I. Introduction

In recent years, artists, entrepreneurs, and nonprofits (collectively “promoters”) have tapped the collaborative power of the online crowds to fund a wide range of charities, creative projects, and even investment opportunities. This phenomenon is called “crowdfunding,” or sometimes “crowd financing” or “crowd-sourced capital.” This Article first examines the intractable conflict between investment crowdfunding and traditional U.S. securities laws and then explores possible solutions that would enable small companies to more easily raise capital through the online crowds.

Many promoters have embraced crowdfunding because obtaining alternate forms of financing from traditional lenders is often difficult or impossible. On
crowdfunding platforms, promoters are usually given the chance to pitch their ideas to potential funders, who then choose which projects to support. In exchange for a contribution, most current crowdfunding sites only allow promoters to reward funders with nominal perks or “thank-you” gifts. Because the contributions are effectively donations, this is called “patronage crowdfunding.”

If promoters reward funders with something more than a thank-you gift, such as an equity share in the project itself, it is “investment crowdfunding.” The principal reason most promoters do not reward their online patrons with equity shares, or any other security, is the danger of getting entangled in complicated securities laws. While the United States is “[b]y far the biggest and most sophisticated country supporting [various forms of financial investment] . . . [f]ederal law seems to rule out . . . online marketing for investment in return for debt or equity.” For instance, it is illegal in the United States to offer or sell a “security” without either complying with arduous registration requirements or wading through the difficult process of obtaining an exemption. Promoters legitimately worry that any investment opportunity in their project could be a security known as an
“investment contract.”

Being subject to securities requirements may spell the end of a small enterprise because the costs of registration, or even obtaining the exemption from registration, may exceed the total capital needed for the project.

This Article is one of the first to examine the conflict between investment crowdfunding and U.S. securities laws and to consider the circumstances under which these laws might be changed to permit this new form of grassroots investment. While it is clear that patronage crowdfunding is not subject to securities regulation, most investment crowdfunding schemes are investment contract securities, which are subject to federal and state securities laws. Furthermore, standard exemptions from federal registration requirements are inadequate or inappropriate for most types of investment crowdfunding.

Given these problems, it is worthwhile to consider the merits of the current proposal for a Securities and Exchange Commission (“SEC”) rulemaking to create a crowdfunding exemption. The current proposal disregards many of the fundamental principles of the modern securities framework, and this Article explores other possible proposals and considers the ultimate viability of SEC action altogether. While SEC Chairman Mary Shapiro promised Congressman Darrell Issa that the SEC would consider a crowdfunding exemption, it is by no means clear that the SEC has the time, resources, or desire to draft what is sure to be a complicated exemption and to see it through the long rulemaking process. Ultimately, legislating a crowdfunding exemption may be easier than obtaining an exemption through the rulemaking process.

Part II of this Article explains the origins of crowdfunding and some of the various models that have been implemented thus far. Part III.A analyzes various crowdfunding models to determine if they are governed by U.S. securities laws. Assuming that U.S. securities laws apply, Part III.B analyzes the feasibility of

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10 See infra p. 80.

11 See Kappel, infra note 1, at 384.


13 Id. at 23.

14 See generally id.
obtaining one of the current exemptions from full registration. Since available exemptions may not be feasible in these circumstances, Part III.C analyzes and critiques a current proposal for a new crowdfunding exemption, provides a balanced proposal for such an exemption, and considers the probability of SEC action on such an exemption. Part IV provides concluding remarks.

II. BACKGROUND AND CONTEXT

Crowdfunding is a burgeoning form of online fund-raising poised to revolutionize the way that artists, entrepreneurs, and nonprofits raise money. It leverages the power of social networking by allowing promoters of all kinds to raise money by pitching ideas to a vast online crowd of potential funders. This Part defines crowdfunding, describes its origins and purposes, introduces readers to “patronage crowdfunding” and “investment crowdfunding,” and explores the modern U.S. securities regime.

A. Definition of Crowdfunding

Like many neologisms of the Internet Age, the definition of “crowdfunding” is a work in progress. The term is sometimes used broadly to describe almost any form of grassroots online fundraising. However, for purposes of this Article, “crowdfunding” is a process where entrepreneurs, artists, and nonprofits raise money for their projects, businesses, or organizations by gaining the support of many people on the internet who collectively contribute money to projects to which they feel some affinity. Unlike other forms of online fundraising, crowdfunding involves a many-to-one relationship between funders and recipients.

15 See Kappel, supra note 1 at 376; Jouko Ahvenainen, Crowd-funding for startups: Idea behind this emerging model is to fix the current inefficiencies of private seed funding for firms, BUS. TIMES, May 3, 2010, available at 2010 WLNR 9097842; Bradford, supra note 7, at 4 (noting that “[b]illions of dollars have been raised through crowdfunding, possibly the beginning of a revolution in how we allocate capital.”)

16 See Ortutay, supra note 3, at B1.

17 Lavinsky, supra note 2 (“Crowdfunding is when a group of people collectively fund a cause. That cause could range from paying for medical bills or a wedding to filming a movie or starting or growing a business. To an extent, crowdfunding has been around forever and is the basis for most nonprofit fundraisers.”).

18 See Bradford, supra note 7, at 4; Alysha Schertz, Crowd funding helps businesses raise capital, BIZTIMES.COM (Apr. 2, 2010), http://www.biztimes.com/news/2010/4/2/crowd-funding-helps-businesses-raise-capital (“Crowd funding is a strategic way for entrepreneurs, artists and nonprofits to
Under this definition, crowdfunding is distinguishable from “microfinance” or “peer-to-peer lending.” While there are various forms of microfinance, one example is making financial services available to the impoverished—usually in developing nations—who do not have access to traditional lending institutions. Besides microfinance, a “peer-to-peer lending” website intermediary like Prosper.com provides online users the opportunity to lend to, or borrow from, other users of the site. While the amounts are usually much larger than with microfinancing, peer-to-peer lending usually involves a one-to-one relationship between funder and recipient, rather than the many-to-one relationship in crowdfunding. Furthermore, while these transactions are structured like loans, most patronage crowdfunding transactions are structured as voluntary contributions.

raise money for their projects, business or organizations by gaining the support of a 'crowd,' or a large group of people, to give them money.”). Crowdfunding is not motivated by charitable intent; instead, it is a means of supporting people who are doing interesting things. See Claire Prentice, Cash-strapped entrepreneurs get creative, BBC NEWS (May 12, 2010), http://www.bbc.co.uk/news/10100885 (“The incentive for backers is both altruistic and actual. ‘Everyone must offer a system of rewards,’ says Kickstarter co-founder Perry Chen. ‘It’s not about philanthropy or charity. It’s about patronage and commerce.’”).

19 See Kappel, supra note 1, at 375.


21 See Anusha Subramanium & Rajiv Bhuva, Angels in the crowd: Start-ups now have a simpler route to tap funding for the early stages than venture capital, BUSINESS TODAY (India), Aug. 22, 2010, at 75, available at 2010 WLNR 16355235. (“Kiva does provide loans to entrepreneurs by partnering with microfinance institutions, but its larger objective is poverty alleviation.”).

22 Id.; Schaff, supra note 20.

23 See Id.

24 See Id.

25 Tom Harnish, Cloud Funding Offers More than Pennies from Heaven, CROWD SOURCE CAPITAL (Aug. 7, 2010), http://crowdsourcercapital.blogspot.com/2010/08/cloud-funding-offers-more-than-
“Crowdfunding” usually implies the presence of an intermediary, who serves as a matchmaker between promoters and funders. An intermediary, however, is not essential to the definition. Instead, the key is the many-to-one relationship between funders and a promoter. The reality is that intermediated crowdfunding is simply more practical for most promoters. Some larger promoters, like Wikipedia, already have a built-in audience they can tap for funding. Wikipedia regularly asks visitors to contribute money for the upkeep of the site itself. Most small promoters, however, do not have such an audience, and thus seek the help of an intermediary that can draw a crowd together. As discussed below, these intermediaries often work in different ways—some merely provide a platform for promoters to pitch their ideas to the crowd, while some newer platforms might even allow the crowd to invest in the intermediary itself.


27 See Kappel, supra note 1, at 375-76.

28 Ortutay, supra note 3, at B1 (“Though the [crowdfunding] sites are reminiscent of single-project online tip jars that popped up earlier in the decade, they work better because they create persistent communities behind the projects.”).

29 Putting your money where your mouse is, ECONOMIST, Sept. 4, 2010, at 69, available at 2010 WLNR 17519138. (“There have of course been 'tip jars' on web pages for years, and even big sites like Wikipedia ask for donations.”). Some crowdfunding advocates reject the idea that this type of fundraising is “crowdfunding.” Id. (“[Crowdfunding is] not a tip jar, and that's what makes it sustainable,' says Perry Chen, the boss of Kickstarter, the largest of several start-ups that act as matchmakers between donors and projects.”). But see A Brief History of Crowdfunding, ULULE, http://blog.ulule.com/post/700805254/a-brief-history-of-crowdfunding (last visited Aug. 27, 2011) (“Beyond artistic projects, crowdfunding also makes it possible for modern-day patrons to help fund a service. That's what happened with Wikipedia, which has been covering its costs with the help of donors since 2003.”). In any case, the sustainability of direct crowdfunding should not necessarily determine what is or is not “crowdfunding.”

30 See id.

31 See Glaser, supra note 26 (Glaser points out that a writer “might have a gift for words but not business.”).
B. Origins and Purpose of Crowdfunding

Now that we have a working definition, we can explore the origins and purpose of this new phenomenon. Crowdfunding originates from “crowd sourcing,” which is “the idea that a [single] task can be delegated to a crowd.”32 Author Jeff Howe, who coined the term “crowdsourcing,”33 recognized that just as many companies had “outsourced” work to other countries, many organizations could now “crowd source” any number of tasks to internet users around the world.34 He observed that “[f]or the last decade or so, companies have been looking overseas, to India or China, for cheap labor. But now it doesn’t matter where the laborers are – they might be down the block, they might be in Indonesia – as long as they are connected to the network.”35 Instead of primarily manual labor, these new online laborers accomplish a range of creative tasks—from solving complex scientific research and development problems to creating a new logo for a company.36

Like crowd sourcing, crowdfunding is a way to use the online masses to supplement or improve existing brick-and-mortar business methods.37 Instead of hiring permanent employees to solve creative problems, crowd sourcing might be

35 Id.
36 Sarah Kershaw, A Different Way to Pay for the News You Want, N.Y. TIMES, Aug. 24, 2008, at WK4, available at 2008 WLNR 15991034 (“This financing model takes its name from crowdsourcing, a method for using the public, typically via the Internet, to supply what employees and experts once did: information, research and development, T-shirt designs, stock photos, advertising spots. In crowdsourcing, the people supply the content; in crowdfunding, they supply the cash.”); Victoria Schlesinger, Seeking to Help Budding Researchers With a Click of the Mouse, N.Y. TIMES, Apr. 2, 2010, at A19, available at 2010 WLNR 6872885.
37 See Subramaniam & Bhuva, supra note 21, at 74 (Jacob Mathew, Managing Director of MAPE Advisory Group, a Mumbai-based investment banking outfit, “points out that the social networking [funding] model works well for early-stage funding, which is an unviable area for an investment bank.”).
more economically efficient for businesses, organizations, and others to keep their costs down without necessarily sacrificing quality work product. Instead of struggling to convince brick-and-mortar financial services companies to lend insignificant amounts of capital, now entrepreneurs, artists, and nonprofits can turn to the online masses for funding. This is important because many of these promoters—for various reasons—would not be able to obtain a loan from a traditional lending institution. First, many of these loans would be too small to be worth the attention of a large institution. Second, many of these promoters have little or no track record. Third, many of these projects are too risky, unpredictable, or just plain bizarre. Finally, even if traditional lenders were more interested in these projects, there are not enough of them to satisfy the demand for funding.

Michael Sullivan apparently coined the term “crowdfunding” in 2006, but the phenomenon had, by that time, already existed in some form for perhaps a decade or

38 Howe, supra note 34 (“[S]mart companies in industries as disparate as pharmaceuticals and television discover ways to tap the latent talent of the crowd. The labor isn’t always free, but it costs a lot less than paying traditional employees.”).

39 Crowdfunding, supra note 32 (“Traditional banks can’t handle microfinancing because their overhead required to underwrite a loan precludes those loans from being too small. The same is true of many other financial service offerings. No bank is going to spend the time to underwrite a $50 loan and chase after small bank accounts that might never have more than $100. They just are not built for that. . . . Similarly, crowdfunding is circumventing traditional funding mechanisms like bank loans or venture capital.”).

40 Ahvenainen, supra note 15 (“One of the most difficult bottlenecks of a startup’s life is the early phase funding.”).

41 Subramaniam & Bhuva, supra note 21, at 74; Crowdfunding, supra note 32 (“No bank is going to spend the time to underwrite a $50 loan and chase after small bank accounts that might never have more than $100. They just are not built for that.”).

42 Sjostrom, supra note 2, at 5 (“For emerging companies, however, debt is generally not an option—they do not have the necessary collateral, operating history, or proven track record to qualify for bank loans.”).

43 See Life Sized Mouse trap - And 3 Other Weird Crowdfunding Projects, ARTICLESBASE.COM (Aug. 18, 2010), http://www.articlesbase.com/business-articles/life-sized-mouse-trap-and-3-other-weird-crowdfunding-projects-3074017.html (“Jerry Paffendorf started his crowdfunded real estate project called ‘Loveland’ and over the course of about a dozen projects raised $11,833.00! The way this crowdfunding project worked was hilarious, you could buy ‘inches’ of property in Detroit, MI through ‘Loveland’ and actually go visit the spot you bought and set it up the way you want!”).

44 See Sjostrom, supra note 2, at 3; Lavinsky, supra note 2.
more. Its conceptual origins are in charitable giving. By the 1990s, however, some musicians and filmmakers raised money through online funders. For example, the British rock band Marillion financed their 1997 U.S. tour and several subsequent albums through online fundraising by their fans. Despite these early examples of promoters directly tapping their own audiences for funding, crowdfunding has only recently gained prominence with the emergence of large crowdfunding intermediaries.

IndieGoGo, Kickstarter, and RocketHub are three popular crowdfunding intermediaries, none of which existed before 2008.

C. Instances of Different Crowdfunding Models

There are now many crowdfunding websites in existence, most of which follow the patronage model. However, some investment crowdfunding sites are coming into the market.


46 A Brief History of Crowdfunding, supra note 29 (“The basic idea is not new – humanitarian organizations have been doing it for decades.”).


48 Id.

49 See Matt Villano, Small Donations In Large Numbers, With Online Help, N.Y. TIMES, Mar. 18, 2010, at F31, available at 2010 WLNR 5630437; Glaser, supra note 26; Fulfill Your Dreams Through Crowdfunding, MY INTERNET BUSINESS REVIEW (May 24, 2010), http://myinternetbusinessreview.org/55/fulfill-your-dreams-through-crowdfunding (“There have been crowdfunding sites online since 2004, and only now is the process really catching on.”).


52 See Villano, supra note 49.
1. Patronage Crowdfunding

As mentioned above, most crowdfunding websites operate on a patronage model, under which promoters can only reward funders with small thank-you gifts. One of the most popular sites under this model is Kickstarter, which focuses on providing a platform for a variety of creative endeavors. Like other crowdfunding sites, Kickstarter imposes certain limitations. For instance, promoters can raise money only for specific and finite projects (i.e., no rent or payroll) and may not include charity projects or causes. Under this model, Kickstarter and other major crowdfunding sites specialize in helping promoters fund creative projects like albums, films, and novels.

Once a crowdfunding intermediary, such as Kickstarter, accepts a project and the promoter has set the fundraising goal, the crowdfunding intermediary allows the promoter to appeal to potential funders. In making this appeal, the promoter typically advertises the rewards available to funders who contribute a particular amount of money. For example, a musician might give a funder a signed copy of the funded album for a thirty dollar contribution, or play a house-show for several hundred dollars.

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53 See id.

54 Project Guidelines, KICKSTARTER, http://www.kickstarter.com/help/guidelines?at=ccc1055ad6bf3dce (last visited Sept. 14, 2011). But see Lavinsky, supra note 2 (“[Crowdfunding] could range from paying for medical bills or a wedding to filming a movie or starting or growing a business.”).

55 While most patronage crowdfunding sites just focus on funding, at least one, FashionStake, also helps market and sell the final products. Lauren Indvik, FashionStake Shifts Fashion Industry Power to the Consumer, MASHABLE (Sept. 1, 2010), available at 2010 WLNR 17398672 (“FashionStake is among the growing number of crowdfunding networks like Kickstarter, which helps aspiring creatives fund small scale projects (typically in the $500 to $20,000 range) by offering different rewards for varying degrees of support. The difference between FashionStake and Kickstarter is that it actually markets and sells the goods online, rather than just providing a platform to raise funding.”).


57 Id. (“Groups that offer to give a concert at the place of a supporter’s choosing request an average of $600. A custom-written song goes for about $500; a signed, vinyl LP edition of a CD, $53. Fans ‘are not buying music, they’re buying a personalized experience,’ said Yancey Strickler, a Kickstarter co-founder.”).
Funders who wish to support a given project pledge the money via their credit card, after which the money might be held in an escrow account until the project meets its funding goal. Kickstarter requires a given project to meet its fundraising goal within ninety days to release the escrowed funds. When a project is successfully funded, Kickstarter takes a small percentage of total money raised, plus an amount to cover transactional costs. In contrast to Kickstarter’s all-or-nothing approach, other sites, like IndieGoGo, transfer contributions directly to the promoter as soon as they come in, regardless of whether the funding goal has been met.

Kickstarter raised over fifteen million dollars for 1,600 projects by July 2010. However, not all crowdfunding sites have been as successful. For example, 15,000 bands have attempted to raise money on SellaBand, a crowdfunding site based in Amsterdam that focuses on providing fans with a chance to finance music projects. Although three million dollars were raised for these 15,000 projects, less...

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58 Id. ("Friends and fans make pledges with a credit card tied to the Amazon Payments system. But it’s a conditional pledge: the cards are charged only if there are enough pledges to meet the fund-raising goal in 90 days.").

59 Id.

60 See Putting Your Money Where Your Mouse Is, supra note 29.

61 Frequently Asked Questions, INDIEGOGO, http://www.indiegogo.com/about/faqs (last visited Sept. 19, 2011) ("If you don’t meet your funding goal, you still keep the money you raise with your campaign. You will be charged a 9% fee on the money you raise, despite the unmet funding goal."); Harnish, supra note 25 ("Surprisingly, if you don’t reach your goal, you still keep the money you raise, less the websites’ take. Even more surprisingly, according to Danae Ringelmann, President and co-founder of IndieGoGo, contributors understand they won’t get their money back if the project isn’t fully funded."). One concern is preventing people from “dishonestly claim[ing] they have a project so they can to run off with the money.” Id. However, funders usually consider a variety of reputational factors. Id. ("’[P]rojects that don’t reveal who’s behind them, don’t have a core community, and don’t do outreach to showcase the community building around it are very poor candidates for success. A person who wanted to commit fraud by raising money and running would have to be willing to destroy their reputation and social graph connections across the web to succeed.’").

62 Putting Your Money Where Your Mouse Is, supra note 29. Ortutay, supra note 3, at B1 ("About 2,500 projects have been funded by about 200,000 people through Kickstarter since the site launched in April 2009. About the same number have failed to meet their funding goals.").

63 Ortutay, supra note 3, at B1. Sometimes the statistics cited do not seem to match up. Compare id. (2,500 total projects) with Mendoza, supra note 50 (2,500 film projects total).

64 Stross, supra note 56, at BU4.
than 50 were funded as of September 2010. Moreover, although SellaBand took a
despite this, it was not enough to prevent the site from filing for bankruptcy protection in February 2006, four years after starting. It remains to be seen whether patronage crowdfunding will gain enough traction among promoters and funders to keep other sites in business.

2. Investment Crowdfunding

While patronage crowdfunding has been online for a decade or more, investment crowdfunding is a more recent phenomenon. In this short time period, however, two types of investment crowdfunding have emerged: patronage-plus and pure investment crowdfunding. Patronage-plus crowdfunding is best understood through the use of an example. For instance, the website Bandstocks allows residents in the UK to contribute money to help bands produce new albums. Like with patronage crowdfunding, Bandstocks funders receive certain in-kind perks, such as a copy of the recording or VIP privileges. Unlike patronage crowdfunding,

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65 Putting Your Money Where Your Mouse Is, supra note 29; Stross, supra note 56, at BU4.

66 Stross, supra note 56, at BU4.


68 Putting Your Money Where Your Mouse Is, supra note 29 ("Crowdfunding may turn out to be a fad, says Cory Doctorow, a bestselling novelist and blogger who is experimenting with various forms of micropatronage, including selling a bespoke short story for $10,000 to one of his fans. ‘There will be some people for whom the fact that they raise money for themselves will be a marketing story,’ he says. But crowdfunding’s early success at raising sums large enough to be useful, though not large enough to replace other sources of funding for creative works, fits in with a broader trend of using technology to bring artists and their audiences closer together.").

69 See Kappel, supra note 1, at 379.

70 See id. at 376; see also Ahvenainen, supra note 15.


72 Kappel, supra note 1, at 380.
however, Bandstocks’ funders acquire a financial interest in the recording. In other words, they are entitled to a share of the net receipts generated by the album.

In pure investment crowdfunding, funders are rewarded with a financial interest only. Pure investment crowdfunding may be the next logical step for crowdfunding because many promoters need more money than they could raise using a pure patronage model. Securities laws, however, are a formidable barrier to investment crowdfunding in the United States as so much of this activity occurs abroad.

Hong-Kong based Grow VC, launched in February 2010, is one of the first pure investment crowdfunding platforms. To participate, potential Grow VC funders must register and pay a subscription fee—between $25 and $140 a month, depending on how much equity that member wants. As of August 2010, Grow VC had over three thousand registered members. Grow VC takes 25% of the subscription fees upfront to cover administrative costs; the rest is pooled together in a community investment fund. Subscribers have the power to allocate a portion of the community investment fund to particular entrepreneurial projects that they think have the most potential for return. Once a project meets its funding goal, “Grow

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73 Id. at 381.
74 Id.
76 See Kappel, supra note 1, at 376 (“Some view patronage-plus ex ante crowdfunding models as more sustainable than those based on pure patronage because fans become literally invested in the success of their artists.”).
77 See id. at 376, 383-84 (“Whatever promise patronage-plus ex ante crowdfunding models hold, without a presence in the U.S. market, their prospects for growth are severely limited. . . . Compared to many foreign jurisdictions, SEC registration is typically more burdensome and expensive.”).
78 Ahvenainen, supra note 15; K. Giriprakash, Come Here to Fund a Promising Idea, BUSINESS LINE (Hindu), Aug. 4, 2010, at 9, available at 2010 WLNR 15425105; Subramaniam & Bhuva, supra note 21, at 73.
79 Subramaniam & Bhuva, supra note 21, at 74.
80 Id. at 73; see also Prentice, supra note 18 (“Some 25% of Grow VC users are in the US, 11% in the UK and 7% in India.”).
81 Subramaniam & Bhuva, supra note 21, at 74.
82 Id.
VC along with its Indian partner, Springboard Ventures, carry out their own evaluation of the start-up and if they are satisfied, hand hold the venture for another three years or more before exiting the venture.\textsuperscript{83}

Upon exit, Grow VC takes another 25\% of any profits from the project, recouping some of its costs during the incubation period.\textsuperscript{84} Those members who invested their portion of the fund into a successful project receive a certain percentage of the profits.\textsuperscript{85} The members who invested first in the successful project are rewarded more handsomely than those who invested just before the project met its fundraising goal.\textsuperscript{86} Thus, Grow VC’s model encourages members to become adept at picking projects that will ultimately prove to be profitable.

The Grow VC model has changed the traditional Venture Capital (“VC”) and Private Equity (“PE”) model—traditional VC/PE firms usually take a small share of a large investment, but Grow VC takes a large share of a small investment.\textsuperscript{87} Grow VC is tapping into a market that has largely been ignored by traditional VC firms.\textsuperscript{88} Traditional VC firms look for companies that have the potential for rapid growth culminating in an initial public offering (“IPO”).\textsuperscript{89} Grow VC and its subscribers, on the other hand, are more interested in start-up companies that are still quite small.\textsuperscript{90} As a result, Grow VC focuses on fledgling companies,\textsuperscript{91} helping them grow to the size where larger VC firms can take them all the way to an IPO.\textsuperscript{92}

\textsuperscript{83} Giriprakash, supra note 78, at 9.

\textsuperscript{84} See Subramanium & Bhuva, supra note 21, at 74.

\textsuperscript{85} See Id.

\textsuperscript{86} See Id.

\textsuperscript{87} See Id.

\textsuperscript{88} Ahvenainen, supra note 15 (“The traditional VC model is not enough anymore; we need a more effective, transparent and global market for startup funding.”).


\textsuperscript{90} Ahvenainen, supra note 15; see Prentice, supra note 18 (“Petra Soderling heard about Grow VC on Twitter and is making the minimum Grow VC investment of $20 a month. ‘For me it’s about investing and hoping to see a profit but also about using a small amount of money to help small companies,’ she says.”).
Another pure investment crowdfunding operation is ProFounder, which functions as a matchmaker between promoters seeking capital in the United States and those who have a “substantial, pre-existing relationship” with a given promoter.93 Thus, the “crowd” is comprised of friends and family.94 ProFounder describes itself as a “community-based crowdfunding platform,” as opposed to the normal crowdfunding platform where promoters appeal to the masses without the need for a preexisting relationship.95 These restrictions provide the environment for “private placement offerings,” which are exempt from full federal registration of the securities under Section 4(2) of the Securities Act of 1933.96 Once family and friends are verified, they may access the promoter’s promotional webpage and even make investments on the site.97 ProFounder then facilitates many of the formalities, most importantly helping entrepreneurs comply with state registration laws based on the location of each investor.98

Besides these two examples, many different variations on the pure crowdfunding investment model are possible. For example, there could be variations on the VC model; instead of offering a monthly subscription, new sites might offer funders freely tradable shares in the intermediary itself. Likewise, new crowdfunding sites might offer a micro-cap mutual fund with redeemable shares in diversified and non-diversified portfolios selected by members of the fund. Finally,

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91 See Sjostrom, supra note 2, at 5 (“There are four recognized broad categories of equity financing that a typical emerging company requires as it grows and matures: seed financing, start-up financing, early-stage financing, and later-stage financing.”).

92 See Greg Ferenstein, HOW TO: Crowdsource Funds for Causes, Creativity and Startups, MASHABLE (Jun. 21, 2010), available at 2010 WLNR 12557746 (“The community fund acts as an “activator” for bigger investments . . . .’’); see Prentice, supra note 18.


94 Id.

95 Id. (emphasis added).


98 Id.
larger entrepreneurs could use crowdfunding momentum to sell securities directly to
the public.\textsuperscript{99}

\textbf{D. Investment Crowdfunding Compared with Direct Public Offerings}

The transition of crowdfunding from the patronage realm into the
investment realm creates some questions about where crowdfunding as a category
leaves off and where traditional investing categories take over. One such question
involves the direct public offering ("DPO"). A DPO is a way for a company to
forego the traditional route of an underwritten IPO by selling securities directly to
friends, customers, and others with an interest in the company.\textsuperscript{100} Some forms of
investment crowdfunding are essentially DPO processes under a new label.

There is some overlap between investment crowdfunding and DPOs. Both
concepts are geared toward selling securities to the public, and since the mid-1990s
several companies have even done DPOs over the internet.\textsuperscript{101} DPOs are significant
because most IPOs are done by means of an underwriter, who usually does most of
the work to sell the shares into the market.\textsuperscript{102} Without an underwriter, a promoter
may need to contract with others—like a financial printer, transfer agent, or
broker—to actually facilitate these sales.\textsuperscript{103} Yet, the promoter is still in charge of the
offering and is not “borrowing” the reputation of the underwriter.\textsuperscript{104} Likewise, while
investment crowdfunding is still in its infancy, a promoter, such as a filmmaker,
might eschew an intermediary and appeal to fans directly to purchase investment
shares in an upcoming film.

Despite these similarities, there are key distinctions between investment
crowdfunding and DPOs. First, unlike DPOs, both patronage and investment

WLNR 14168054 ("[W]ith viral channels and increasing knowledge through companies like
Kickstarter and Sellaband in other sectors, we could see models emerge where financial and other
incentives, such as your name in the film credits, prove exciting enough for some to pay big sums.").

\textsuperscript{100} William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for

\textsuperscript{101} Id. at 531-32.

\textsuperscript{102} Id. at 534.

\textsuperscript{103} Id. at 543–44.

\textsuperscript{104} See generally Bernard S. Black, Information Asymmetry, The Internet, and Securities Offerings, 2 J. SMALL &
crowdfunding typically involve intermediaries that serve as matchmakers between promoters and funders. Second, DPOs are typically attempted by companies looking to raise several million dollars. Crowdfunding promoters tend to look for significantly less; for example, Grow VC looks for initial investments between ten thousand and one million dollars. While this could be seen as a mere difference in scale, the different motivations of promoters and funders of investment crowdfunding compared to DPOs are important. Investment crowdfunding mirrors the ethos of patronage crowdfunding—funding projects aligned with the funder’s ideology or tastes. The DPO generally adheres to the more bottom-line investing approach common to traditional investing.

III. Analysis of Crowdfunding Vis-à-Vis U.S. Securities Regulation

There is an obvious conflict between investment crowdfunding and U.S. securities regulation. This Part will explore three main issues: (1) to what extent crowdfunding is governed by U.S. securities regulations; (2) if subject to such laws, how crowdfunding could function under current securities regulation; and (3) if current regulations, particularly the registration exemptions, are inadequate, what a new crowdfunding exemption would look like. Investment, as opposed to patronage, crowdfunding arrangements likely qualify as investment contract securities, and are subject to regulation under U.S. securities laws. Furthermore, while there are ways for investment crowdfunding to work under current exemptions, many crowdfunding participants would still be excluded. Since current exemptions are too restrictive, this Article will explore different forms that a new crowdfunding exemption could take.

A. Is Crowdfunding Governed by U.S. Securities Regulation?

This Section considers whether crowdfunding arrangements can be considered “securities” by being classified as “investment contracts.”

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106 See, e.g., Sjostrom, supra note 100, at 581.
107 Ahvenainen, supra note 15.
108 Giriprakash, supra note 78 (“The subscribers may not want returns as much as they want to be part of an idea which they believe strongly in.”).
109 See generally Sjostrom, supra note 100.
1. “Investment Contract” Security

The two fundamental U.S. securities regulation statutes, the Securities Act of 1933 (“33 Act”) and the Exchange Act of 1934 (“34 Act”), never define “security.” Instead, they simply provide examples of securities—stocks, bonds, debentures, investment contracts, and others. In SEC v. W.J. Howey Co., the Supreme Court provided more direction by creating a catch-all test for determining whether a particular investment scheme is an “investment contract” and thus a “security.” The Court held that “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 the promoter or a third party” is an investment contract subject to securities regulation.

2. Does Crowdfunding Create an “Investment Contract” Security?

Patronage crowdfunding does not create an investment contract. As described in Part II, patronage crowdfunding is characterized by promoters rewarding funders with only nominal “thank-you” gifts; funders do not expect profits from the promoter’s enterprise. Thus, patronage crowdfunding does not create an investment contract under the Howey test and is not governed by U.S. securities laws.

In contrast, an investment contract security is created by a Grow VC-like situation because members invest a certain amount of money into a common investment pool with the expectation that they will receive a share of the profits derived from successful projects that they initially support. Although this is likely an investment contract under the Howey test, there are some doubts because

111 Id.
113 Id. at 298–99.
114 See Kappel, supra note 1, at 376 (“In return, financial contributors typically receive ‘patronage perks’ such as use of their name in the film credits or album liner notes, advanced autographed copies of the work, or backstage access at a performer’s show.”).
115 See Howey, 328 U.S. at 298-99.
116 See id.; Giriprakash, supra note 78.
investors are rewarded only when they invest in successful enterprises. Perhaps investors are not deriving profits “solely from the efforts of the promoter or a third party.”

But while investors choose which projects to fund, that is essentially all they do. Once the projects are selected, Grow VC solely supervises and assists the new start-up’s growth and profitability, while the investor does little or nothing. Lower courts have long held that “solely” is not a literal limitation. Instead, courts consider whether there is a “reasonable expectation . . . of significant investor control” in the enterprise; if they have exercised such control, the enterprise could be excluded from classification as an investment contract. The Howey Court would almost certainly agree that while Grow VC investors play an important part in the initial selection of projects, they still rely almost entirely on the expertise and experience of the Grow VC managers to help the start-up become profitable. Thus, the investment scheme is an investment contract.

Would this analysis necessarily apply to an investment crowdfunding scheme different from Grow VC’s? ProFounder, for example, is structured to provide private placement offerings and therefore involves securities. While information about other investment crowdfunding schemes is scarce, it is unlikely that any possible investment crowdfunding platform will be able to avoid the investment contract label. Through these platforms, people invest money with the expectation of earning profits primarily from the work of the promoter, the intermediary, or

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117 See Giriprakash, supra note 78.

118 See Howey, 328 U.S. at 299; Subramanium & Bhuva, supra note 21, at 74.

119 See generally Subramanium & Bhuva, supra note 21, at 74.

120 Id.

121 See, e.g., United States v. Leonard, 529 F.3d 83, 88 (2d Cir. 2008).

122 See, e.g., id. (quoting SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir. 1982)).

123 See Howey, 328 U.S. at 298-99.

124 Id.

125 See Lang, supra note 93 (asserting that by allowing entrepreneurs to reach out to those with whom they have a “specific, identifiable connection or affiliation,” the risk of fraud decreases and investors are protected – the primary goals of securities regulation).
At the outset, promoters probably will not want to cede any significant control over the enterprise. Even if investors have some control, it is highly unlikely that every investor will contribute significantly to the profitability of the operation. If there are any passive investors, those investors are “led to expect profits solely from the efforts of the promoter or a third party.” Thus, there is little chance for an investment crowdfunding operation to avoid qualifying as an “investment contract” security.

B. The Feasibility of Investment Crowdfunding under Current Securities Regulation

Since most, if not all, investment crowdfunding schemes will fall under the aegis of U.S. securities laws, we need to consider where to go from here. As an initial matter, it is illegal for any crowdfunding promoter, or any intermediary, to offer anyone a security without either registering the offering with the SEC or complying with an applicable exemption from traditional registration requirements. This Section will discuss the feasibility of these two options.

1. Traditional Registration Process

The traditional registration process’s burdens are legendary. Issuers must put together a detailed registration statement that requires extensive technical assistance from attorneys and accountants. These costs are “relatively fixed, regardless of the size of the offering,” and on the low end, may be in the range of a few hundred thousand dollars. These costs would almost certainly be higher than most small

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126 See Kappel, supra note 1, at 383 (“[A] security is sold any time a fan gives money . . . expecting to share in the profits but does not actively participate in . . . the business. Thus, offering investors a return . . . over which they have no control would be considered selling securities.”).

127 See id. at 384 (“[M]any artists may not be willing to share creative control, making widespread acceptance of such a model uncertain.”).

128 See Howey, 328 U.S. at 299.

129 William K. Sjostrom, Jr., Carving a New Path to Equity Capital and Share Liquidity, 50 B.C. L. REV. 639, 645 (2009). There are also other costs, like registration fees, printing materials, etc.; see Anand, infra note 232, at 443.


131 Id. at 35.
investment crowdfunding promoters’ entire fundraising goals,\footnote{See Kappel, supra note 1, at 384 ("Indeed, a standard SEC registration would cost much more in legal fees than an average recording project-- nullifying much of the Investment Model’s value as an alternative funding mechanism.").} yet they would have to be paid \textit{before} any securities were even sold.\footnote{Sjostrom, supra note 100, at 576 ("Unfortunately, the large majority of costs for a public offering are incurred up front."); Stuart R. Cohn & Gregory C. Yadley, \textit{Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns}, 4 N.Y.U. J. L. & BUS. 1, 9 (2007) ("[T]he 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.").} Given these high costs, the traditional federal exemption process is probably not feasible for these small crowdfunding promoters.

However, the traditional registration process may not be out of reach for an investment crowdfunding intermediary. Presumably a company like Grow VC could afford registration costs under the 33 Act, and may even be able to attract a reputable underwriter that would make for a successful offering.\footnote{However, it is important to realize that underwriters are particularly selective. Sjostrom, supra note 2, at 8. ("As a general rule, however, no underwriter will take a company public unless the company has, at a minimum: (1) annual revenue of $20 million, (2) net income of $1 million, and (3) the potential to achieve and sustain significant growth rates (such as twenty percent or greater in revenues) for the next five to ten years.").} Flush with cash, Grow VC might then be able to invest in many small-time promoters picked by Grow VC’s investors. Besides Grow VC, larger financial services companies might also want to enter the investment crowdfunding market and operate either as investment companies or even underwriters for small-time promoters.

However, even if an investment crowdfunding intermediary, like Grow VC, could successfully raise money and gain investors through a registered federal offering, there may be reasons why it would not want to complete a federal registration. An issuer would become a public company upon federal registration, and public companies are subject to rigorous and costly requirements regarding, among other things, disclosures, proxy statements, and tender offers.\footnote{Sjostrom, supra note 129, at 643–645.} While technically feasible for larger crowdfunding intermediaries, these concerns may discourage many otherwise eligible intermediaries from the federal registration of securities.
2. Private Placement Offerings

In contrast to public offerings of securities through federal registration, some investment crowdfunding schemes might work by means of private placement offerings, which are exempt from full registration under Section 4(2) of the 33 Act. These offerings must be carefully tailored to only reach sophisticated or wealthy investors who have a pre-existing relationship with either the promoter or an affiliate of the promoter. These investors must also agree not to resell their securities before eligible to do so. Since most promoters do not know many of these types of investors, they must seek out partners, like broker-dealers, who do.

For small-time crowdfunding promoters, it may be difficult to recruit broker-dealers to help them reach these elusive investors. After all, the profit margin on a small transaction would not do much to persuade a broker-dealer to become involved. Furthermore, a broker-dealer would not want to bombard, or otherwise risk alienating, its wealthy clients with insignificant offers. Also, if there were any deals, the transaction costs might consume much of the incoming investment. Given these hurdles, private placement offerings are likely not feasible for small-time investment crowdfunding promoters.

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137 See Sjostrom, supra note 2, at 14. See generally Cohn & Yadley, supra note 133.
138 Cohn & Yadley, supra note 133, at 54 (“As a general rule, restricted securities cannot be resold except pursuant to Rule 144, the safe harbor adopted by the SEC to determine when restricted securities, and securities owned by control persons, may be safely resold.”). However, “privately-held companies often cannot take advantage of the resale safe harbor provided by Rule 144. Rule 144 provides that as a condition for resale there be available at the time of resale 'adequate public information' with respect to the issuer of the securities.” Id. at 55.
139 See Sjostrom, supra note 2, at 14–15.
140 Cohn & Yadley, supra note 133, at 11 (“[B]ecause small transactions are less lucrative than large ones, they are of less interest to broker-dealers.”).
141 Id.
142 Id.
143 The U.S. government set up an internet site that allows certain issuers to appeal to wealthy investors, but it is not available broadly for all exemptions. See Q&A: Small Business and the SEC, SEC, http://www.sec.gov/info/smallbus/qasbsec.htm (“The Office of Advocacy of SBA has established an [...]nternet site where small companies may list their Regulation A and Regulation D 504/SCOR stock offerings. ACE-Net is a cooperative effort between SBA and nine universities, state-based
These arrangements are probably more realistic for larger investment crowdfunding intermediaries. Instead of ordinary investors, an intermediary like Grow VC could sell investment contracts solely to wealthy and sophisticated investors. Likewise, this funding mechanism could work with other potential crowdfunding intermediary models, such as the crowdfunding mutual fund intermediary or the crowdfunding underwriter. However, to make this work, the crowdfunding intermediary would need to be large and profitable enough to make it worth the time for the broker-dealer and its wealthy clients.

Besides issues of feasibility, the fact that all the members of the “crowd” are wealthy and sophisticated may strain the limits, definition-wise, of the crowdfunding label. In other words, while there may be a many-to-one relationship between funders and a small-time promoter, the fact that the funders are all wealthy seems to go against a fundamental, if largely unarticulated, crowdfunding ethos that values broad participation by ordinary people who are not exclusively interested in profit. Thus, this type of arrangement with only wealthy funders might not truly be “crowdfunding.”

3. Intrastate Exemptions

In addition to the private placement offering exemption, the intrastate exemption is another statutory exemption from federal registration in Section 3(a)(11) of the 33 Act. There are typically three requirements to qualify for this type of exemption: (1) the promoter must be incorporated or otherwise have its principal place of business in the targeted state where it offers the security; (2) the

entities, and other non-profit organizations to provide a listing service where small companies may list their stock offering for review by high net worth investors (accredited investors)."

144 See Bradford, supra note 7, at 17.
145 See id. at 3-4.
146 See id. at 4.
147 See Kappel, supra note 1, at 385 (“These investments are not driven solely by the profit motive . . . ”); Michael Miner, Pay for News, Then Brag About It, READER, Apr. 8, 2010, at 6, available at 2010 WLNR 9281201 (“It’s not only about making money. It’s about getting people to invest in your site and make a deeper connection with your site.”).
promoter must carry out a significant amount of its business in that state; and (3) the promoter may make offers and sales only to residents of that state.149

These requirements make it difficult, if not impossible, for a small-time crowdfunding promoter to sell securities over the internet. Even if a promoter were organized under the laws of a particular state, conducted most of its business in that state, and planned on using the money it raised in that state, it can only make offers to other residents of that state.150 If a promoter makes an offer to even one non-resident, then the exemption is lost.151 This is hard to comply with because the SEC construes “offer” to mean anything that conditions the market for a future sale.152 Under this broad definition of “offer,” a promoter making a pitch directly on its own website, or indirectly through a crowdfunding intermediary, will have likely made a general offer to anyone who visits that site.

There are ways to get around this general solicitation problem, though. The promoter (if it is a direct offering) or a crowdfunding intermediary might offer potential funders the chance to pre-register for offerings only for residents of a particular state, without disclosing the offer itself.153 However, before pursuing this internet-based pre-registration system, it would be wise to seek a “no-action” letter from the SEC.154 Yet, even if the SEC staff were inclined to grant such a request, these letters are not binding, and thus provide limited comfort.155 The precarious nature of no-action letters might give pause not only to the promoter who received the letter, but also to other promoters who want to follow a similar course.156

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149 See Q&A: Small Business and the SEC., supra note 143.
150 Id.
151 Id.
152 See generally Cohn & Yadley, supra note 133; Sjostrom, supra note 100.
154 See generally id.
156 See Jonas A. Marson, Surfing the Web for Capital: The Regulation of Internet Securities Offerings, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 281, 308–09 (2000) (“Companies wishing to raise small sums over the [i]nternet, or services linking such issuers with investors, should no longer have to rely on a string of no-action letters to guide their actions. Indeed, the president of IPONet has complained that
In addition to these barriers, an issuer of securities would need to comply with state registration requirements, which may impose many of the same requirements as full-blown federal registration. While a later section addresses some of the specific concerns with state registration, suffice it to say that it may impose significant legal and accounting costs on an issuer. Small-time investment crowdfunding promoters might be able to reduce some of these costs, but perhaps not enough to make the intrastate exemption a feasible option, especially considering the inherent limitations of only selling securities to fellow residents. Larger crowdfunding intermediaries, like Grow VC, would probably be able to afford state registration, but it does not make much sense for a large company to use the intrastate exemption because it must confine the scope of its operation to just one state.

4. Regulation A

Besides the statutory exemptions from federal registration, there are several administratively created exemptions, one of which is Regulation A (“Reg A”). This exemption allows certain issuers the opportunity to avoid full federal registration by following a simplified mini-registration process. This process excuses issuers from many requirements, like the need for audited financial statements. Reg A also has two other attractive features: (1) issuers may “test the waters” to gauge interest in the offering, and (2) investors may freely trade Reg A shares on the open market.
Reg A seems to be an appealing option, especially for small-time investment crowdfunding promoters.\textsuperscript{166} After all, they could gauge interest in their offering \textit{before} committing the time and money to prepare a Reg A offering statement.\textsuperscript{167} Unfortunately, while Reg A excuses issuers from many onerous registration requirements, state law remains an obstacle. Issuers are required to follow state registration requirements in each state where they intend to offer or sell securities.\textsuperscript{168} Because few states provide a parallel exemption to Reg A, most advantages of using Reg A are nullified.\textsuperscript{169} Thus, for small-time promoters, Reg A is not a feasible option. For larger intermediaries, the question of feasibility is irrelevant because Reg A excludes investment companies from using the exemption.\textsuperscript{170}

5. Regulation D

The other major administrative exemption is Regulation D (“Reg D”),\textsuperscript{171} which is actually three different exemptions: Rule 504, Rule 505, and Rule 506.\textsuperscript{172} Under each of these exemptions, an issuer can raise different dollar amounts.\textsuperscript{173} However, all three exemptions are subject to several important restrictions. For instance, most issuers may not make general solicitations, and most investors may not freely transfer their shares.\textsuperscript{174} Additionally, under Rules 505 and 506, issuers are largely limited to selling shares to larger institutions or wealthy individuals.\textsuperscript{175}

\textsuperscript{166} See Kappel, \textit{supra} note 1, at 384 (“This ‘testing the waters’ provision may allow Investment Model sellers to gauge the level of interest in a particular artist before creating and offering securities to potential investors, thereby avoiding unnecessary legal fees spent on artists with no likelihood of raising sufficient capital to fund a recording.”).

\textsuperscript{167} See 17 C.F.R. § 230.254 (2010).

\textsuperscript{168} Bradford, \textit{supra} note 7, at 89.

\textsuperscript{169} Cohn & Yadley, \textit{supra} note 133, at 28.

\textsuperscript{170} 17 C.F.R. § 230.251(a)(4) (2010).

\textsuperscript{171} \textit{Id.} §§ 230.501–230.508.

\textsuperscript{172} \textit{Id.} §§ 230.504–230.506.

\textsuperscript{173} \textit{Id.} Under Rule 504, issuers may offer no more than an aggregate of one million dollars in a twelve-month period. They can raise more under Rule 505 (up to five million dollars), and Rule 506 imposes no limit at all. Cohn & Yadley, \textit{supra} note 133, at 30.

\textsuperscript{174} Cohn & Yadley, \textit{supra} note 133, at 30.

\textsuperscript{175} \textit{Id.}
Much of the discussion above regarding private placement offerings applies to Rules 505 and 506.\textsuperscript{176} After all, they share the same basic prohibition on general solicitation and the same focus on selling to wealthy investors.\textsuperscript{177} Thus, small-time investment crowdfunding promoters probably will have little luck attracting a broker-dealer to facilitate contact with wealthy clients.\textsuperscript{178} Some crowdfunding intermediaries may even have trouble reaching these wealthy investors. In other words, Rules 505 and 506 are probably not much help to small-time promoters, but may be useful for larger intermediaries in certain circumstances.

In contrast, Rule 504 may be useful to small-time promoters, and perhaps even to intermediaries. The million-dollar limit seems appropriate, and investors need not be wealthy or sophisticated.\textsuperscript{179} If an issuer complies with state registration requirements, there may even be general solicitations and free trading of shares.\textsuperscript{180} Thus, the feasibility of a Rule 504 exemption seems to turn mostly on the feasibility of state registration requirements.

6. State Registration Requirements

Even if an issuer qualifies for an exemption from federal registration requirements, it likely still must comply with state registration requirements in every state in which it intends to offer or sell securities.\textsuperscript{181} This creates problems in the

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\textsuperscript{176} See discussion infra Part III.B.2.

\textsuperscript{177} 17 C.F.R. §§ 230.505-230.506 (2010).

\textsuperscript{178} There is, however, an effort to create a network of sophisticated and wealthy investors. A Silicon Valley investor, Naval Ravikant, “recently launched his own push into crowdfunding with AngelList, a site that enables entrepreneurs to contact a growing group of angel investors around the country.” \textit{Clipped Wings, DAILY DEAL} (Jul. 29, 2010), available at 2010 WLNR 16283159. The problem is that the new financial reform legislation makes it harder for investors to qualify as “accredited investors.” \textit{Id.} (“In an attempt to protect unsophisticated investors, the sweeping financial reform legislation signed into law by President Obama July 21 raises the bar an individual must clear to be considered an ‘accredited investor’ -- one who is cleared to invest in certain ‘high risk’ assets. For decades, an individual had to earn more than $200,000 in annual income and own net assets worth more than $1 million, a standard that for many was relatively easy to meet. But under the new law, an investor’s home is no longer considered an asset.”). Some estimate this new change may reduce the number of angel investors by half. \textit{Id.}

\textsuperscript{179} Sjostrom, supra note 2, at 9.

\textsuperscript{180} 17 C.F.R. § 230.504(b)(1) (2010).

\textsuperscript{181} Sjostrom, supra note 2, at 11. The two broad exceptions to this requirement are private placement offerings and offerings made pursuant to Rule 506 of Reg D, which excuses the issuer from any state
context of investment crowdfunding because it means that an issuer would have to screen potential funders based on their residency. Furthermore, it creates a tension, if not a paradox, between the viability of the offering and the costs of even making the offering. After all, the offer will be more viable if available in more states, but more states mean higher costs. Small-time promoters may only be able to afford to register in a few states, which may jeopardize the viability of their offerings. Larger intermediaries might be able to bear some of these costs, but the million-dollar limit might make a broadly available offering infeasible given the fixed costs.

The process for the issuer will be easier and more cost-effective to the extent that there is more overlap between the materials needed to qualify for federal exemptions and those needed for state registration requirements.182 There is a continuum of overlap between the two systems, with some federal exemptions having quite a bit of overlap with state requirements, and others with almost none.183 On one end of the continuum is Rule 504 of Reg D, which has requirements similar to most state requirements.184 On the other end, Reg A has almost nothing in common with state requirements, which nullifies its most attractive features, like the ability to “test the waters” or the free trade of shares.185

While there are varying levels of discrepancy between state and federal requirements, most states have adopted some uniform registration requirements.186 Yet, states often implement these requirements in different ways.187 Thus, issuers

registration requirements. Id. at 11-12. However, as previously discussed, these exceptions are very restrictive.

182 See Kappel, supra note 1, at 384 (“[T]he costs saved from the federal registration exemption are somewhat offset by the multitude of state law compliance requirements.”).

183 See Sjostrom, supra note 2, at 40-42.

184 See id. at 29–31; Cohn & Yadley, supra note 133, at 58–59.

185 Sjostrom, supra note 100, at 543.

186 Marc I. Steinberg & Chris Claassen, Attorney Liability Under the State Securities Laws: Landscapes and Minefields, 3 BERKELEY BUS. L.J. 1, 8 (2005).

187 See Daniel Everett Giddings, Comment, An Innovative Link Between the Internet, the Capital Markets, and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital, 25 PEPP. L. REV. 785, 790–91 (1998); Q&A: Small Business and the SEC, supra note 143 (“Historically, most state legislatures have followed one of two approaches in regulating public offerings of securities, or a combination of the two approaches. Some states review small businesses’ securities offerings to ensure that companies disclose to investors all information needed to make an informed investment
subject to these laws must usually hire experts familiar with state-specific registration requirements. Legal costs will rise proportionally to the number of states in which an issuer sells securities. Beyond legal fees, most states require audited financial statements, which, can be extremely costly. For a small-time promoter, these requirements may prove onerous. After all, legal and accounting fees must be paid before any securities are sold.

However, there are ways to avoid requirements for audited financial information. Most states allow small companies to use Small Company Offering Registration (“SCOR”) forms to register their offering, and the North American Securities Administrators Association (“NASAA”) publishes a manual on how to complete these forms. Under NASAA guidelines, while independent certified public accountants (“CPAs”) must audit most financial statements, they may instead simply review the financial statements of issuers that meet certain conditions. Companies that have never publically sold securities and whose present offering is

decision. Other states also analyze public offerings using substantive standards to assure that the terms and structure of the offerings are fair to investors, in addition to the focus on disclosure.”).

188 See infra note 192.

189 Cohn & Yadley, supra note 133, at 13 (“The need to review state law adds uncertainty and expense to a small private offering, and where there are only a few known prospective purchasers in a particular state, the time and costs of investigation and state qualification may not be worth the effort.”).

190 See sources cited supra note 133.

191 Sjostrom, supra note 100, at 551. See generally SCOR Overview, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., http://www.nasaa.org/industry___regulatory_resources/corporation_finance/535.cfm (last visited Oct. 8, 2011) [hereinafter SCOR Overview] (“The SCOR Form is not available for use in connection with every type of securities offering. The Form was designed for use by companies seeking to raise capital through a public offering of securities exempt from registration with the U.S. Securities and Exchange Commission (SEC) under SEC Regulation A, Rule 504 of SEC Regulation D (“Rule 504”), or Section 3(a)(11) of the Securities Act of 1933.”).


under one million dollars qualify for this privilege. While most small crowdfunding promoters would likely qualify for these reduced burdens, it is unclear whether the accounting costs would be reduced enough to make state registration feasible.

Because intermediaries have more financial resources, a larger investment crowdfunding intermediary probably can afford to comply with state registration requirements. However, because it costs more to register in more states, promoters must raise more money to cover expenses. With increased costs, intermediaries may avoid funding the smallest promoters because they will be more trouble than they are worth. In the end, these large investment crowdfunding intermediaries may start to act more like the traditional financial services institutions that have long ignored and rejected small-time promoters. If that becomes the case, then crowdfunding will come full circle and become part of the problem it was originally designed to fix.

C. New Crowdfunding Exemption

As discussed above, the current securities framework in the United States makes it extremely difficult for most promoters, and even some larger intermediaries, to build a vibrant investment crowdfunding market. However, there is some interest in the creation of a new exemption specifically for investment crowdfunding. This Section addresses some proposals for a new exemption, and makes a proposal for a new crowdfunding exemption.

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194 Id.

195 It is important to realize that not all investment crowdfunding intermediaries will be able to take advantage of the simplified SCOR forms. See SCOR Statement of Policy, supra note 193.

196 See Sjostrom, supra note 100, at 544–45.

197 See Subramanium & Bhuva, supra note 21, at 74 (“The efforts that go into getting a start-up funded are no different from those involved in making a growth investment. And the latter is more remunerative because of its larger ticket size.”).

198 See Sjostrom, supra note 2, at 3.
1. Kassan Petition for Rulemaking

In July 2010, Jenny Kassan filed a petition for rulemaking with the SEC. The petition asked the SEC, pursuant to Rule 192(a) of the Rules of Practice, to “adopt a rule exempting individual purchases of securities totaling $100 or less from registration requirements and from all other requirements other than [a few express exceptions].” Kassan’s petition suggests several requirements:

1) No purchaser may invest more than $100.

2) The aggregate offering must be limited to $100,000.

3) Offerors must be individuals. Offerors may not be entities, and must be United States Citizens or legal residents.

4) No offeror may have more than one offering open at any time.

5) All offering materials and communications must contain a disclaimer clearly stating the possibility of total loss of the investment and the necessity of careful evaluation of each offeror's trustworthiness by the individual purchaser.

In support thereof, Kassan’s petition mentions the importance of capital for small businesses, and the impracticability of seeking out capital in accordance with current regulation. Specifically, it describes how “small enterprises are often stifled because of an inability to raise funds” and “[e]ven though there may be no shortage of interested investors, and no shortage of capacity for these small enterprises to reward their investors, securities regulations create a prohibitive hurdle.” Kassan posits that her proposal would alleviate these problems, while maintaining investor protections. “The small amount at stake and maximum aggregate cap ensure the

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199 Letter from Jenny Kassan, Sustainable Economies Law Center, to Elizabeth M. Murphy, Office of the Secretary, SEC (Jul. 1, 2010), available at http://www.sec.gov/rules/petitions/2010/petn4-605.pdf [hereinafter Kassan petition].


201 Kassan petition, supra note 199, at 7.

202 Id.

203 Id. at 1–2.

204 Id. at 2.

205 Id. at 7–8.
protection of investors while furthering the public interest in this type of investment.”

Since Kassan filed this petition, there have been over fifty original articles posted on the SEC’s webpage commenting on the petition. While most of these articles support the proposal, there is no broad agreement on the dollar limitations. For example, many commentators want higher dollar limitations—some as low as $250 per investor with a $250,000 cap, others as high as $1,000 per investor with a $1,000,000 cap. There is also no broad agreement on whether anti-fraud provisions would apply. While many commentators have expressed the general desirability of investor protection, most are comfortable with a caveat emptor

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206 Id. at 2.


208 However, while all the posted Articles are supportive, there are skeptics within the crowdfunding community. See, e.g., Kevin Lawton on Strategy, CHANGE CROWDFUNDING LAW (Jul. 23, 2010), http://crowdfundinglaw.posterous.com/kevin-lawton-on-strategy (“Ironically, [the Kassan] initiative may actually harm the chances for legal crowdfunded securities at any economically meaningful level. The SEC may eventually green-light this exemption as a way to throw a bone to the crowdfunding crowd (and avoid significant change). And because government is slow, it will be even more years before those numbers would be revisited.”). Instead of the current proposal, some argue that there should be a more carefully considered proposal that truly represents the major crowdfunding players. Id. (“For a rulemaking petition to the SEC, a better approach would be to hammer out a more inclusive proposal with a small, smart group that includes experts on community-supported entrepreneurship, the heads of the big crowdfunding sites, and people in the business investment world. Come up with a proposal that appeals to all of these groups, and then rally everyone to support this new proposal, retracting the current one and transferring its momentum to the new one. The SEC would be more moved by an explicit, ‘Here’s the one killer crowdfunding proposal that all of these diverse groups support,’ than any possible implicit, ‘A bunch of competing pro-crowdfunding petitions have been submitted for your review by different groups— they all ask for slightly different things-- good luck figuring it out!’


210 See e.g., Letter from James J. Angel, Assoc. Professor of Finance, Georgetown Univ., to the SEC (Sept. 21, 2010), available at http://www.sec.gov/Articles/4-605/4605-33.pdf [hereinafter Angel Letter].

approach under which any anti-fraud provisions would be eliminated.\footnote{212}{See e.g., Angel Letter, supra note 210.} These commentators believe that a small investment cap is sufficient to protect investors.\footnote{213}{See id.}

2. Critique of the Kassan Petition

The rules proposed in the Kassan petition would make investment crowdfunding easy and accessible. Recognizing that current regulation is far too complicated, it proposes some simple, plain-English rules.\footnote{214}{Kassan petition, supra note 199, at 7.} By stating that these should be the only applicable rules, the petition implicitly argues that state registration laws should be preempted by any new federal rules.\footnote{215}{See id. at 2.} Preemption would both simplify the process for small promoters and reduce the costs involved.\footnote{216}{See id. at 3-4.} Because the proposed rules are so simple, promoters could dispense with the expensive assistance of lawyers and accountants altogether.\footnote{217}{Id. at 2.} Without those expenses, crowdfunding promoters could keep more of what they raise, up to $100,000, which seems like a reasonable cap given the amounts currently being raised on patronage crowdfunding sites.\footnote{218}{Id. at 7-8.}

While this Article supports a crowdfunding exemption, it does not agree with Kassan’s proposal for how such an exemption should be written. Although Kassan’s proposal would give investment crowdfunding promoters everything they want, it is too idealistic. After all, Kassan’s solution to the conflict between crowdfunding and the securities regulatory regime suggests simply to discard all state and federal securities regulations and to substitute in their place five simple rules.\footnote{219}{Id.} That may not be such a bad idea, especially if the regulations are not worth saving. However, while this clean-sweep approach would be satisfying to many small-time promoters—and to many others advocating for simpler regulations—it does not seem likely to transpire.
In 1992, the SEC amended Rule 504 of Reg D to drastically reduce the restrictions on small issuers, who could then make general solicitations and sell securities that could be freely traded on the open market.\textsuperscript{220} The SEC’s rationale was that “the size and local nature of these small offerings did not appear to warrant imposing extensive federal regulation.”\textsuperscript{221} However, seven years later, the SEC reversed course and readopted the pre-1992 restrictions.\textsuperscript{222} This reaction was prompted by a surge of “pump and dump” schemes perpetuated by unscrupulous promoters.\textsuperscript{223} Given this example, the SEC may suffer from a “once bitten, twice shy” attitude toward small-issuer concerns.

Setting aside the significant issue of whether the SEC would enact such a far-reaching proposal, there are several reasons why Kassan’s clean-sweep approach may not promote the long-term interests of crowdfunding. While many legitimate promoters will initially benefit from regulatory liberalization, there is a serious danger that, ultimately, these new laissez faire regulations may, like the Rule 504 amendment, allow unscrupulous promoters to victimize unsophisticated investors.\textsuperscript{224} In other words, if the pendulum swings too far toward deregulation, there is a risk of killing the crowdfunding goose that lays the golden egg.

In addition to the above concerns, the Kassan approach arguably throws the baby (market efficiency and investor protection) out with the regulatory bathwater. The modern securities regulatory framework is essentially designed to advance at least two broad principles: (1) providing investors with access to accurate material information about companies\textsuperscript{225} and (2) protecting investors from market

\textsuperscript{220} Sjostrom, \textit{supra} note 2, at 25

\textsuperscript{221} Id. (quoting Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Release No. 33-7644 (Feb. 25, 1999), 1999 SEC LEXIS 408, at *6).

\textsuperscript{222} Id.

\textsuperscript{223} Cohn & Yadley, \textit{supra} note 133, at 71–72 (“Rule 504 was being used by nefarious promoters to distribute up to $1 million of securities in New York to a select favored group, followed promptly by boiler-room promotions that artificially drove up the secondary market price until such time as the initial purchasers could sell their shares at a handsome profit, leaving the gullible crop of new investors with suddenly deflated shares and irrecoverable losses.”); Sjostrom, \textit{supra} note 2, at 25.

\textsuperscript{224} Cohn & Yadley, \textit{supra} note 133, at 71-72; Sjostrom, \textit{supra} note 2, at 25-26.

\textsuperscript{225} See \textit{The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation}, SEC, http://www.sec.gov/about/whatwedo.shtml (last updated July 25, 2011) (“The laws and rules that govern the securities industry in the United States derive from a simple and
manipulation and fraud.\textsuperscript{226} After all, it is widely believed that an efficient market depends on accurate material information and a means of punishing those committing fraud who might otherwise scare investors from the capital markets.\textsuperscript{227}

Kassan’s proposal disregards both of these principles with little explanation. It disregards the first principle, the availability of accurate material information, by not requiring any specific information about the business itself.\textsuperscript{228} Besides the boilerplate warning,\textsuperscript{229} the only disclosure that the promoter would have to make is his or her name.\textsuperscript{230} While promoters probably would voluntarily disclose some information about their business, the lack of uniformity between disclosures would make it hard for investors to compare promoters.\textsuperscript{231} Without specific guidelines, promoters would be free to paint rosy pictures of their businesses without mentioning any potential risks or liabilities.\textsuperscript{232} Consequently, if one promoter is free to puff its prospects to gain funders, other promoters will likely follow suit, and the result would be a crowdfunding market full of unrealistic, and likely fraudulent, sales.

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\textsuperscript{226} See \textit{id.} (“The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. Here the SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud. Crucial to the SEC’s effectiveness in each of these areas is its enforcement authority . . . . Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them.”).

\textsuperscript{227} See \textit{id.; Black, supra note 104, at 93.}

\textsuperscript{228} See Kassan petition, \textit{supra} note 199, at 7-8.

\textsuperscript{229} \textit{Id.} at 8 (“All offering materials and communications must contain a disclaimer clearly stating the possibility of total loss of the investment, and the necessity of careful evaluation of each offeror’s trustworthiness by the individual purchaser.”).

\textsuperscript{230} \textit{Id.}

\textsuperscript{231} Black, \textit{supra} note 104, at 96–97.

\textsuperscript{232} Anita Indira Anand, \textit{The Efficiency of Direct Public Offerings}, 7 J. SMALL \& EMERGING BUS. L. 433, 455 (2003); Black, \textit{supra} note 104, at 92.
Without the availability of uniform, accurate, and material information about promoters and their businesses, the market might degrade, prices might fall, and investors might not want to invest because the investments all sound too good to be true. This is often called the “death spiral,” a problem the United States has avoided by imposing “a complex set of private and public institutions that give investors reasonable assurance that the issuer is truthful.” Yet, Kassan makes no mention of this traditional concern for the health of the market.

While Kassan’s proposal ignores the first traditional principle of securities regulation, it does address the second principle: protecting investors from market manipulation and fraud. Kassan argues, “The limitation of a $100 maximum investment by each purchaser ensures investor protection by preventing individuals from incurring significant financial risk. Even a total loss of $100 is unlikely to be financially crippling for anyone considering investment.” She continues, “The aggregate maximum of $100,000 furthers the public interest by preventing large devastating aggregate losses in a single community.” These limitations probably, but not necessarily, limit investor losses to a reasonable degree.

Anand, supra note 232, at 455. (“An adverse selection problem exists because investors are unable to discern which issuers are truthful; investors therefore discount the prices that they will offer for all securities. High-quality issuers exit the market, forgoing a potentially valuable investment opportunity, because they are unable to obtain a fair price for their securities. Low-quality issuers remain in the market and, as a result, investors discount still more the prices they will pay. This in turn only drives more honest issuers away from the market and exacerbates the adverse selection problem.”) (alteration in original) (footnotes omitted).

See Black, supra note 104, at 92 (“In modern lingo, securities markets are a particularly vivid example of a market for lemons. Investors don’t know which issuers are truthful and which aren’t, so they discount the prices they will offer for all securities. That makes honest issuers less interested in offering securities, but doesn’t discourage the dishonest ones.”); Iris H-Y Chiu, Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from European Union Securities Regulation, 2 VA. L. & BUS. REV. 307, 311 (2007).

Kassan petition, supra note 199, at 7-8.

Id. at 7.

Id.

While under this proposal a person may only invest $100 in any one project, there is no limitation on the number of projects to which an investor may contribute. So, if a person invested in several dozen projects, potential losses could run into the thousands of dollars.
However, even though it is important to limit investor losses, Kassan’s approach does not deter or punish unscrupulous promoters. Professor Stephen Choi remarks in his article, Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation, that “[s]mall companies . . . pose the greatest risk to investors of fraud”\(^{240}\) and “present investors with the greatest risk of getting stuck with a lemon.”\(^{241}\) Choi also mentions that while “the number of small businesses able to seek capital may increase over the [i]nternet, the proportion of fraudulent issuers will also rise.”\(^{242}\)

It is not clear whether Kassan is skeptical of the merits of anti-fraud liability in general, or whether she merely believes that the benefits of such liability are outweighed by the burdens imposed on small-time promoters.\(^{243}\) Perhaps she recognizes that “no amount of technical exemption requirements will hinder the fraud artists from their endeavors.”\(^{244}\) Yet, she ignores the danger of a “death spiral” due to the presence of too many dishonest issuers in the market.\(^{245}\) In any case, Kassan seems comfortable to jettison anti-fraud liability without much explanation and replace traditional protections with a de facto “caveat funder” attitude.\(^{246}\) She

\(^{240}\) Choi, supra note 130, at 29.

\(^{241}\) Id. at 31.

\(^{242}\) Id. at 38.

\(^{243}\) Kassan petition, supra note 199, at 4.

\(^{244}\) Cohn & Yadley, supra note 133, at 72; see Choi, supra note 130, at 40 (“The level of disclosure may be too great or too costly. Antifraud rules may lead to frivolous suits against companies and therefore only raise costs without generating much deterrence against fraud.”).

\(^{245}\) See Black, supra note 104, at 93 (“[I]nstitutions and ‘reputational intermediaries’ reduce both the likelihood of fraud or extreme puffing, and the extent of adverse selection. They thus attract honest issuers into the securities market, at the same time that they drive at least some dishonest issuers out of the securities market. As the average quality of disclosure improves, investors will place greater faith in issuer disclosures, and will pay more for securities. This, in turn, will attract still more high-quality issuers to the securities market. The death spiral of the unregulated market can become a virtuous spiral instead, as long as dishonest issuers can be (mostly) kept out of the market.”) (emphasis added).

\(^{246}\) See Christine Hurt, Peer-to-Peer Microfinancing for the Arts? Looking at Kickstarter, CONGLOMERATE BLOG (Jul. 9, 2010), available at 2010 WLNR 13822720 (“Kickstarter seems to have adopted a ‘caveat backer’ approach and merely tells would-be backers to ‘use your internet street smarts.’”). Other articles suggest that the principal means of protecting investors is by disclosure requirements. Prospectus, CROWDFUNDING CAMPAIGN TO CHANGE CROWDFUNDING LAW, http://www.panix.com/~pspinrad/prospectus (last visited Aug. 31, 2011) (“Much of securities law is rightly devoted to protecting investors. The main way it does this is by detailing the documents that
suggests simply warning investors that they should carefully invest after checking the
identity of the promoter, who is essentially given a license to steal up to $100 per
investor and $100,000 per enterprise.\(^{247}\)

Besides imprudently dismissing some of the fundamental principles of the
modern securities regulatory regime, Kassan does not explain four important
practical ramifications of her proposal. First, she does not address whether
crowdfunding promoters should be exempted from broker-dealer requirements.\(^{248}\)
Second, she does not address the role of intermediaries.\(^{249}\) Third, she does not
discuss whether these new crowdfunding securities would be freely traded in the
general market, and if so, what impact they would have on “pump and dump”
scams.\(^{250}\) Finally, because the proposal disqualifies entities, it is unclear how a
promoter would actually issue a security.\(^{251}\)

3. Alternate Proposal for New Exemption

Despite the weaknesses in the Kassan proposal, there are ways to modify it
to create a more pragmatic exemption for investment crowdfunding. Parts of the
Kassan proposal must be included in any new exemption. First, given the
fragmented nature of state registration requirements and the inefficiency of
complying with two often wholly disjointed regimes, a new federal exemption should
preempt state law.\(^{252}\) Second, there must be no limits on general solicitation.\(^{253}\)

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\(^{247}\) Kassan petition, \textit{supra} note 199, at 7.

\(^{248}\) Sjostrom, \textit{supra} note 100, at 565 (“[U]nder the Uniform Securities Act, neither a DPO company
nor its agents would have to register as broker-dealers. However, some states specifically include a
company distributing its securities directly to the public without using a broker-dealer within the
definition of dealer. Therefore, a company conducting a DPO in one of these states would have to
register as a dealer.”) (footnote omitted).

\(^{249}\) See Kassan petition, \textit{supra} note 199, at 7-8.

\(^{250}\) \textit{Id.}

\(^{251}\) \textit{Id.} at 7.

\(^{252}\) State regulators, of course, disagree with any proposal to take away anything from their jurisdiction.
Sjostrom, \textit{supra} note 2, at 48–49. They “often bear the brunt of criticism when defrauded investors
Third, circumscribed dollar limitations should be included to prevent significant investor losses while also allowing small companies to raise sufficient capital. The caps should probably reflect the stringency of the actual exemption (i.e., the more stringent the exemption, the more money allowed) and should allow accredited investors to invest more than unaccredited investors. Fourth, promoters should be limited to one offering at a time to make compliance easier to monitor. Finally, promoters should be required to provide investors with a disclaimer that this type of investment is inherently risky and should be evaluated carefully for trustworthiness.

Beyond these requirements, a new exemption should maintain the balance among the needs for capital financing, market efficiency, and investor protection. To that end, before issuing securities, promoters should be able to gauge how much support there is for such an offering. This could be accomplished, for example, by using a crowdfunding pledge system. Once a promoter decides to issue securities, it should have to comply with streamlined registration and disclosure requirements. These requirements should excuse small issuers from producing audited financial statements, thereby reducing the initial barriers to entry. However, excused issuers should either (1) be subject to other financial statement verifications, like the relaxed standards under the NAASA guidelines, or (2) have stricter limits on the dollar amounts they could raise. After securities are issued pursuant to this new exemption,

discover their losses” and are thus legitimately concerned about deregulation that may open the door to fraud. Cohn & Yadley, supra note 133, at 61. However, “the status quo is equally inimical to the universally acknowledged desire to facilitate capital raising opportunities for legitimate small businesses.” Id. To resolve this stalemate, it may be necessary to use federal preemption, unless states are willing to coordinate with federal regulators to create a workable small issuer exemption. See id.

253 Kevin Lawton on Strategy, supra note 208 (“[T]o move the ‘soul’ of crowdfunding forward, to activate its ability to reach and leverage the greater talents and expertise of the many outsiders over the few insiders-- the wisdom of the crowd-- the prohibition against General Solicitation is the more important first target.”); see Sjostrom, supra note 2, at 4.

254 Kassan petition, supra note 199, at 7.

255 Id. at 8.

256 Id.

257 A more relaxed liability standard (perhaps gross negligence) for misstatements and omissions should be used to enforce the accuracy of these requirements.
trading requirements should be imposed to limit the danger of “pump and dump” scams.\textsuperscript{258}

The role of crowdfunding intermediaries is another important consideration for any new crowdfunding exemption. In a traditional IPO, underwriters play an important role in not only the efficient sale of securities to end-investors, but also as intermediaries that conduct due diligence on behalf of investors.\textsuperscript{259} Underwriters tend to be important bridges between issuers and investors because they arguably maximize value for issuers and reduce risks for investors.\textsuperscript{260} Given that larger underwriters may not be interested in small distributions because they are not profitable enough, a new crowdfunding exemption could include provisions making it easier for smaller underwriters to serve the crowdfunding market. For the same reasons, a new exemption should relax requirements for investment companies. Crowdfunding intermediaries should be involved in this relaxation of requirements to reduce information asymmetry and to ensure the future vitality of investment crowdfunding.

4. The Possibility of SEC Action

Having discussed some of the potential forms a new crowdfunding exemption could take, how likely is SEC action? While the SEC has paid lip service to the concerns of small companies vis-à-vis the deficiencies of current regulation for many years now, very little action has been taken.\textsuperscript{261} Despite various theories, the rationale for this inaction is not fully clear.\textsuperscript{262} The SEC may not want to liberalize the rules for small offerings because of the possible political blowback if securities fraud increases.\textsuperscript{263} Additionally, in the wake of budgetary strain and increased duties

\textsuperscript{258} See Cohn & Yadley, supra note 133, at 71-72.

\textsuperscript{259} Anand, supra note 232, at 437-38; see Choi, supra note 130, at 43–46.

\textsuperscript{260} Anand, supra note 232, at 438.

\textsuperscript{261} Cohn & Yadley, supra note 133, at 1 (“Despite years of criticism from small business advocates, the Securities and Exchange Commission has made little effort to ameliorate the severe burdens on small companies seeking to raise capital in compliance with the Securities Act of 1933 and SEC regulations.”).

\textsuperscript{262} Id. at 68–77 (noting three possible theories).

\textsuperscript{263} See Ross Pruden, Biracy & Crowdfunding—Peril or Paradise?, A CURIOUS LIFE (Jan. 9, 2010), http://rosspruden.blogspot.com/2010/01/biracy-crowdfundingperil-or-paradise.html (“[Y]ou never really know how governments react to radical new business models. Once crowdfunding begins to
pursuant to financial reform legislation, the SEC may have neither the time nor the resources to address this issue.

Even so, a growing chorus is calling for regulatory reform, and it may only be a matter of time before it compels the SEC to modernize its approach to small company offerings. In May 2011, the House Committee on Oversight and Government Reform ("OGR") held a hearing designed to "provide lawmakers with an opportunity to better understand how securities regulations have harmed public and private capital formation in the United States," taking it as a given that securities laws harm capital formation. With such a shot across the bow, SEC Chairman Mary Shapiro defended her agency's very legitimacy. In an earlier letter from Shapiro to OGR Chairman Darrell Issa, she respectfully explained the Commission's difficult job:

Regardless of the form or size of the offering, companies seeking access to capital in the U.S. markets should not be overburdened by unnecessary or superfluous regulations. At the same time, all offerings must, of course, provide the necessary information and protections to give investors the confidence they need to invest in our markets. Striking the right balance between facilitating access to become popular, all it takes is one egregious crowdfunding scandal to push the SEC towards clamping down on 'risky new businesses using securities law loopholes to rip off unsuspecting victims').

Prospectus, supra note 246 ("If this enthusiasm can be mobilized towards the SEC in a way that guarantees their engagement, such as on their own website, that's a win. Their reputation has been battered recently, for good reason, and they may be looking for ways to show that they want to help the little guy. Regulatory reform is in the air, and Congress is currently reviewing a bill to change financial regulations. These things generally come to the table top-down, but this project proposes a relatively simple regulatory change that would spark innovation and financial activity from the bottom up."); see Kappel, supra note 1, 385 ("Clearly, establishing these [crowdfunding] models in the U.S. will not be easy, but perhaps the country is primed for a more fundamental shift in ethos: one where honest investment in creativity is not treated like betting on a football game or investing in the complex financial instruments that helped turn the securities market into a legal 'pyramid scheme'.")


Shapiro Letter, supra note 12, at 1.
capital by companies and protecting investors in our rules and orders is a critical goal of the SEC.\textsuperscript{267}

After explaining the need for various securities laws and noting the instances where the Commission had relaxed rules, Shapiro promised that the SEC staff would “review the impact of our regulations on capital formation for small businesses,” including a focus on “the regulatory questions posed by new capital raising strategies.”\textsuperscript{268}

Despite Chairman Shapiro’s promise to have SEC staff review the impact and questions involving crowdfunding, her letter to Congressman Issa seemed to indicate how the Commission might approach a crowdfunding exemption.\textsuperscript{269} Shapiro referenced the SEC’s Rule 504 double take, where it removed most barriers, only to put them back after a rise in “pump and dump” fraud.\textsuperscript{270}

The Commission’s rules previously included an exemption (Rule 504) that allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on resales of the securities sold. These offerings were subject only to state blue sky regulation and the anti-fraud and other civil liability provisions of the federal securities laws. In light of investor protection concerns about fraud in the market in connection with conduct pursuant to this exemption, the exemption was significantly revised in 1999.\textsuperscript{271}

In considering a potential crowdfunding exemption, Shapiro said that “it will be important to consider this experience and build in investor protections to avoid the issues created under the prior exemption.”\textsuperscript{272} While “the limits on both individual investment and offering amounts contemplated by crowdfunding may reduce the incentives for abuse,” Shapiro noted that “the widespread use of the internet for these types of funding strategies may present additional challenges to

\textsuperscript{267} Id.

\textsuperscript{268} Id. at 24.

\textsuperscript{269} Id. at 23.

\textsuperscript{270} See \textit{supra} p. 96 and accompanying notes.

\textsuperscript{271} Shapiro Letter, \textit{supra} note 12, at 23

\textsuperscript{272} Id.
investor protection as compared to those that were present when Rule 504 was revised.”

In other words, the Kassan petition, which eliminates disclosure and anti-fraud elements in exchange for reduced losses to investors, is a non-starter. Instead, Shapiro seems to describe in her comments the Commission’s likely approach, which will not sacrifice rigorous investor protection mechanisms in exchange for increased capital formation.

Although indicating what could be described as a “once bitten, twice shy” attitude, Shapiro explained that the Commission was not opposed to new small issuer exemptions. In particular, she explained that in 1996, the Commission adopted Regulation CE (“Reg CE”) to “assist small businesses in California to raise capital” via a “coordinated federal and state exemption . . . for sales of securities of up to $5 million to a qualified purchaser, which is defined to be less restrictive than an accredited investor under Regulation D.” It is hard to imagine the relevance of Reg CE to the crowdfunding issue because Reg CE only excuses the issuer from the federal registration requirements, leaving state requirements intact, which would be untenable for most crowdfunding operations. If Reg CE is the type of exemption that the SEC would consider for a crowdfunding exemption, many crowdfunders will likely be disappointed.

Any prediction about SEC action on this issue is premature. Even so, it is important to understand the realistic probability of action and the realistic limits of such action. The fact that the SEC has historically ignored small issuer concerns certainly decreases the probability that the Commission will commit significant resources to drafting permanent rules for a quickly changing area of innovation. Ultimately, the fastest way to get a crowdfunding exemption likely would be to pass new legislation.

273 Id.
274 Id.
275 Id.
277 Cohn & Yadley, supra note 133, at 1.
IV. CONCLUSION

In the last several years, crowdfunding has dramatically increased the ability of artists, entrepreneurs, and nonprofits to find capital for a variety of projects. Many promoters have embraced this type of fund raising because alternate forms of capital financing are difficult, if not impossible, to obtain. While pure patronage crowdfunding has filled a void by allowing promoters to raise several thousand dollars at a time, many promoters find this insufficient. Investment crowdfunding is the next logical step, filling the void between patronage crowdfunding and traditional brick-and-mortar financing.

However, current U.S. securities laws materially limit investment crowdfunding. For instance, current state and federal regulation make investment crowdfunding infeasible for most investment crowdfunding promoters and intermediaries. The reality is that the upfront legal and accounting costs associated with navigating the regulatory waters are too onerous for most investment crowdfunding promoters.

Because the current securities regulatory regime does not adequately allow for investment crowdfunding, there has been a petition for SEC rulemaking that includes a proposal for a new exemption. If enacted, this proposal would make investment crowdfunding easy and accessible. However, the proposal is too ambitious and probably has little chance of being adopted by the SEC. Yet, this Article explores some ways to correct the principal deficiencies of the current proposal for rulemaking. Ultimately, though, it is up to the SEC or Congress to clear a path for an important new source of grassroots financing. Because small businesses are the lifeblood of the nation’s economy, this Article recommends careful reforms that would make it easier for small businesses to raise money through investment crowdfunding, while still maintaining robust investor protection.

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278 See Kappel, supra note 1, at 376.

279 Could the web reinvent film industry economics?, supra note 99 (“The amount available through crowdfunding is too small to influence any film with a budget of over $100,000.”).

280 Cohn & Yadley, supra note 133, at 9.

281 Sjostrom, supra note 2, at 1–2.