicable parties to the provisions of Section 5 and results in liability exposure for material misrepresentations and nondisclosures contained in the registration statement."²⁰⁹ The Securities Act defines an "underwriter" as

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.²¹⁰

This definition encompasses any party "who offers or sells for an issuer in connection with a distribution."²¹¹ Courts have generally followed the Second Circuit's reasoning in *Gilligan, Will & Co. v. SEC*²¹² that a distribution is synonymous with a "public offering," as that term is defined in *Ralston Purina*. In other words, if investors in an offering need the protection of the Securities Act—if they cannot fend for themselves—the offering is a distribution. Someone who offers or sells securities for an issuer in that offering (or who participates in that offer or sale) is an underwriter under the Securities Act. A common function of crowdfunding Web sites is to provide each featured crowdfunded venture with access to a base of investors that may be willing to purchase interests in that venture and to assist in promoting the venture to those potential investors. In this sense, crowdfunding Web sites perform much the same traditional function that investment banks play when they serve as underwriters in prototypical underwritten public offerings: the identification of potential investors and the promotion of the issuer and the securities being offered and sold.²¹³

²⁰⁹ MARC I. STEINBERG, UNDERSTANDING SECURITIES LAWS 175-76 (5th ed. 2009).

²¹⁰ 15 U.S.C. § 77b(a)(11) (2006).

²¹¹ COX ET AL., *supra* note 122, at 339.

²¹² See *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466-67 (determining that the "public offering" issue is "dispositive of the question whether petitioners 'purchased . . . with a view to . . . distribution.'").

²¹³ We note that people who perform these functions also may be deemed to be finders, who may be classified as brokers for purposes of the Exchange Act. See Bradford, *supra* note 6, at 32-42; Brumberg, Mackey & Weil, P.L.C., No Action Letter, May 17, 2010, *available*

Of course, investment banks serving as underwriters in public offerings typically act as conduits for the distribution of securities by purchasing the securities from the issuer and reselling them to the public.. But in *Sec's Exch. Comm'n v. Chinese Consolidated Benevolent Association*,²¹⁴ the defendant association, which the court found to be an underwriter, merely solicited purchase orders for the securities and handled ministerial duties in connection with the sale of Chinese government bonds. The court referenced the language from the statute.

[T]he words "[sell] for an issuer in connection with the distribution of any security" ought to be read as covering continual solicitations, such as the defendant was engaged in, which normally would result in a distribution of issues of unregistered securities within the United States. Here a series of events were set in motion by the solicitation of offers to buy which culminated in a distribution that was initiated by the defendant. We hold that the defendant acted as an underwriter.²¹⁵

The tasks undertaken by the association in *Sec's Exch. Comm'n v. Chinese Consolidated Benevolent Association* are similar to tasks undertaken by crowdfunding Web sites. As an underwriter, the crowdfunding Web site could be liable for Section 5 violations, even if the crowdfunding Web site is not a co-issuer.

The doctrine of participant liability, as fashioned by judicial decisions, supports the regulation of both the venture and the crowdfunding Web site under the Securities Act as offerors or sellers of securities. Under this doctrine, Section 5 liability will attach to an individual or entity who or which has a "significant role" in the offer or sale of securities.²¹⁶ A "significant role" has been defined to "include one who is both a 'necessary participant' and a 'substantial factor' in the sales transaction."²¹⁷ Where an offering participant is necessary to and a substantial factor in an offering that violates Section 5, that party is liable for the violation. This liability is a form of underwriter liability, since an individual or entity who has a "significant role" in an offering seemingly is a participant in a distribution

at <http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf>. See also 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, 897-920 (2005) (describing the role and legal status of finders in securities offerings). We also note that crowdfunding Web sites may perform additional functions (including post-sale administrative or ministerial functions) that are not easily classified as underwriting or finding services. See, e.g., *supra* note 207 and accompanying text.

²¹⁴ 120 F.2d 738 (2d Cir. 1941).

²¹⁵ *Id.* at 741.

²¹⁶ *SEC v. Phan*, 500 F.3d 895, 906 (quoting *SEC v. Murphy*, 626 F.2d 633, 652 (9th Cir. 1980)).

²¹⁷ *Id.*

of securities by and issuer and, therefore, an underwriter.²¹⁸ Under participant liability, there is no question that Section 5 compliance and liability will attach to both the crowdfunded venture and the crowdfunding Web site. Both are necessary participants in the offering; there would be no offer or sale of a crowdfunding interest without the crowdfunded venture, and the crowdfunding Web site is the essential vehicle for the offer and sale of the crowdfunding interests. Crowdfunding Web sites may be involved in the distribution of crowdfunding interests offered on their sites in many ways other than as a host site for crowdfunded ventures. Examples include: screening the projects prior to offering the investment to the public,²¹⁹ making promotional videos or designing individual web pages for the projects,²²⁰ serving as conduits for invested funds,²²¹ collecting cash from the venture and distributing it to investors in accordance with to the profit-sharing or revenue-sharing components of the crowdfunding interests promised to investors at the time the interests are purchased,²²² and performing accounting and other ministerial functions for crowdfunded ventures.²²³ Both the crowdfunded venture and the crowdfunding Web site are substantial factors in the sale transaction because both work together to provide potential and actual investors with a crowdfunding interest—a financial interest in the underlying venture. In the prototypical crowdfunding model, the principals behind the crowdfunded venture create or secure the business or project that necessitates funds, while the crowdfunding Web site attracts investors, supports them in their chosen investments, and administers the relationship between the crowdfunded venture and its investors.

²¹⁸ See *SEC v. Allison*, Fed. Sec. L. Rep. (CCH) P98,774 (1982) (“When, as in this case, a defendant’s actions were necessary to and a substantial factor in an illegal securities distribution, the defendant is a participant and thus an underwriter irrespective of the defendant’s intent” (citing *Murphy*, 626 F.2d at 648-50)).

²¹⁹ For example, MicroVentures pre-screens all business ideas to evaluate whether the business meets the criteria to be listed on the site. See *Investors: Frequently Asked Questions*, MICROVENTURES, <http://www.microventurers.com/investors/faq>. Some factors include the company’s business plan, prior business experience of the company’s leaders, how the company will use the funds, and the risk to investors. *Id.*

²²⁰ Profounder, for example, creates individual fundraising web sites to market the business ventures that are selected for funding. See *For Investors: How it Works*, PROFOUNDER, <http://www.profounder.com/entrepreneurs>.

²²¹ Microfinancing enterprises, such as Kiva, match investors’ funds to microfinancing institutions in less developed countries, who ultimately provide funding to the principal. See *How Kiva Works*, KIVA, www.kiva.org/about/how.

²²² Appbackr (which facilitates the development and sale of newly created mobile apps on the Apple App Store), like most crowdfunding sites with revenue-sharing or profit-sharing arrangements, “acts as the intermediary between [funders and principals].” See *How Does it Work?*, APPBACKR, http://www.appbackr.com/learn_more.php.

²²³ The Biracy Project, which seeks investments to fund motion pictures, retains 40% of the funds raised, some of which is used to pay for “project marketing, project development costs and administration salaries and overhead.” See *Q + A*, THE BIRACY PROJECT, <http://www.biracy.com/faq/>.

Finally, we note the possibility that crowdfunding Web sites could be brokers or investment advisors or exchanges another form of intermediary or investor fiduciary under the federal securities laws.²²⁴ We have left the analysis of those possibilities to others.²²⁵

B. Policy Underpinnings

The system of regulation described *supra* in this Part II serves two overarching policies: the protection of investors and the maintenance of market integrity.²²⁶ These policies are effectuated principally through doctrinal rules that provide for mandatory disclosure and liability for noncompliance, material misstatements and omissions, and fraud. However, in particular in and since the adoption of the Sarbanes-Oxley Act of 2002, Congress and the SEC also have used substantive regulation of constituents and conduct to effectuate investor protection and maintain market integrity.²²⁷

The registration of offerings is the vehicle for mandatory disclosure under the Securities Act, and liability flows from a failure to register offers or sales of securities and fraudulent and other objectionable activities in connection with (or in contravention of) that registration requirement. Congressional and SEC rulemaking and decision-making in and under the Securities Act focuses on supporting investor protection and market integrity in this context. For example, the SEC's general exemptive authority under the Securities Act is subject to the requirement that the exemption be "necessary or appropriate in the public interest, and . . . consistent with the protection of investors."²²⁸ The Securities Act also imposes market-oriented requirements on the SEC's rule-making authority.²²⁹

²²⁴ See *supra* notes 8, 195 & 213.

²²⁵ See, e.g., Bradford, *supra* note 6, at 30-51.

²²⁶ See LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 385 (5th Ed. 2010). See also Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 941-44 (1998).

²²⁷ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) ("The Securities Act . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 142-43 (2006) (describing substantive regulation under Sarbanes-Oxley). Mandatory disclosure serves to inform investor decision-making and enhance the efficiency of the market. See HAZEN, *supra* note 165, at 168-69; Ripken, *supra*, at 145 ("For the last seventy years, federal securities legislation in general has consistently relied on the philosophy of disclosure as the primary tool for protecting investors and regulating the securities market.").

²²⁸ 15 U.S.C. § 77z-3 (2006).

²²⁹ 15 U.S.C. at § 77b(b).

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in

The various types of statutory and regulatory exemptions in and under the Securities Act are rooted in different subsidiary policies consistent with the protection of investors and markets. For example, it appears that Congress intended Section 4(2) of the Securities Act to allow for offerings that are limited in character in a way that makes the registration and liability protections of the Securities Act unnecessary for the maintenance of adequate investor and market protections.

The legislative history is of little help except insofar as the general tone may be set by the House Committee's reference to this exemption as permitting "an issuer to make a specific or an isolated sale of its securities to a particular person," and to the exemption generally as directed to transaction "where there is no practical need for [the bill's] application or where the public benefits are too remote."²³⁰

Section 3(b) is founded on different objectives, however. It seeks to encourage capital formation through small offerings likely to be used to finance small ventures.

A perennial conundrum of the securities laws is how to treat small businesses fairly. Historically, considerable evidence has demonstrated that a substantial proportion of securities fraud is committed by the promoters of new, speculative firms. To fully exempt small business from the reach of the securities laws would deprive investors of protection in some of the instances where investors need protection most. On the other hand, there is no question that when small firms issue new securities they pay a proportionately higher price for underwriting compensation (the primary expense), accounting, legal, and filing costs than larger businesses. For some small firms, the costs of a *public* securities distribution are prohibitive. Unless it is national policy to give the large business firms advantages over the small in capital formation, it is essential to create compensatory programs to stimulate the financing of small firms.²³¹

By its express terms, this objective—fostering small business venture capital—is constrained by the overall policy aims of the Securities Act; Section 3(b) only authorizes the SEC to adopt exemptions for offerings with an aggregate value of \$5,000,000 or less and only "if it finds that the enforcement of this title [the Securities Act] 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."²³²

the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Id.

²³⁰ LOSS ET AL., *supra* note 226, at 395.

²³¹ *Id.* at 387.

²³² 15 U.S.C. at § 77c(b).

Regulation A is an example of SEC rulemaking that effectuates these purposes. Regulation D, which relies on both Section 4(2) and Section 3(b) of the Securities Act for its statutory authority, encompasses the underlying policies of both sections by efficiently combining and enhancing earlier registration exemptions adopted under Sections 3 and 4 of the Securities Act.²³³

Crowdfunded offerings are not, by nature, isolated offers and sales of securities. However, there may be no practical need for the application of the Securities Act's registration scheme or the public benefits of the registration regime may be too remote for crowdfunded offerings of a relatively small number of units or offerings that are small in aggregate dollar value or have other attributes. Crowdfunded offerings typically are small in size—well less than the \$5,000,000 maximum for SEC exemptions under Section 3(b) of the Securities Act.²³⁴ Accordingly, given that the existing regulatory framework is unfriendly to crowdfunded offerings and assuming crowdfunding is (in at least some incarnations) an activity that is desirable and consistent with investor protection and the maintenance of market integrity, it seems appropriate that an exemption from registration be considered.

III. EXEMPTING CROWDFUNDING OFFERINGS FROM SECURITIES ACT REGISTRATION REQUIREMENTS

The preceding paragraph assumes that crowdfunding may be desirable and that an exemption from Securities Act registration may be appropriate. This Part first articulates an argument for providing a registration exemption for crowdfunding and then proceeds to propose elements of a possible crowdfunding exemption.

A. Why Consider an Exemption for Crowdfunding?

Crowdfunding is a very new corporate finance tool, and existing applicable law shapes (even when it does not constrain) crowdfunding's current parameters. Accordingly, a comprehensive analysis of crowdfunding's current and projected future benefits and costs is not yet possible. However, it is feasible to review at a high level some of crowdfunding's perceived and actual advantages and disadvantages to venturers, investors, other market participants, and the public at large.²³⁵

²³³ HAZEN, *supra* note 165, at 418-19.

²³⁴ Although not much empirical data yet is available on crowdfunded ventures and offerings, in a recent study by two Belgian business scholars, Thomas Lambert and Armin Schwienbacher, the mean amount of funds raised by the 33 crowdfunded ventures for which finding data was available was \$3.5 million, and the median amount of funds raised was under \$29,000. *See* Lambert & Schwienbacher, *supra* note 5, at 17 (Table 2).

²³⁵ Because "[c]rowdfunding is a market of and for the participants," LAWTON & MAROM, *supra* note 6, at 162, some traditional financial intermediaries may be shut out of this sector of the capital formation process. No doubt, however, new support roles for crowdfunding will develop as the industry matures. Crowdfunding sites like 33needs are, in fact, new forms of financial intermediation. *See* Lambert & Schwienbacher, *supra* note 5, at 4. No attempt is made here to assess the various social and economic tradeoffs among

1. Perceived and Actual Advantages of Crowdfunding

Crowdfunding may solve a key problem that small businesses have in funding their operations: the location of a sufficient number of potential and actual investors on a cost-effective basis. Most people seeking to fund businesses and projects—especially younger entrepreneurs—do not have relationships with enough entities and individuals to create a stable source of venture capital without the assistance of a third party.²³⁶ And these same venturers also often have few connections to people who can find investors for them (and if they do have these connections, they are unlikely to have the funds to retain these individuals and access their services).²³⁷

The scalability of classic human-centric networks has hit the skids. Fortunately, while the Internet has to a large degree exacerbated this problem, it also holds many solutions. We live in the age where a couple billion of people use the Internet, and social networking has become part of our lives, whether it be using Facebook, Twitter, LinkedIn, Foursquare, Blippy, Quora, YouTube, blogging or otherwise. The irony is, many individuals who have created big social networking presences have a bigger “Rolodex” than many financiers.²³⁸

Crowdfunding enables entrepreneurs to more quickly and easily identify supporter-investors who are willing and able to fund their businesses or projects. These investors may be more likely than repeat players in the seed, angel, or venture capital game to be engaged with—and even passionate about—the ventures they are funding. No doubt many of these investors are not otherwise involved in funding business ventures and were an untapped source of small business capital prior to the advent of crowdfunding. Crowdfunding gives them a way to participate in corporate finance that they are not otherwise likely to have. Specifically, crowdfunding provides a new outlet for the capital of

transaction participants that inevitably will occur as crowdfunding further develops. *See generally* LAWTON & MAROM, *supra* note 6, at 167-72 (describing a few ways in which traditional finance professionals could engage with crowdfunding). That analysis must wait for another day.

²³⁶ *See* Campbell, *supra* note 127, at 89 (“Usually, company employees do not know where to find potential investors”). *Cf. id.* at 81 (“[S]mall businesses face daunting economic and structural conditions when they enter the capital markets. External capital for them is hard to find and expensive to acquire.”).

²³⁷ *See id.* (“The absence of financial intermediation services for small businesses means that they are almost always on their own to find investors; their small capital needs mean that their relative offering costs are often sky high.”); *id.* at 88-90 (describing the lack of an underwriting market for small business offerings).

²³⁸ LAWTON & MAROM, *supra* note 6, at 55. *See also* Lambert & Schwienbacher, *supra* note 5, at 5 (“[T]he development of Web 2.0 is a critical ingredient that has facilitated the access to the “crowd”. Roughly speaking, Web 2.0 is a Web-as-participation-platform that facilitates interaction between users. This structure is crucial for entrepreneurs to be able to easily reach networks of investors or consumers.” (footnote omitted)).

ardent consumer-investors on the Internet—where these potential funders spend much of their time. Because of their particularized interest in the ventures they choose to fund and their Internet savvy, investors in crowdfunded ventures may choose to fund businesses and projects different from those funded through more traditional capital-raising methods.²³⁹ These crowdfunded ventures may be more welfare-enhancing or more successful in their relevant product or service markets than businesses and projects funded through standard venture capital financings.²⁴⁰

Crowdfunding also has the potential to help stimulate the economy through the efficient financing it provides to some small businesses. Small businesses have the capacity to be an engine of economic growth—providing hope and creating jobs.²⁴¹ However, the general difficulty that small businesses have in funding their operations has worsened as a result of the economic crisis and continuing contractions in the economy.²⁴² Crowdfunding may help generate capital to enable small businesses to commence or continue operations that help to fuel economic growth. To that point, veteran crowdfunding site IndieGoGo is

²³⁹ See Lambert & Schwienbacher, *supra* note 5, at 11 (“Compared to other means of financings, crowdfunding opportunities exhibit several important differences that are likely to affect risk-return profile of investors and motivations for providing money to crowd-funders.”).

²⁴⁰ See LAWTON & MAROM, *supra* note 6, at 55 (“[W]ith the hyper-awareness and immersion that comes from using these modern [social networking] tools, many individuals in the crowd have a much better chance of screening and picking the best and most interesting new projects.”); Lambert & Schwienbacher, *supra* note 5, at 12 (Crowdfunding “is a unique way to validate original ideas in front of a specifically targeted audience. This may in turn provide insights into market potential of the product or service offered.”).

²⁴¹ See Campbell, *supra* note 127, at 81 (“Society needs small businesses. They are vital to our national economy, both qualitatively and quantitatively. They account for as much as 40% of our total economic activity and provide consumers with many of the services and products that are essential in our day-to-day lives.”); *id.* at 84-86 (chronicling the social and economic importance of small business); Orcutt, *supra* note 213, at 861-62 (referencing information from the U.S. Small Business Administration Office of Advocacy); William K. Sjostrom, Jr., *Relaxing The Ban: It's Time To Allow General Solicitation And Advertising In Exempt Offerings*, 32 FLA. ST. U.L. REV. 1, 1 (2004) (“Small businesses play a pivotal role in the United States economy. ‘They are the foundation of the Nation's economic growth: virtually all of the new jobs, 53 percent of employment, 51 percent of private sector output, and a disproportionate share of innovations come from small firms.’” (footnote omitted)); Katherine Reynolds Lewis, Crowdfunding Promoted to Help Small Businesses, FISCAL TIMES, Apr. 17, 2011, <http://www.thefiscaltimes.com/Articles/2011/04/17/Crowdfunding-Promoted-to-Help-Small-Businesses.aspx> (“President Obama launched Startup America to encourage entrepreneurship, stressing that small businesses traditionally have been the engine of job creation, and Federal Reserve Board Chairman Ben Bernanke regularly talks up his concern for small businesses and keep tabs on small business funding.”).

²⁴² See Lewis, *supra* note 241.

among the participants in Startup America,²⁴³ a White House initiative that features small business as a driver of economic recovery in the United States.²⁴⁴

2. Perceived and Actual Disadvantages of Crowdfunding

Yet, “crowdfunding is in a very early and noticeably unsettled state.”²⁴⁵ As a rapidly changing set of Internet business models, crowdfunding may be less transparent and more intangible to investors and regulators. Promoters of crowdfunding interests often are anonymous individuals and unknown entities. Moreover, as a small business start-up financing method (in its prevalent current form), crowdfunding shares many of the overall negative attributes of small business and start-up capital formation.²⁴⁶

In this relatively new, rapidly developing, faceless transactional environment, there are many traps for the unwary. Small businesses (especially start-ups) fail at a relatively high rate, and investors in them are likely to lose all of the money they invest.²⁴⁷ It may be

²⁴³ See Colleen DeBaise, *Kickstarting Entrepreneurship With “Startup America”*, In Charge, WSJ.COM, Feb. 1, 2011, <http://blogs.wsj.com/in-charge/2011/02/01/kickstarting-entrepreneurship-with-startup-america/?KEYWORDS=%22StartUp+America%22>.

²⁴⁴ See Angus Loten, *‘Startup America’ Embraces Crowd-funding*, In Charge, WSJ.COM, Apr. 22, 2011, <http://blogs.wsj.com/in-charge/2011/04/22/‘startup-america’-embraces-crowd-funding/>. See also Lewis, *supra* note 241.

²⁴⁵ LAWTON & MAROM, *supra* note 6, at 71.

²⁴⁶ See, e.g., Jill E. Fisch, *Can Internet Offerings Bridge The Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58-64 (1998) (summarizing many of these clarifications).

²⁴⁷ LAWTON & MAROM, *supra* note 6, at 180-81 (“The risk-reward curve in the startup world is quite well established At the risk of sounding too general, a lot of time most of the investment is lost”); *id.* at 58 (“Companies with small capitalizations present disproportionate risks of . . . business failure”); Brian Headd, et al., *What Matters More: Business Exit Rates or Business Survival Rates?*, <http://www.ces.census.gov/docs/bds/Exit%20Rates%20or%20Survival%20Rates.pdf> (“The one-year survival rates for establishments born to firms started in 2004 was 76.4 percent and the five-year survival rates for establishments born to firms started in 2000 was 50.7 percent.”). The U.S. Small Business Administration cites to the following findings about the survival of new firms, based on the same data used by Headd, *supra*:

Seven out of ten new employer firms last at least two years, and about half survive five years. More specifically, according to new Census data, 69 percent of new employer establishments born to new firms in 2000 survived at least two years, and 51 percent survived five or more years. Firms born in 1990 had very similar survival rates. With most firms starting small, 99.8 percent of the new employer establishments were started by small firms. Survival rates were similar across states and major industries.

U.S. Small Business Administration, *What is the Survival Rate of New Firms?*, <http://www.sba.gov/advocacy/7495/8430>.

easier on the Internet for investors who lack corporate finance expertise and experience or knowledge of relevant industries to lose their savings.²⁴⁸ The SEC provides specific guidance to retail investors engaging in online trading.

Online trading is quick and easy, but online investing takes time.

With the click of a mouse, you can buy and sell stocks Although online trading saves investors time and money, it does not take the homework out of making investment decisions. You may be able to make a fast trade, but making wise investment decisions takes time. Before you trade, know why you are buying or selling, and the risk of your investment.²⁴⁹

Moreover, the Internet may have a capacity to over-inform (and, as a result, the potential to obfuscate or bury important information) in connection with securities offerings.²⁵⁰ The Internet's capacity for encouraging suboptimal decision-making and the perceived higher probability of investor losses are real concerns. Having said that, however, the Securities Act is not designed (and does not exist) to protect all investors from losing their money in all circumstances; in other words, the Securities Act is not an insurance policy against investor losses.²⁵¹ That is not possible, or even desirable.²⁵²

²⁴⁸ See LAWTON & MAROM, *supra* note 6, at 180 (noting that people commonly are concerned about “unsophisticated investors losing all of their money” in crowdfunding interests); Stephen J. Choi, *Gatekeepers and The Internet: Rethinking The Regulation of Small Business Capital Formation*, 2 J. SMALL & EMERGING BUS. L. 27, 37-38 (1998) (“With the increase in the number of active investors on the Internet comes a corresponding increase in potentially unsophisticated investors. . . . Because fraudulent issuers may sell securities with greater ease over the Internet, these investors are at risk.” (footnote omitted)); Fisch, *supra* note 246, at 58 (“[R]isks may be magnified by Internet-based securities transactions. The low cost and wide distribution of Internet offerings makes the Internet an easy vehicle for fraudulent securities transactions.”).

²⁴⁹ U.S. Sec’s & Exch. Comm’n, *Online Investing*, INVESTOR.GOV, <http://www.investor.gov/researching-managing-investments/investing-your-own/online-investing>.

²⁵⁰ See Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417, 419 (2003) (“Studies show that at some point, people become overloaded with information and make worse decisions than if less information were made available to them.”).

²⁵¹ See, e.g., *In re Williams Secs. Litig. - WCG Subclass*, 558 F.3d 1130, 1137 (10th Cir. 2009) (“The securities laws are not meant to ‘provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.’” (citation omitted)); Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473, 485 (2006) (noting that the materiality standard applicable to liability actions under, among other provisions, Section 17(a) of the Securities Act bases investor protection on the reasonable investor—“someone who grasps market fundamentals”).

A more specific worry is the capacity for fraud in crowdfunding.²⁵³ Fraud protection is a focus of the Securities Act, and the Internet is a common vehicle for securities fraud.²⁵⁴

²⁵² The law's protection of people who unwisely part with money varies depending on context and is based on a balancing of relevant policy interests. For example, crowdfunding advocates and analysts note the lack of parallel regulation of crowdfunding, gambling, and charitable solicitations, each of which may result in the loss of some or all of the funds conveyed by the people providing money (investors, gamblers, and donors, respectively). See LAWTON & MAROM, *supra* note 6, at 179-80 (noting that people can gamble away \$5,000 without question but cannot invest \$5,000 because of existing "American SEC regulation"); Angus Lotan, *Crowd-Fund Sites Eye Boom*, WSJ.COM, May 12, 2011, <http://online.wsj.com/article/SB10001424052748703806304576245360782219274.html> ("Until now, U.S. regulations permitted these [crowdfunding] sites only to facilitate donations—not purchases of equity stakes."); Gus G. Sentementes, *Crowdfunding Allows Everyone to Be an Arts Patron*, BALTIMORE SUN, June 13, 2011, available at http://articles.baltimoresun.com/2011-06-13/business/bs-bz-crowdfunding-websites-20110613_1_arts-organizations-crowdfunding-arts-spending (describing charitable fundraising through crowdfunding and noting that "[f]ederal regulations prohibit fundraisers from using the websites to sell shares in projects to entice investors looking for a financial return.").

²⁵³ LAWTON & MAROM, *supra* note 6, at 180 (indicating concern about crowdfunding's "potentials for fraudulent fund raising activities"). See generally Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 308 (2000) ("Allowing truly unsophisticated investors to purchase securities of small speculative businesses, however, may lead to both mistake and fraud.").

²⁵⁴ Gregory C. Yadley, *General Solicitation: Looking for Funds in all the Wrong Places*, 70 FLA. BAR J. 80, 81 (1996) (describing concern about securities fraud in "cyberspace"); Jake van der Laan, et al., *Identifying Internet Mediated Securities Fraud: Trends and Technology*, Apr. 2010, at 2, http://journal.webscience.org/367/2/websci10_submission_71.pdf ("Over the last number of years North American securities regulatory agencies have noted a material increase in the number of securities fraud cases mediated through the internet." (footnotes omitted)). This issue is not new. Thirteen years ago, a respected securities law scholar made the following observations, which continue to be true today.

Internet offerings present the risk of fraud. The media have publicized the popularity of the Internet as a tool for fraudulent transactions generally, and although Internet offerings are in their infancy, dishonest promoters have been quick to capitalize on the Internet's potential for cheating investors. The SEC has already identified and prosecuted promoters in connection with a variety of fraudulent Internet offerings, including pyramid schemes, false promises and sales of nonexistent securities.

Fisch, *supra* note 246, at 80 (footnote omitted).

Additional regulation is unlikely to change this significantly. As a result, the SEC has directed efforts toward investor education. For example, it has a Web page devoted to Internet fraud.²⁵⁵ Of particular note: small businesses may be disproportionately involved in securities fraud.²⁵⁶ The SEC has recognized and reacted to the capacity for fraud in the market for securities of small business issuers.²⁵⁷ But this enhanced potential for small business fraud does not mean we should ban, thwart, or unduly constrain securities offerings by small business issuers, even if those offerings occur over the Internet.

Small companies have been responsible for a large proportion of the instances of investor fraud. By allowing small companies to make Internet offerings will we be giving the green light to the scam artists? No doubt more will try. Better investor education and stronger enforcement efforts should make the increase in fraud bearable, however. Moreover, the increase in fraud will be offset by the increase in legitimate business activity stimulated by the reduced costs of raising capital for many of our most innovative and productive companies.²⁵⁸

Together with the prospect of investor losses resulting from small business failure and fraud, and in spite of the potential capital formation efficiencies and other benefits it may create for small business, crowdfunding may, if unregulated or under-regulated, foster a lack of trust in the securities markets (or at least in the crowdfunding market). Investor losses and fraud, as well as inconsistent business practices, may contribute to perceptions that the crowdfunding market is dishonest or corrupt. Any perception of market unfairness or distrust may have serious effects on investor confidence and investment behavior.

In order for the securities markets to work, it is critical to maintain investor trust in the integrity of the market because this trust is the foundation on which the markets are built. Without a broad-based investor perception of legitimacy, people will not

²⁵⁵ U.S. Sec's & Exch. Comm'n, *Internet Fraud*, <http://www.sec.gov/investor/pubs/cyberfraud.htm>.

²⁵⁶ See Choi, *supra* note 248, at 29; Richard J. Pierce, Jr., *Small Is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms*, 50 ADMIN. L. REV. 537 (1998); Fisch, *supra* note 246, at 58; David B. Guenther, Note, *The Limited Public Offer in German and U.S. Securities Law: A Comparative Analysis of Prospectus Act Section 2(2) and Rule 505 of Regulation D*, 20 MICH. J. INT'L L. 871, 908 (1999).

²⁵⁷ See Bradford, *supra* note 126, at 30.

²⁵⁸ Dale A. Oesterle, *The High Cost Of IPOs Depresses Venture Capital In The United States*, 1 ENTREPREN. BUS. L.J. 369 (2006) (footnote omitted). See also Bradford, *supra* note 126, at 30 ("There may be more fraud in small offerings, or at least proportionately more, but that does not refute the basic argument: as long as many small offerings are legitimate, there is some offering amount below which registration, or any conditional exemption, is inefficient."); *id.* at 34 ("The SEC's concern with microcap fraud is laudable, but the Commission should not penalize all small business issuers for the misdeeds of a few. The answer to fraud lies in aggressive use of Rule 10b-5 and other antifraud rules, not in a prophylactic bar that ensnares even the smallest, least sophisticated businesses.").

invest in the market, but put their money elsewhere, in "gold or real estate, or under their mattresses."²⁵⁹

Although the relative ease with which an unsophisticated investor may lose money in small business issuers, the high relative rate of securities fraud in the small business context, and the anonymity of the internet may give us pause about extending exemptive relief to crowdfunded offerings, crowdfunding has the capacity to fuel small business growth and satisfy the demand for a securities market that serves the everyman. Moreover, crowdfunding is a social and economic force to be reckoned with. "Just how encompassing crowdfunding is, speaks to the enormity of its potential for economic and social impact. In the same way that social networking changed how we allocate time, crowdfunding will change how we allocate capital."²⁶⁰ Accordingly, we believe that crowdfunding should be encouraged; but because it comes with both positive and negative consequences, a crowdfunding registration exemption should be appropriately tailored to accentuate the positive and minimize the negative.

B. The Contours of a Possible Crowdfunding Exemption

Based on this top-level analysis, in an effort to take away unnecessary legal and regulatory barriers to crowdfunding (while, at the same time, maintaining investor and market protections), we begin by establishing foundational principles and considering appropriate rulemaking options and processes. Then, with these principles, options, and processes in mind, we outline the possible parameters of a crowdfunding exemption from the registration requirements of the Securities Act that we believe forms an important basis for discussion. This Part sets forth those principles, options and processes, and parameters as a basis for further dialogue and action.

1. Foundational Principles

Although the following overlapping principles may seem simple and obvious, we consider each to be of importance in fashioning appropriate changes to crowdfunding regulation:

- Limit investor risk;
- Optimize fraud protection;
- Enhance informational transparency;
- Foster standardization of disclosures and enforcement;
- Constrain regulatory costs; and
- Minimize costs to issuers and investors.²⁶¹

²⁵⁹ Ripken, *supra* note 227, at 194 (footnote omitted).

²⁶⁰ LAWTON & MAROM, *supra* note 6, at 1.

²⁶¹ We note that Woodie Neiss, a Member of the Small Business and Entrepreneurship Council Advisory Committee, suggested four similar principles as a basis for crowdfunding regulation in a December 2010 letter appended to the Final Report of the 2010 Forum on Small Business Capital Formation. See 2010 Annual SEC Government-Business Forum on Small Business Capital Formation, Final Report, June 2011, *available at*

The first three of these principles derive directly from the policies underlying the Securities Act described *supra* Part II.B. As corollaries of the investor protection and market integrity maintenance objectives of the Securities Act, these principles are central values for any variance in the current scheme of securities regulation. Among other things, the mandatory disclosure rules exist to promote transparency for the protection of investors, prevent fraud, and promote the perception (if not the reality) of fair and honest markets.²⁶² Moreover, the three initial principles go to the heart of the matters described *supra* Part III.A.2. as regulatory concerns applicable to crowdfunding: specifically, unease about the relationship between Internet offerings and investor losses and higher probabilities of fraud in small business capital formation. Transparency—meaning not necessarily more disclosure, but (rather) more targeted, simple, easy-to-access disclosure—should support more effective transmission of information to the potentially inexperienced or less experienced Internet investors that are among those attracted to crowdfunding.²⁶³ In addition, transparency should help limit cases of fraud to crowdfunded businesses that are affirmative bad actors whose conduct is not likely to be deterred by *ex ante* regulation and must be punished by *ex post* enforcement.

The fourth value, standardization, is closely related. The standardization of disclosures (through mandatory disclosure requirements) and enforcement is an efficient way to accomplish the first three principles, but especially relates to (and operates hand-in-hand with) transparency. In addition, standardization is a potential source of economic efficiencies that may help constrain costs to market participants (the fifth and sixth principles in our list of foundational principles) while also protecting investors.

Absent standardization of disclosure requirements, such as those provided by the SEC, there will remain "grave uncertainty about outcomes because such matters as intent and negligence need to be sorted out in court." By contrast, the securities regulatory system is standardized, which makes disclosure more efficient.

<http://www.sec.gov/info/smallbus/gbfor29.pdf>.

²⁶² See Judge Stanley Sporkin, *The Worldwide Banning of Schmiergeld: A Look at the Foreign Corrupt Practices Act on its Twentieth Birthday*, 18 NW. J. INT'L L. & BUS. 269, 272 (1998) ("The securities laws have long been a model for appropriate government regulation. They are largely statutes that mandate transparency. Full and fair disclosure is the general concept underpinning these laws."); Kevin Werbach, *Sensors and Sensibilities*, 28 CARDOZO L. REV. 2321, 2345 (2007) ("A great deal of securities regulation revolves around mandatory disclosure, in order to promote transparency of financial markets.").

²⁶³ See Lotan, *supra* note 252 (noting that "crowd-funding sites advertise start-ups to a broad audience, and could easily attract people who shouldn't be involved in speculative offerings").

The standardization of disclosure and enforcement rules is a central benefit for securities regulation and a key reason why private contracting cannot as efficiently protect the investor.²⁶⁴

Although a number of respected law and economics scholars advocate voluntary disclosure, rather than mandatory disclosure, for many good reasons,²⁶⁵ because standardized disclosures exist for issuers outside the crowdfunding context (e.g., through registration requirements and Regulations D and A²⁶⁶), we also include standardization as a foundational regulatory principle here. We want to be clear, however, that the fostering of standardization does not necessarily require homogenization or the imposition of weighty line-item disclosure rules.

Finally, our listed foundational principles recognize that it is important, in our attempt to both promote crowdfunding and protect investors and markets, not to impose on regulators or market participants a level of costs that is perceived to be prohibitively high (such that the proposed regulatory solution is not feasible for regulators or represents a disincentive for issuers or investors). The cost of compliance with regulatory change is an important consideration. Certain costs are obvious (e.g., the resources devoted to completing necessary filings and disclosures). Yet, the assessment of those costs in a crowdfunding context may be difficult, especially given crowdfunding's varied forms and relatively short track record. Moreover, current regulatory cost-benefit analyses for federal agency rulemaking may not be as broadly applicable as they should be or, when applicable, may be unavailing for other reasons.²⁶⁷ Accordingly, additional means of assessing the costs and benefits of a crowdfunding exemption should be identified, explored, and (potentially) used to supplement existing methods.²⁶⁸

These additional cost-benefit analyses should take account of the costs associated with the *fact* of a change in legal rule in addition to those associated with the specific substantive

²⁶⁴ Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 356-357 (2006) (footnotes omitted).

²⁶⁵ See, e.g., Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023 (2000) (setting forth both neoclassical economic and behavioral aspects of the mandatory disclosure debate).

²⁶⁶ See *supra* notes 124, 173 & 191 and accompanying text.

²⁶⁷ See generally CASS R. SUNSTEIN, *THE COST-BENEFIT STATE: THE FUTURE OF REGULATORY PROTECTION* (2002) (defending the use of cost-benefit analysis in regulatory rule-making, but criticizing its misuse and suggesting alternative approaches); Susan Rose-Ackerman, *Putting Cost-Benefit Analysis in Its Place: Rethinking Regulatory Review*, 65 U. MIAMI L. REV. 335 (2011) (critiquing and suggesting revisions to the existing means of engaging cost-benefit analysis); Arden Rowell, *The Cost of Time: Haphazard Discounting and the Undervaluation of Regulatory Benefits*, 85 NOTRE DAME L. REV. 1505 (2010) (criticizing regulatory cost-benefit analysis on the basis of, among other things, time indeterminacy).

²⁶⁸ See, e.g., Bradford, *supra* note 126, at 30-33 (modeling the costs and benefits of registration or partial regulation, on the one hand, and exemption on the other).

attributes of the proposed new rule.²⁶⁹ These legal transition costs frequently go unnoticed and unaccounted for in assessing the overall costs associated with a new legal rule.

What has been overlooked is the friction inherent in change itself. Whatever one's normative perspective, a legal system will incur costs simply in adjusting to the existence of a new legal norm. These will arise, for instance, from the need to learn about the content of new law, as well as from an increased risk of uncertainty about its meaning and effect. Changes in legal directives likewise will compel intraparty adjustments and have subtle effects on interparty relationships forged around the old legal order. Indeed, transition costs reflect a systemic phenomenon. Although in differing degrees, they will arise from legal change in all fields, with all lawmaking structures (whether statutory, administrative, or judicial), and for all types of reform (regulatory, deregulatory, and so on).²⁷⁰

These costs are inevitable in any legal rule change, but can be greater in some rule changes than others. In the case of a possible new crowdfunding registration exemption, legal transition costs may be borne by regulators, issuers, investors, and others, and may include, e.g.:

- those associated with lawyers, judges and other legal professionals, principals of crowdfunding Web sites and crowdfunded ventures, and others learning about the new exemption;
- those borne by people with knowledge of and experience with the old rule (trading off their own knowledge of SEC registration exemptions for an untested new exemption) and by people who struggle with interpretive questions about and possible gaps in the new registration exemption regime;
- lost opportunities resulting from a lack of clarity or precision in the expression of the new exemption;
- the expense for creating new forms and business practices to comply with the new exemption;
- those incurred by legal actors who misunderstand the new exemption and act in reliance on that misunderstanding in creating faulty new forms or business practices, in giving erroneous advice on the application of the new exemption, or in conducting their crowdfunding businesses; and
- those suffered by the SEC in administering and applying the new exemption.²⁷¹

The SEC can reduce these types of costs by constructing any new crowdfunding exemption in a way that minimizes variation from the existing registration exemption scheme and otherwise decreases uncertainties and misunderstandings. Making use of the existing exemptive framework and industry best practices, for example, may best serve this purpose.

²⁶⁹ See generally Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789 (2002) (cataloguing and categorizing legal transition costs).

²⁷⁰ *Id.* at 793.

²⁷¹ See *id.* at 816-52 (describing an illustrating the carious forms of legal transition cost).

2. Rule-Making Options and Processes

Having established the basic values that should underlie any proposed changes to crowdfunding regulation, we next focus on the options and process for creating a new registration exemption for crowdfunding consistent with those values. Several possible paths are immediately apparent. Because we assume that profit-sharing crowdfunding interests are securities under the Securities Act and that regulatory change is required to serve our interest in facilitating crowdfunded offerings,²⁷² however, the full-blown regulation of all those crowdfunding interests as securities under current law (i.e., keeping the status quo, in which no registration exemption is available) is excluded as a possible regulatory option.

First, we could treat crowdfunding as a completely new, distinct business model and regulate it (if at all) separately from other capital formation activities. The starkest way to do this would be for the SEC to provide, by regulation or interpretive guidance, that crowdfunding interests are not securities for purposes of the Securities Act and the Exchange Act.²⁷³ Absent further regulation or guidance, this approach would render the registration requirement in Section 5 of the Securities Act²⁷⁴ inapplicable to crowdfunded offerings. This means of facilitating crowdfunding would minimize costs to issuers, investors, and the SEC, because it leaves any regulation of crowdfunding to the market. This course of action may, however, present more perceived or actual risk to investors and create moral hazard by decreasing protections against fraud (by eliminating the coverage of antifraud statutes and regulations under federal securities law²⁷⁵). Moreover, while effects of market self-regulation on informational transparency and disclosure and enforcement standardization may be theorized in this context, they are unclear.

One way to address the uncertainties created by deregulating the offer and sale of crowdfunding interests under the federal securities laws is by regulating those transactions under another one or more existing areas of law (e.g., through gambling

²⁷² See *supra* Part III.A.

²⁷³ See *supra* Part I. Although the definition of a security differs under the Securities Act and the Exchange Act, we believe that treating the two definitions similarly in this context makes sense since the current definitions are substantially the same and the regulatory environments are interwoven. See *supra* note 122.

²⁷⁴ See *supra* notes 115 & 116 and accompanying text.

²⁷⁵ Prosecutors, federal agencies, and aggrieved investors still may have paths to enforcement under state securities (or “blue sky”) laws and regulations as well as federal and state fraud law outside the securities fraud context. These other fraud actions may or may not have desirable remedies or advantageous claim elements for public enforcement authorities or a particular aggrieved private investor, however. By cutting down the number of potential enforcement avenues, perceptions of both investor protection and market integrity may suffer.

regulation or the regulation of charitable donations²⁷⁶) or by regulating them under a new scheme of regulation altogether—one created especially for crowdfunding. Existing regulatory frameworks would likely have to be modified significantly to comply with our articulated principles of regulatory change if this path were to be pursued, and the creation of a new regulatory scheme consistent with these principles would consume significant (if not prohibitive) time and resources. Both of these options—modifying and using a pre-existing regulatory scheme and creating a new regulatory scheme—increase regulatory costs and costs to issuers and investors and may not be customized to, optimize fraud protection, enhance informational transparency, and foster disclosure and enforcement standardization.

The more promising regulatory option is to clarify that some or all crowdfunding interests are securities under federal law and to work within the existing securities regulation scheme to fashion a registration exemption that is consistent with the foundational principles articulated *supra* Part III.B.1. First, by working in the existing regulatory framework, we can constrain both regulatory costs and costs to issuers and investors. Second, through customized provisions, the architects of the exemption can work to limit investor risk, optimize fraud protection, enhance informational transparency, and foster disclosure and enforcement standardization. This seems like the best approach.

Of course, this path is not as easy as it sounds. As we earlier noted, crowdfunding incorporates a variety of different business models²⁷⁷ and it is still a new phenomenon with uncertain apparent advantages and disadvantages.²⁷⁸ Knowledge of and experience in crowdfunding is dispersed and disparate, and no individual or collection of individuals in the SEC is likely to have sufficient expertise to piece together an appropriate exemptive solution.

[R]egulators and policy makers are just waking up to crowdfunding. There have been a limited number of regulatory shut-down events in the recent years, but by and large regulators need to play catch-up. . . . [T]he velocity of this space is accelerating, and even for someone who spends full-time looking into it [sic], it's impossible to keep track of it all. How people who have other roles and responsibilities . . . could properly regulate crowdfunding is hard to imagine.²⁷⁹

²⁷⁶ For a brief “take” on the gambling and securities analysis of crowdfunding on the music industry written by a student author, see Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.*, 29 LOY. L.A. ENT. L. REV. 375 (2008-09).

²⁷⁷ See *supra* note 6 and accompanying text. See also LAWTON & MAROM, *supra* note 6, at 201 (“It’s worth noting that there are many categories of crowdfunding, and it would not be appropriate to apply the same disciplines across them all.”).

²⁷⁸ See *supra* Part III.A.

²⁷⁹ See LAWTON & MAROM, *supra* note 6, at 198. Although two industry researchers suggest self-regulation of crowd-funding, see *id.* at 198-202, we are not persuaded that this is a wise course of action given the foundational principles we articulate *supra* Part III.B.1. , Our discussion *supra* in this Part III.B.2. is instructive in this regard. Even these two

Accordingly, it seems prudent to engage those involved in crowdfunding in the regulatory discussions in a meaningful way *before* an SEC rule proposal is published as part of the notice-and-comment process required under the U.S. Administrative Procedure Act (“APA”).²⁸⁰ SEC Chairman Mary Schapiro embraced this idea in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act and is again embracing it in the context of reforms to small business capital formation (of which crowdfunding regulation may become a part).²⁸¹ We endorse this approach.

This involvement of crowdfunded businesses, promoters, and investors in the creation of a crowdfunding exemption may have more than a substantive advantage, however. There may be positive cognitive effects to employing industry participants in the process of regulation. There is a proven value, in the form of buy-in, when members of a group are asked to comply with direction by members of their in-group.²⁸² In addition, the introduction of non-SEC personnel into the regulatory decision-making process may mitigate the effects of bounded search, bounded rationality, groupthink, and other operative behavioral biases.²⁸³ A regulatory process that achieves buy-in to mutually acceptable rules and engages fresh, proactive decision-making by incorporating regulated businesses into the rulemaking process early may better serve the foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, and standardizing disclosure and enforcement. Positive effects on costs also may result.

researchers offer that regulators should be involved in the process. *Id.* at 198-99. The question is one of who controls, monitors, and enforces the regulation.

²⁸⁰ See Administrative Procedure Act, 5 U.S.C. § 553 (2006). Under the APA, “[a]fter notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation.” *Id.* at § 553(c).

²⁸¹ See Schapiro Testimony, *supra* note 11 (noting that, in conducting a review of the regulation of small business capital formation, the SEC “will gather data and seek input from many sources, including small businesses, investor groups, the public-at-large, and a new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming, so that we consider a variety of viewpoints.”); Mary L. Schapiro, Remarks before the Society of American Business Editors and Writers, Apr. 8, 2011, available at <http://www.sec.gov/news/speech/2011/spch040811mls.htm> (reflecting on regulatory efforts undertaken by the SEC under Dodd-Frank and noting that “[q]uality rules can’t evolve in a Washington bubble. We understand the impact our actions can have on the financial markets, on companies large and small, and on individual lives. This understanding drives us to hear a wide range of opinions, and consider every view as we move forward to carry our mission . . .”).

²⁸² See LYNN STOUT, *CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE* (2010).

²⁸³ See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

While potentially advantageous for all these reasons, the integration of crowdfunding representatives with regulatory authorities in the rulemaking process will have to be done carefully to avoid both inefficiencies in process that may result from the involvement of disparate industry participants in the regulatory process and the perceived or actual co-opting of regulators by industry—so-called regulatory capture.²⁸⁴ We have considered the use of a wiki or other form of crowdsourced regulatory initiative as a potential solution to these problems (as well as a possible cost-saving device), but we have concluded that this vehicle, taken alone, likely would not provide the kind of detailed input, debate, and discussion that group working meetings (conducted in person or electronically) would provide. Further, we have determined that it may be prudent to introduce the collaboratively developed regulatory response in the form of a pilot program for further study after a period of years. While this would increase regulatory costs, it seems unlikely, given the fast rate of speed at which crowdfunding is developing, that an initial regulatory response—even with industry input—would be able to fully anticipate the actions and reactions of industry participants.

3. Substantive Elements of a Proposed Exemption

In a July 1, 2010 petition to the SEC, the Sustainable Economies Law Center (“SELC”) advocates the adoption of a rule that would exempt from registration offerings up to \$100,000, with a maximum of \$100 per investor.²⁸⁵ With crowdfunded ventures as the target of this exemption, the petition specifies that the entity seeking funding, which the SELC refers to as the “Offeror,” must be an individual residing in the United States, and this individual may only have one offering open at any given time.²⁸⁶ In its petition, the SELC asserts that such an exemption will promote entrepreneurship and allow small businesses to raise equity rather than debt.²⁸⁷ According to the SELC, both of these consequences are desired, as they will stimulate economic recovery.²⁸⁸ The SELC concludes by noting that Section 3(b) and Section 4(2) are possible sections under which the rule could be promulgated, but acknowledges that if the rule is created under Section 4(2), no general solicitation or advertising will be permitted. SEC Chairman Mary Schapiro references the

²⁸⁴ See generally Choi, *supra* note 248, at 40 (“Regulators may also be subject to possibilities of regulatory capture from the very groups that the regulators seek to regulate.”); Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 463 (2011) (“Regulatory agencies in charge of the financial services sector often display strong signs of industry “capture” and increasingly engage in nontransparent and highly informal rulemaking that falls outside public scrutiny and tends to favor the industry.”); Wendy E. Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L.J. 1321 (2010) (describing and illustrating the role of information capture in agency rulemaking and enforcement).

²⁸⁵ Petition from the Sustainable Economies Law Center to the Securities and Exchange Commission (July 1, 2010), available at <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>.

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

petition in her April 2011 letter to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform of the U.S. House of Representatives.²⁸⁹

The SELC petition caught the attention of crowdfunding advocates and the SEC. It has served a valuable role as a catalyst of change. Although the petition includes certain key tenets of a possible crowdfunding exemption, it represents a unilateral, incomplete response to the issues crowdfunding raises under the Securities Act. In particular, while the inclusion of aggregate and per investor caps has merit as a risk-reduction device, we are concerned that more can be done in this regard at a relatively low cost to the SEC, issuers, and investors. Moreover, the SELC proposal does not address fraud protection, informational transparency, or disclosure and enforcement standardization. As discussed *supra* Part III.B.1., we believe that these principles are central to an appropriate, successful regulatory response. For example, although we may be persuaded otherwise in the context of a specific rule-making proposal that otherwise minimizes investor risk, we do not find it acceptable, as an initial matter, that a regulatory exemption for crowdfunding leave those who invest a small dollar value in a venture to fend for themselves²⁹⁰—even though we allow individuals to bear the loss of the same amount of funds in gambling transactions or as financially ill-advised charitable donations or consumer purchases.²⁹¹ Generally, market integrity would not be promoted or supported by that approach, even if investor protection is deemed unnecessary for those advancing a small amount of capital. Finally, the SELC petition does not address a means for engagement of crowdfunding participants in the process of constructing the exemptive proposal (although, of course, crowdfunding issuers, investors, and advocates would have the opportunity to participate in the overall regulatory effort through the notice-and-comment process under the APA, as earlier noted²⁹²).

We also are aware of two other proposals being forwarded by fellow law scholars at or about the time this article is being published. Both authors have kindly made their related papers available to us.²⁹³ Other proposals also have been advanced (and likely will continue to be advanced) on both formal and informal bases.²⁹⁴ Each proposal has

²⁸⁹ *Id.* See Issa Letter, *supra* note 10.

²⁹⁰ See Bradford, *Crowdfunding*, *supra* note 10 (“Obviously, an offering isn’t any safer just because a large number of people invest small amounts. And people who invest small amounts aren’t necessarily sophisticated enough to protect themselves; in fact, smaller investors are probably less sophisticated on average.”). We are mindful, however, that the more limited protections afforded to accredited investors under Regulation D rely on the ability of accredited investors to bear the potential loss of their entire investment. See *supra* notes 172 & 177 and accompanying text. See also Bradford, *Crowdfunding*, *supra* note 10 (noting that the “argument for an exemption if investors can afford to lose the money isn’t as novel as it sounds. It essentially underlies Regulation D’s designation of investors as “accredited” if they meet specified income or net worth limits.”).

²⁹¹ See *supra* note 252.

²⁹² See *supra* note 280 and accompanying text.

²⁹³ See Bradford, *supra* note 6; Pope, *supra* note 193.

²⁹⁴ See Bradford, *supra* note 6, at 3, 51-54.

attributes common to others; and each proponent makes important arguments. We believe there is value in reading and considering each of these proposals in the regulatory process. We are not confident that any one of them is a precise template for congressional or SEC rulemaking.

In our view, the collaborative process suggested *supra* Part III.B.2 represents a constructive and optimal approach to determining the specific terms of a proposed exemption from registration for the offer and sale of crowdfunding interests consistent with the foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, fostering the standardization of disclosures and enforcement, constraining regulatory costs, and minimizing costs to issuers and investors.²⁹⁵ We also suggest that those engaged in crafting an appropriate exemption consider proposing a new rule-based exemption using some or all of the following general substantive attributes:

- Limit and tailor the exemption to Internet offerings;
- Do not allow use of the exemption by foreign issuers, investment companies, and public companies (issuers who do not have a class of securities registered under Section 12 of the Exchange Act²⁹⁶);
- Permit general solicitation and general advertising;
- Limit the aggregate offering price to a specified dollar amount (e.g., \$100,000 or \$250,000, or maybe even lower thresholds for some types of exempt offering than for others²⁹⁷) over a 12-month period;
- Limit the aggregate dollar value of crowdfunding interests that a single investor may purchase in a single crowdfunded venture (e.g., \$100 or \$250) in a single offering or over a specified period,²⁹⁸ unless the investor is an accredited investor or (alone or

²⁹⁵ In saying this, we acknowledge that others may have a different set of values, consistent with the policy underpinnings of the Securities Act, that they desire to promote in this regulatory process. Regardless, we would hope that the group crafting any exemption in this area would develop a set of principles to guide its activities.

²⁹⁶ 15 U.S.C. § 78(l) (2006).

²⁹⁷ Regulation A formerly permitted offerings of up to \$100,000 with limited required mandatory disclosures. *See* 17 C.F.R. § 230.257 (1991). Moreover, early guidance from the SEC's General Counsel noted that small aggregate offering size is a characteristic of a private placement exempt from registration under Section 4(2). *See* SEC General Counsel Letter, *supra* note 143. Also, we note that one academic proposal would limit the use of an exemption to "microstartups"—businesses "in which one or two creative people have an idea for a product or service that can be developed, launched, and marketed for a few thousand dollars." Pope, *supra* note 193, at [103].

²⁹⁸ Those crafting the regulatory exemption must be mindful of the relationship between the per-investor and per-offering caps, since crowdfunded ventures and crowdfunding Web sites will not want to trigger registration requirements under Section 12(g)(1) of the Exchange Act, 15 U.S.C. § 78l(g)(1) (2006), and Rule 12g-1, 17 C.F.R. § 240.12g-1 (2011), which together require registration under the Exchange Act if an issuer has a class of equity securities held of record by at least 500 people and total assets of at least \$10,000,000. *See* Pope, *supra* note 193, at [124]. Although many (if not most) business ventures we envision

together with a purchaser representative) sophisticated (as those concepts are defined and used in Regulation D);

- Restrict resales of crowdfunding interests;
- Compel issuers (both crowdfunded ventures and their promoters, including crowdfunding Web site operators²⁹⁹) to file with the SEC a brief issuer registration and a brief offering notice; and
- Mandate that certain limited disclosures, including cautionary language, be included on the crowdfunding Web site in a specified manner and, in some cases, using specific text.

We expect that the precise combination of these attributes that will best effectuate the foundational principles we established *supra* will be the subject of significant discussion and debate among participants in the regulatory process. The remainder of this Part III.B.3. sets forth our thoughts that may be relevant to those interactions.

We contemplate that the SEC would use its exemptive authority under Section 3(b) of the Securities Act³⁰⁰ to promulgate this exemption, which could be included in Regulation D as, e.g., Rule 504A, or in a new parallel regulation modeled after Regulation D (perhaps denominated Regulation CF). The concepts of integration³⁰¹ and aggregation³⁰² applicable to Rule 504 and 505 offerings under Regulation D also would be applicable to exempt crowdfunded offerings (although we recommend that the SEC look at shortening the periods for each, consistent with its rule-making authority under Section 3(b) and Section 28 of the Securities Act³⁰³). By working within the existing regulatory framework for

using an exemption from registration under the Securities Act would not have sufficient total assets to trigger registration under the Exchange Act (which constitutes public company status and involves significant expense), attention should be given to this issue.

²⁹⁹ For purposes of this Part III.B.3., we treat crowdfunding Web sites as co-issuers for most purposes. *See supra* Part II.A.3. By imposing regulation on crowdfunding Web sites as well as crowdfunded ventures, crowdfunding Web sites should be incentivized to engage in rigorous pre-screening of the crowdfunded ventures they host and promote. We note, however, that for our solution to work in this co-issuer context, a number of details would need to be worked out. For example, any aggregate offering cap would have to apply to each crowdfunded venture and not to each crowdfunding Web site (since there are crowdfunding Web sites that host and promote the securities of multiple crowdfunded ventures). Alternatives exist to treat the crowdfunding Web sites as brokers, investment advisors, exchanges, or other investor fiduciaries. *See supra* note 224 and accompanying text. The issue of how to treat promoters of small business offerings has been on the SEC's radar screen for quite some time. *See Cohn & Yadley, supra* note 125, at 61-63.

³⁰⁰ *See supra* note 163.

³⁰¹ *See supra* note 166 and accompanying text.

³⁰² *See supra* note 169 and accompanying text.

³⁰³ *See Cohn & Yadley, supra* note 125, at 47-54. The SEC proposed shortening the integration window from six months to 90 days in 2007. *See* Sec's & Exch. Comm'n, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828 (Aug. 3, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.

Section 3(b) exemptions under Regulation D, regulatory costs would be less than they would be if new regulations were created from whole cloth.

The substantive characteristics set forth above are designed to operate in the limited context of very small Internet-based offerings for relatively small U.S. issuers—a context in which crowdfunding has its perceived maximum net advantages under current circumstances and in which U.S. law applies.³⁰⁴ Although the substance of our proposal may be faulted for representing a somewhat timid response, it is “much better than nothing.”³⁰⁵ We may be wrong, but given the relatively novel nature of crowdfunding and the existing state of the SEC, we believe that a conservative initial approach is warranted. There may, in fact, come a day on which it would be appropriate to extend a crowdfunding exemption to larger offerings in wider contexts; however, we are concerned that the multiplicity of crowdfunding models and flux in current crowdfunding platforms make it too difficult to fashion a wider exemption that adequately limits investor risk and optimizes fraud protection.³⁰⁶ There also may be a future time at which it would be advisable to initiate an overhaul of the entire regulation of small business capital formation. The current investor-protection focus of the SEC and its lack of adequate funding³⁰⁷ make this an improbable current objective. Accordingly, as a more limited approach, we suggest an Internet small issuer exemption that limits the aggregate dollar value of offerings covered, and we recommend limiting the availability of the exemption to non-public U.S. issuers who are not investment companies³⁰⁸ that are using open-access Web sites to enhance their base of prospective and actual funders.

³⁰⁴ See *supra* Part III.A.1.

³⁰⁵ LAWTON & MAROM, *supra* note 6, at 188 (also noting that “from a macro view, exemptions like this can be counter-productive, and in fact might hold back crowd-funding’s potential.”).

³⁰⁶ See LAWTON & MAROM, *supra* note 6, at 93-102 (describing actual and aspirational attributes of crowdfunding platforms, noting in the process that the characteristics of a potential future crowdfunding platform may make regulators “a lot more comfortable” and better support necessary fraud prevention algorithms).

³⁰⁷ See generally Joan MacLeod Heminway, *Sustaining Reform Efforts at the SEC: A Progress Report*, 30 BANKING & FIN. SVCS POLICY REPORT 1 (2011) (discussing the SEC’s investor-protection mission and funding situation in the context of an evaluation of reform efforts at the SEC).

³⁰⁸ We note that neither investment companies nor public companies can use Rule 504 to avoid registration under the Securities Act and that Rule 505 is not available to investment companies. See 17 C.F.R. §§ 230.504(a) & 505(a) (2011). See also Campbell, *supra* note 127, at 103 (noting that “[t]o be eligible for Regulation A, an issuer cannot be a reporting company under the 1934 Act. The point of this requirement is apparently to force public offerings by larger, 1934 Act companies onto either S Forms or SB Forms, with their more extensive disclosure requirements.” (footnotes omitted)). While this limitation may not be essential, see Bradford, *supra* note 6, at 77-78, we offer it as part of the mix of attributes to be considered by rule-makers. By varying the new exemption little from the existing Rule 504 exemption, we believe that regulatory costs are saved.

Our focus on open Internet offerings means abandoning Regulation D's prohibition on general solicitation and general advertising. Commentators have long argued that the general solicitation and advertising ban is defective or unnecessary,³⁰⁹ and the SEC did, in fact, remove the proscription in Rule 504 offerings for a seven-year period during the 1990s (only to reinstate it because of renewed concerns about fraud).³¹⁰ There are a number of potential benefits associated with open Web sites and the enhanced information they may provide.³¹¹ Moreover, the restriction is out of step with current communication norms, business practices, and lifestyles.³¹² The SEC has thus far been reluctant to take an aggressive view on abandoning this proscription, despite its uncertain purpose and effect and its datedness.³¹³ We have determined that the abandonment of general solicitation and general advertising is appropriate. To the extent, however, that the ban on general solicitation and general advertising provided some measure of limiting investor risk or

³⁰⁹ See, e.g., Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67 (1989) (contending that the general solicitation and advertising ban is "unconscionably vague" and "broader than it should be"); Sjostrom, *supra* note 241 (demonstrating "that there is no strong ideological foundation for the ban."); Yadley, *supra* note 254, at 82 ("Permitting greater use of general solicitation is not likely to diminish consumer protection or open the floodgates to fraud.").

³¹⁰ See Campbell, *supra* note 127, at 97 n.92 (summarizing the relevant history); Bradford, *supra* note 126, at 19 (same).

³¹¹ See Bradford, *supra* note 6, at 78-79.

³¹² See Olufunmilayo B. Arewa, *Securities Regulation of Private Offerings in the Cyberspace Era: Legal Translation, Advertising and Business Context*, 37 U. TOL. L. REV. 331, 362 (2006) ("The SEC view of general solicitations and advertising is based on assumptions about the distribution of information that are inconsistent with post-Internet era standards of information dissemination and business practice.").

³¹³ Professor Don Langevoort notes this puzzle in one of his articles.

[W]e must ask why general solicitations are barred in the first place - something on which the Commission has never been particularly forthcoming. One possibility is simple concern for the statutory language, which speaks in terms of non-public offerings rather than sales. But there is no obvious reason why "offerings" must necessarily be given a meaning that precludes public advertising or mass mailings, and the statutory restraint concern is no longer applicable at all in light of the Commission's new exemptive authority under the Act, which allows it to eliminate any statutory restrictions it wishes. Another possibility is that the prohibition is designed to protect the unsophisticated investor who might be tempted by the promotion into misrepresenting his or her qualifications in order to take part in the deal. That paternalistic concern is strained on its face; elsewhere, the Commission has recognized that since no prequalification procedures are fail safe, all we should require is reasonable belief by the issuer in the offeree's qualifications.

Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 24 (1998) (footnotes omitted). See also Cohn & Yadley, *supra* note 125, at 36-42.

fraud (two of our foundational regulatory principles), we believe it is important to place a renewed focus on means of addressing those values.

One way to constrain investment risk is by limiting the exposure of each investor to losses in a particular enterprise. This approach is more than a bit patronizing—a form of substantive regulation. A per-investor cap curtails investor freedom by cutting the investor off from unacceptable losses before they occur, in much the same way that one might cut off a partygoer from inebriation by limiting the number of drinks that she may have. We have very mixed feelings about this aspect of our proposal.

As a result, we recommend limiting the applicability of any per-investor cap to those investors who are not accredited or sophisticated. The logistics of implementing this type of hybrid requirement in crowdfunded offerings will not be trivial, and the costs may well exceed the benefits. In that event, a per-investor cap would be an unwise regulatory element. This approach represents a heavy-handed form of investor protection, and if it is adopted, offering processes will need to be redesigned or modified. On the other hand, the nature of the crowdfunding market is such that it may attract participants who are intent on abusing the privilege of open solicitation and advertising.³¹⁴ Just as Professor Margaret Sachs suggests reaching out to protect the “least sophisticated investor” from fraud in inefficient markets,³¹⁵ it may be appropriate in these early stages of the development of crowdfunding to extend extraordinary protection to the unsophisticated unaccredited investors in a crowdfunded offering by limiting their capacity to invest in crowdfunding interests *ex ante*.³¹⁶

In a similarly over-protective way, restricting the resale of crowdfunding interests that are securities may help constrain fraud, which may be more likely to occur in resale markets.³¹⁷ An investor who sells and buys securities in a resale market may find himself or herself attenuated from an accurate and complete source of information about the crowdfunded venture or the crowdfunding interest being offered. Typically, crowdfunding Web sites are designed to attract interest in primary offerings conducted over a short, defined period. Investors advance funds to a crowdfunded venture toward achievement of

³¹⁴ See *supra* Part III.A.2.

³¹⁵ See Sachs, *supra* note 251.

³¹⁶ An interesting question is whether the per-investor cap should be an aggregate cap for all of a single investor’s crowdfunding investments (perhaps together with investments made by affiliates and associates) or whether the cap should only apply to investments in a particular crowdfunded venture. Professor Steve Bradford posits that the former is more reasonable. See Bradford, *supra* note 6, at 76.

³¹⁷ In reinstating the prohibition on general solicitation and advertising under Rule 504 in 1999, the SEC noted concern about fraud in the trading markets for securities offered and sold by issuers under Rule 504. See Campbell, *supra* note 127, at 97 n.92; Bradford, *supra* note 126, at 19. The risk may have been overstated or given undue effect in the SEC’s decision-making, however. *Id.*

a specified funding target that must be achieved by a date certain.³¹⁸ Most current crowdfunding Web sites are *not* built to serve as markets for secondary offerings or even as hosts for ongoing disclosures that might support an appropriate secondary market. SEC endorsement of secondary trading in crowdfunding interests is unlikely in the absence of a reliable means for market participants to obtain current information about those interests and the crowdfunded venture.³¹⁹

Information is, in practice and in theory, very important to investor protection and market integrity. Investors typically will not fund unknown risks.³²⁰ Moreover, the regulation of securities offerings provided in and under the Securities Act reflects the semi-strong version of the efficient capital markets hypothesis³²¹ and, as a result, prescribes disclosure of investor-significant information through mandatory disclosure rules (in the form of prospectuses, offering circulars, and otherwise in registration exemptions) and fraud-protection rules that call for the disclosure of material information where there is a duty to disclose. Neither Congress nor the SEC has deemed mandatory disclosure or fraud

³¹⁸ See Part I.B.3. (describing this funding model in the context of the commonality element of the *Howey* test).

³¹⁹ This apparently was a further concern of the SEC in its decision to reinstate the general solicitation and general advertising requirement to Rule 504. See Bradford, *supra* note 126, at 19 (“The SEC believed that . . . the lack of widely-distributed public information about companies making Rule 504 offerings, and the freely tradable nature of Rule 504 securities may have exacerbated the opportunities for microcap fraud.”). We note that it is difficult for issuers in this context to constraint resale transactions, however, and any regulatory solution should address the manner in which investor violations of any resale prohibition impact the issuer’s exemption. See Cohn & Yadley, *supra* note 125, at 54-58 (raising this issue).

³²⁰ I have been known to begin my first Securities Regulation class of the semester with a simple statement and question that illustrate this basic point. I say: “I have started a business. Do you want to buy an interest in it?” Students hesitate, and when I ask why (to the extent they do not offer a reason), they respond with something akin to: “Well, before I put down my hard-earned money, I would like to know something about the business.” Further discussion illuminates that they want to know about the finances and operations of the business, as well as the nature of the interests being offered and where the offering proceeds will go A well-guided discussion can touch on all of the areas of mandatory disclosure in a Securities Act registration statement.

³²¹ See Robert A. Brown, *Financial Reform and the Subsidization of Sophisticated Investors’ Ignorance in Securitization Markets*, 7 N.Y.U. J. L. & Bus. 105, 165 (2010) (“[M]any legal commentators, courts and lawmakers have cited the EMH as a guiding principle in articulating rules of the architecture of American securities markets. The Securities Act of 1933 and Securities Exchange Act of 1934, which preceded formal development of the theory, have at their heart a desire to disclose to investors unknown risks.” (footnote omitted)); Michael W. Prozan & Michael T. Fatale, *Revisiting “Truth in Securities”: The Use of the Efficient Capital Market Hypothesis*, 20 HOFSTRA L. REV. 687, 697 (1992) (“The Commission explicitly adopted the ECMH in its refinement of the registration process.”).

protection to be a sufficient regulatory tool taken on its own.³²² Consistent with these regulatory objectives, and in furtherance of our foundational principles of enhancing informational transparency and fostering standardization of disclosures and enforcement, we suggest that putative rule makers consider requiring issuers/offerors to (a) file with the SEC both an issuer registration form and an abbreviated brief notice of each offering and (b) include cautionary language and certain other limited disclosures on the crowdfunding Web site through which the offering is made.

The important issue in fashioning these filing and disclosure requirements is balancing the desired level of information against the costs of producing and disseminating that information (bearing in mind that constraining regulatory costs and minimizing costs to issuers and investors are additional foundational principles for our proposed regulatory solution, as set forth *supra* Part III.B.1.). “Too much complexity at the entrepreneurial level will . . . destroy the exemption’s utility.”³²³ Accordingly, our suggested filing and other disclosure requirements are intended to be minimal. At the low dollar-value level of investment that issuers would be requesting and investors would be making under the exemption, most of the disclosure guidance for crowdfunding Web sites and crowdfunded ventures would come from compliance with the anti-fraud protections afforded by Section 17 of the Securities Act and Section 10(b) of and Rule 10b-5 under the Exchange Act.³²⁴

³²² In early presentations of this article to faculty audiences, we advocated mere reliance on antifraud rule protections, suggesting that (given the minimization of investor risk) mandatory disclosures in the form of SEC filings or investor information materials were not needed. After some push-back from those audiences, we rethought the issue and determined that minimal mandatory disclosures would best serve the policies underlying the Securities Act and support important related regulatory values. *See Cohn, supra* note 131, at 365 (“The impetus for disclosure in the nonregistered setting is compliance with exemption conditions and effective sanctions.”). Any abandonment of mandatory disclosure must meet a high burden of proof, given its centrality to the federal securities regulation scheme.

[A]t the same time that the Internet is increasing the impact of small business offerings, regulatory reform efforts . . . may be effectively transforming [Internet offering] regulation . . . from a prophylactic disclosure structure to one that merely reacts to and combats fraud. The original promulgation of the federal securities laws was based on congressional perception that such a structure was an ineffective means of regulating the national securities markets. Proponents of regulatory reform need to explain why technological developments since the 1930s have rendered that perception obsolete.

Fisch, *supra* note 246, at 89.

³²³ Bradford, *supra* note 6, at 68.

³²⁴ *See supra* notes 121-123 and accompanying text. We also note the probable application of Section 12(a)(2) of the Securities Act to prospectuses used in offerings exempt under Section 3(b). *See Elliott J. Weiss, Some Further Thoughts on Gustafson v. Alloyd Co.*, 65 U. CIN. L. REV. 137, 152 (1996) (“[M]ost important . . . are . . . small-scale offerings made

In that spirit, we envision SEC filing requirements that are simple notice submissions—one or more forms that would represent a stripped down version of either the Form D required for offerings under Regulation D³²⁵ or the Small Company Offering Registration form.³²⁶ For example, the issuer registration would include basic information about the crowdfunding Web site or crowdfunded venture, as applicable (including information necessary to locating and notifying the filer and its relevant personnel in connection with monitoring and enforcement³²⁷). Similarly, the level of information required for the notice of each offering would be comparable to that required for completion of a Form 144 under the Securities Act.³²⁸ Logically, the amount of required disclosure in the company registration and offering notice would bear an inverse relationship to the aggregate size of the offering and the dollar value of the per-investor cap,³²⁹ with a certain minimal amount of information (that necessary for monitoring and enforcement) being required as a threshold matter.³³⁰

In addition, rule makers should consider requiring the inclusion of certain cautionary language and (potentially) other required disclosures on the crowdfunding Web sites

pursuant to section 3(b). . . . [A]t least where securities are sold to the public, section 12(2) applied preGustafson, and section 12(2) would continue to apply.”); Natasha S. Guinan, Note: *Nearly a Decade Later: Revisiting Gustafson and the Status of Section 12(a)(2) Liability in the Courts - Creative Judicial Developments and a Proposal for Reform*, 72 FORDHAM L. REV. 1053, 1069 (2004) (“Section 12(a)(2) liability expressly attaches to Section 3 offerings by referring to: ‘Any person who ... offers or sells a security (whether or not exempted by the provisions of [Section 3]).’”).

³²⁵ See 17 C.F.R. § 230.503 (2011). A .pdf version of Form D is available at <http://www.sec.gov/about/forms/formd.pdf>.

³²⁶ See North American Securities Administrators Association, Form U-7, available at www.nasaa.org/content/files/scorform92899.doc.

³²⁷ Although registration requirements will not enable the SEC, the Department of Justice, or the Federal Bureau of Investigation to find every Internet fraudster, we offer it as a way to ameliorate the effects of the faceless, opaque, remote nature of the Internet. See Fisch, *supra* note 246, at 81 (“The power of the Internet to transcend jurisdictional boundaries suggests . . . that it may be more difficult for victims and regulators to trace the source of fraudulent offers and obtain legal recourse against wrongdoers.” (footnote omitted)).

³²⁸ See 17 C.F.R. at § 230.144(h). A .pdf version of Form 144 is available at <http://www.sec.gov/about/forms/form144.pdf>.

³²⁹ Cf. C. Steven Bradford, *Expanding The Non-Transactional Revolution: A New Approach To Securities Registration Exemptions*, 49 EMORY L.J. 437, 449 (2000) (“Intermediate disclosure rules that do not provide the full benefit of registration, but also have lower compliance costs, could be economically efficient for all but the smallest offerings. An incremental system in which the level of investor protection increases as the size of the offering increases could make sense.” (footnote omitted)).

³³⁰ We acknowledge that standardized disclosures have a cost to the crowdfunded venture and crowdfunding Web site. We believe that these costs are not significant, but we may be wrong in this regard. See Bradford, *supra* note 6, at 84-85.

through which crowd funded offerings of securities are being made. Professor Steve Choi aptly summarizes the basis for these types of requirements in securities regulation as a means of protecting investors.

One possible method of correcting for behavioral biases is to provide corrective or cautionary information to investors. If investors view sales materials too optimistically, then providing the investors more sober materials on the issuer's business, properties, and financial health may, in theory, help overcome their overoptimism. Additional information may serve to educate investors about the potential pitfalls they face in investing . . . or, alternatively, caution the investors to take extra care in their investment decisions. If investors are capable of learning, then mandatory disclosure and legends may work to educate investors, reducing their behavioral biases.³³¹

In a crowdfunding context, these required disclosures could be made on the Web page for each crowd funded venture and, for the most critical information, also displayed for and acknowledged by would-be investors as a condition to acceptance of their investment funds by the crowdfunding Web site (through, e.g., something akin to a click-wrap agreement³³² implemented through a pop-up window with a check-the-box requirement). Warning and advisory legends already are used in disclosure rules and exemptions under the Securities Act.³³³ Although many may read over a standard cautionary legend without heeding or reacting rationally to its content,³³⁴ we believe that those investing in crowdfunding interests should (at a minimum) be put on notice that their entire funded amount is at risk, that the probability of any return is remote, and that their interests are illiquid. Discussions among regulators and the industry will help decide whether and how additional cautions also should be issued. This approach represents a minimal and

³³¹ Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 116 (2006) (footnote omitted).

³³² See generally Francis M. Buono & Jonathan A. Friedman, *Maximizing the Enforceability of Click-Wrap Agreements*, 4 J. TECH. L. & POL. (1999), <http://jtlp.org/vol4/issue3/friedman.html> ("A 'click-wrap agreement' is an agreement, formed entirely in an online environment such as the Internet, which sets forth the rights and obligations between parties.").

³³³ See 17 C.F.R. at § 230.134(b) & (d) (requiring certain statements in communications used after the filing of a registration statement that may otherwise be prospectuses within the meaning of the Securities Act); 17 C.F.R. at § 230.135(a)(1) (requiring in a communication used before the filing a registration statement "a statement to the effect that it does not constitute an offer of any securities for sale" so that the issuer will "not be deemed to offer its securities for sale through that notice"); 17 C.F.R. at § 230.163(b)(2) (requiring issuers to state that they may file a registration statement with the SEC and directing potential investors to read the prospectus included in that filing); 17 C.F.R. at § 230.433(c)(2) (requiring issuers to state that they have filed a registration statement and directing potential investors to read the prospectus included in that filing).

³³⁴ For a pithy critique of legending requirements (focused on those in connection with the SEC's 2005 offering reforms), see Choi, *supra* note 331, at 118-19.

inexpensive means of promoting investor protection and fosters transparency and standardization.³³⁵

Transparency and standardization, as well as (potentially) investor protection and fraud prevention, also may be promoted by mandating certain simple disclosures on the crowdfunding Web site about the crowdfunding Web site, the crowdfunded ventures, the interests being offered, the way in which the offering is being conducted, the ongoing role of the crowdfunding Web site after investments are made, and any follow-on ministerial services (delivery of investor funds to the crowdfunded venture, monitoring of the crowdfunded venture's operations and financial data, collection and distribution of profit-sharing or revenue-sharing amounts to investors, etc.) that will be rendered. The major disadvantages of this type of disclosure requirement are its costs and its potential to stifle efficient, desirable innovation.³³⁶ Again, however, we posit that the required disclosures could be minimal given the relatively low amount at risk (assuming low caps on both the aggregate offering price and per-investor funding). More disclosure is not necessarily more protective to investors.³³⁷ We suggest an assessment of investor needs, a review of industry best practices, and a touch of aspirational visioning to identify the nature and extent of appropriate, efficient, and efficacious mandatory disclosure requirements in the crowdfunding context.

³³⁵ Before implementing the legending requirement, however, we suggest that the SEC study its efficacy. *See id.* at 128 (suggesting four ways in which the SEC should clarify and make explicit the assumptions about investors on which its regulatory proposals rest). Consistent with our foundational principles on constraining regulatory costs and minimizing costs to issuers and investors, disclosure burdens should not be added unless their benefits clearly exceed their costs. *See id.* at 119 (noting that the SEC likely bases its decisions to impose legends on an “*ad hoc* basis”); *id.* at 122 (“[T]he SEC implicitly makes assumptions about how investors behave”). We acknowledge the possibility that standardization, if taken too far, can dampen positive entrepreneurial innovation. Bradford, *supra* note 6. at 85.

³³⁶ Professor Alan Palmiter expresses the concern well and advocates that issuers be permitted to choose the level of disclosure they offer.

The Securities Act often compels issuers to disclose and warrant more than investors are willing to pay for, driving issuers to avoid mandatory disclosure or to choose other financing techniques. Disclosure choice in securities offerings promises to expand the methods and reduce the costs of capital formation by aligning disclosure (both its contents and methods) with actual investor information demands, not legislative or administrative assumptions.

Alan R. Palmiter, *Toward Disclosure Choice In Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 86.

³³⁷ *See Choi, supra* note 331 (“While more disclosure into the market may help some investors, the increased information may simply cause others to fall further into the traps of overconfidence and overoptimism.”).

In addition, as we have noted in several places throughout the text, neither the suggested process for regulatory change nor the substantive recommendations we outline in this article addresses market regulation issues under the Exchange Act, investment advisory issues under the Investment Advisors Act of 1940, the interaction of crowdfunding with state securities (or “Blue Sky”) rules, or the inherent cross-border nature of Internet securities offerings (including crowdfunded offerings).³³⁸ We leave federal market regulation and investment advisory issues to another commentator or another article.³³⁹ As to state securities law interactions, we believe that the SEC is best positioned to administer and enforce crowdfunding regulation, which would require federal preemption of state regulation.³⁴⁰ And finally, as to the globalization of securities markets and transactions, we join the growing chorus of voices that urge continued consideration of a more coherent approach to international regulation and enforcement in an increasingly global transactional world.³⁴¹

³³⁸ See *supra* notes 8, 195, 213, 224 & 299 (noting these exclusions as well as the exclusion of other regulatory schemes—e.g., gambling and charitable solicitation regulation, from treatment in this article). We also do not address the precise status of crowdfunding Web sites for purposes of the overall regulatory scheme under the Securities Act. See *supra* note 299. Any crowdfunding regulatory solution, regardless of whether it follows any or all of the elements of the proposal we set forth in this article, should address the issue of the regulatory status of crowdfunding Web sites under all applicable securities laws.

³³⁹ See Bradford, *supra* note 6, at 30-51. The need for improved regulation of market professionals extends beyond the crowdfunding context. See, e.g., Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 191 (2010) (“[A]s the recent financial crisis has demonstrated, there is much room to improve the regulation of institutions that intermediate between individual investors and the securities markets. Many scholars believe that the SEC should increase its oversight of these intermediaries, such as investment advisors and broker-dealers.” (footnote omitted)).

³⁴⁰ Accord Bradford, *Peer-to-Peer Lending*, *supra* note 8 (“A federal exemption that does not preempt state law isn’t going to accomplish much.”). This is not a new suggestion. Scholars have argued for preemption in connection with existing registration exemptions. See, e.g., Bradford, *supra* note 126, at 33-34 (“Small businesses should receive the same consideration that the 1996 Act gave public companies: the states should be preempted from requiring the registration of Rule 504 offerings.”); Campbell, *supra* note 127, at 106-110 & 119 (describing the high cost of state securities compliance for small businesses using Regulation A offerings and concluding that “[t]he best way to eliminate state interference is for Congress to expand the preemption of NSMIA to include securities issued under Section 3(b) of the 1933 Act.”); Rutheford B. Campbell, Jr., *The Insidious Remnants Of State Rules Respecting Capital Formation*, 78 WASH. U. L. Q. 407, 413-33 (2000) (arguing generally for federal preemption of state securities law regulation of capital formation). But see Johnson, *supra* note 339, at 192 (arguing for a return to state regulation “of Rule 506 private placements by private entities to largely retail investors.”).

³⁴¹ See, e.g., Chris Brummer, *Post-American Securities Regulation*, 98 CALIF. L. REV. 327 (2010) (noting the need for, barriers to, and prospects for international securities regulation); Eric C. Chaffee, *Contemplating the Endgame: An Evolutionary Model for the Harmonization and Centralization of International Securities Regulation*, 79 U. CIN. L. REV.

IV. CONCLUSION

Crowdfunding is an exciting, dynamic, inclusive capital formation model for small businesses (and, in some present and envisioned future forms, for larger business ventures). But crowdfunded ventures and crowdfunding Web sites that offer profit-sharing interests to funders violate the Section 5 of the Securities Act when they offer or sell those interests without registration or compliance with an applicable exemption. Investor protection and the perception of fair and honest investment markets—key policies underlying the Securities Act—are sources of concern as the crowdfunding market rapidly develops in the absence of a clear regulatory framework or response. With the thought of harnessing crowdfunding's positive attributes and minimizing its potential negative characteristics, this article suggests a conservative approach to regulating crowdfunding through an exemption from registration adopted by the SEC under Section 3(b) of the Securities Act.

Yet, as this article amply illustrates, the exemption process will not be simple. It will require a delicate balancing of interests between and among the SEC, industry participants, and investors. This is, of course, not new. The debate over the regulation of crowdfunding illustrates the classic tension between regulatory and market-based solutions to perceived and actual market failures. SEC Commissioner Troy Paredes states the basic issues well.

Government intervention in securities markets to put information in investors' hands and to protect investors against corporate abuses serves a distributional goal by protecting investors against losses. Such government intervention also serves the larger goal of promoting capital formation and more efficient and liquid securities markets in that investor protection regulation can shore up investor confidence in the integrity of securities markets. Sometimes, though, increased investor protection, such as through more mandatory disclosure and more aggressive SEC oversight and enforcement, can impede market participation and thus undercut the capital formation process and the efficiency and liquidity of securities markets.

This tension drives the cost-benefit analysis of regulating securities markets. Regulatory systems that allow for flexible, dynamic financial markets inevitably come at the risk of investor loss, fraud, and corruption. Regulators have to exercise restraint and allow for misconduct and abuse of investors because, at some point, investor protection overburdens financial markets. The question of when it becomes too costly for the government to protect investors is a fundamental

587 (2010) (arguing for reform, harmonization, and centralization of securities regulation); Stephan J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (proposing "portable reciprocity" and recommending "a regulatory regime that focuses on regulatory competition and gives issuers and investors the ability to choose the law that governs their transactions.").

challenge of securities regulation.³⁴²

The determinations that must be made to resolve this tension are all-the-more difficult in the crowdfunding context because of the way in which crowdfunding interfaces directly with rapidly changing technology, state securities regulation, and globalism. We do not have all of the answers to the questions that may be raised about regulating crowdfunding. However, we do believe that it is important that the process and outcome of crowdfunding regulation strike an appropriate balance that both fosters crowdfunding's promise—as a means of raising investment funds for small businesses and allowing individual retail investors to access a user-friendly business finance market—and supports policies and values central to crowdfunding's role in small-business capital formation. This article is designed to contribute positively to the regulatory debate in that spirit.

³⁴² Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1006.