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

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PROCEED AT YOUR PERIL: CROWDFUNDING AND THE SECURITIES ACT OF 1933

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I. INTRODUCTION ....................................... 880

II. ARE CROWDFUNDING INTERESTS SECURITIES UNDER THE SECURITIES ACT? 885
   A. Howey Explained and Interpreted .................................. 886
   B. Howey Applied in Context ........................................ 890
      1. Contract, Transaction, or Scheme ............................... 892
      2. Investment of Money ........................................... 895
      3. Common Enterprise ............................................. 901
      4. Expectation of Profits ......................................... 902
      5. Solely from the Efforts of Others .............................. 903
   C. The Question of Context .......................................... 904

III. FEDERAL REGULATION OF OFFERINGS OF CROWDFUNDING INTERESTS AS SECURITIES ........................................... 906
   A. Applicable Regulation ............................................. 907
      1. Registration and Related Liability and Costs ................ 907
      2. Exemptions from Registration ................................... 911
         a. Private Offering Exemption under Section 4(2) of the Securities Act ............................................. 912
         b. Rules 504, 505, and 506 of Regulation D .................... 916
         c. Regulation A .................................................. 921
      3. Whose Conduct is Regulated? .................................... 922

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879
I. INTRODUCTION

Funding small businesses while complying with applicable securities laws and regulations is tricky. Businesses need money to commence and sustain operations, but most non-bank funders desire to subscribe for interests in the firm that are deemed securities, invoking the possibility that federal or state securities laws regulate the transaction. Under federal law, an offer or sale of securities must be registered unless the security or the transaction is exempt.¹

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

A promising web-based funding model for small business firms (and potentially for larger enterprises) has emerged over the past few years. Crowdfunding, as this model has come to be known, has been defined and described in various ways.² A recent article explains crowdfunding as follows:

² See, e.g., JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS Driving Business 281 (2008) [hereinafter HOWE, CROWDSOURCING] (“Crowdfunding taps the collective pocketbook, allowing large groups of people to replace banks and other institutions as a source of funds.”); Kristina Dell, Crowdfunding, TIME.COM (Sept. 4, 2008), http://www.time.com/time/magazine/article/0,9171,1838768,00.html (describing crowdfunding as “[o]ne part social networking and one part capital accumulation”). Some define crowdfunding to exclude websites that promise to pay profit sharing to the funders. See Kieran Masterton, How to Crowdfund Your Startup, THINK VITAMIN (Apr. 22, 2010), http://thinkvitamin.com/web-industry/how-to-crowdfund-your-startup/ (“[R]ule number one of Crowdfunding is that you don’t offer a percentage of your venture as a reward.”). Crowdfunding is sometimes confused or conflated with crowdsourcing, which also is a
The concept of crowdfunding finds its root in the broader concept of
crowdsourcing, which uses the “crowd” to obtain ideas, feedback and
solutions in order to develop corporate activities. In the case of
crowdfunding, the objective is to collect money for investment; this is
generally done by using social networks, in particular through the Internet
(Twitter, Facebook, LinkedIn and different other specialized blogs). The
crowd-funders (those who provide the money) can at times also participate
in strategic decisions or even have voting right. In other words, instead of
raising the money from a very small group of sophisticated investors, the
idea of crowdfunding is to obtain it from a large audience (the “crowd”),
where each individual will provide a very small amount.  

Crowdfunding includes a variety of business financing models that use
the Internet. As we use the term in this article, crowdfunding involves
using a web-based business enterprise to seek and obtain incremental
venture funds from the public using a website (which we refer to as a
“crowdfunding website”) to connect businesses or projects in need of
funding (which we refer to as “crowdfunded ventures”) with potential
funders. While some crowdfunding websites specialize in a particular
crowdfunded venture or type of crowdfunded venture, others are more

3. Paul Belleflamme et al., Crowdfunding: Tapping the Right Crowd 2 (Feb. 21,
(“[T]he true social vibrance of crowdfunding is difficult to capture in a definition. The
crowdfunding space is quite diverse, comprised of many niches, and shares a lot of social
networking’s energy.”); C. Steven Bradford, Crowdfunding and the Federal Securities Laws
9-17 (Oct. 7, 2011), http://ssrn.com/abstract=1916184 (accepted for publication in the
Columbia Business Law Review) (describing various different models).
5. This definition is not vastly different from the one constructed by the authors of
the article cited supra note 3. These authors define crowdfunding, based on the fifty-one
examples they reviewed, as involving “an open call, essentially through the Internet, for the
provision of financial resources either in form of donation or in exchange for some form of
reward and/or voting rights in order to support initiatives for specific purposes.”
Belleflamme et al., supra note 3, at 6.
We became interested in this venture finance model because it has huge appeal in a number of obvious respects, yet we could not understand how some of the crowdfunding websites and crowdfunded ventures (especially those offering profit-sharing interests to funders) were complying with federal securities laws. This article is the result of our study of these firms in that context and includes both descriptive and normative observations. It is clear that some but not all manifestations of the crowdfunding model result in the offer and sale of interests that are securities under the Securities Act of 1933, as amended (the “Securities Act”). Because the offers and sales are neither registered nor exempt from registration as required under the Securities Act, these crowdfunded ventures are at risk. They are the focus of the analysis and prescriptions we offer here.

We are not alone in our engagement with the federal securities law aspects of crowdfunding. Among others, the U.S. Securities and Exchange Commission (“SEC”) and the U.S. Congress have taken an interest in crowdfunding. In an April 2011 letter to the Chairman of the Committee on Oversight and Government Reform of the U.S. House of Representatives, SEC Chairman, Mary Schapiro expressly mentions crowdfunding as a new capital-raising strategy. She further indicates that the SEC has been

6. Table 1 features websites in existence as of the date we completed this article, unless otherwise expressly noted.

7. We focus in this article on the federal laws and regulations governing securities offerings—most specifically the Securities Act and rules that the SEC adopted under it. We note here, however, the potential applicability of aspects of broker-dealer, investment advisory, or exchange regulation and state securities (or “blue sky”) laws and regulations. See Bradford, supra note 4, at 30–51; Thomas Lee Hazen, Crowdfunding, Social Networks, and the Securities Laws—The Inadvisability of a Specially Tailored Exemption Without Imposing Affirmative Disclosure Requirements 6, 15–16 (Nov. 18, 2011) (unpublished manuscript), available at http://ssrn.com/abstract-1954040; C. Steven Bradford, Peer-to-Peer Lending, Crowd-funding, and Securities Law, BUS. L. PROF. BLOG (June 17, 2011), http://lawprofessors.typepad.com/business_law/2011/06/peer-to-peer-lending-crowd-funding-and-securities-law.html [hereinafter Bradford, Peer-to-Peer Lending]. We also note that the possibilities and perils of crowdfunding cross state borders internationally. While this is extremely important, it is part of a larger issue in international (and especially Internet) securities offerings that this article does not attempt to resolve. At various points throughout, however, as relevant to our analysis, we reference crossover issues under other federal, state, and international law. And finally, although we note in several places the possibility of other regulatory schemes (notably, the regulation of gambling and charitable solicitations), this article does not address in any meaningful way the possible application of these other potential sources of regulation.


engaged with industry participants, and is focusing on how to address regulatory concerns relating to crowdfunding. Later, in testimony before that House Committee, Chairman Schapiro echoed many of the same themes from the letter, without expressly mentioning crowdfunding:

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

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

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

Federal legislative interest followed. First, in early November 2011, the U.S. House of Representatives passed the Entrepreneur Access to Capital Act, H.R. 2930, which had been introduced in September 2011.
The U.S. Senate then took up the cause. As the House passed its bill, Senator Scott Brown introduced a Senate crowdfunding bill, the Democratizing Access to Capital Act of 2011, S. 1791. Hearings were held on December 1, 2011. The information in this article remains current to that date, except as otherwise specified.

The federal government's current focus on crowdfunding and related capital formation strategies and business models is an important and necessary step in defining the reach of federal securities law rules in regulating crowdfunding and other innovative capital-raising methods and capital markets. We assert that, with the right approach, Congress and the SEC can work with the crowdfunding industry in defining responsible parameters for crowdfunding. This article is designed to contribute to the regulatory conversation.

In our view, protecting investors and maintaining market integrity—the two principal policies underlying the federal securities laws—do not clearly compel registering interests offered and sold through crowdfunding websites, even if those interests are securities within the meaning of the Securities Act. This article supports our contention in several ways. First, it explores both the foundational definitional question—whether crowdfunding interests are securities, and if so, when—and the implications of the answer to that definitional question as a matter of positive law and underlying policy. The article then addresses the advantages and disadvantages of the crowdfunding venture finance model. Finally we conclude by proposing the principles, processes, and substantive

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

17. This question is of paramount importance to the SEC as it contemplates the appropriate level of regulation of crowdfunding. See Issa Letter, supra note 9, at 23. ("In considering whether an exemption from the registration requirements of the Securities Act is appropriate for capital formation strategies like crowdfunding, the Commission will be mindful of its dual responsibilities of facilitating capital formation and protecting investors.")
components of a registration exemption designed to enable the crowdfunding model to survive as an investment vehicle while appropriately protect those investors who cannot fend for themselves.

To accomplish these objectives, the article proceeds in four additional parts. Part II analyzes the circumstances under which crowdfunding interests are securities under the definition provided in Section 2(a)(1) of the Securities Act. After situating crowdfunding interests as potential investment contracts governed by the Howey test (or, in the alternative, debt interests governed by the Reves test), this Part of the article explains the elements of an investment contract and compares and contrasts them, in pertinent part, to the attributes of crowdfunding interests. This analysis reveals that some crowdfunding interests are likely classifiable as securities. Given that some crowdfunding interests may be securities, Part III of the article then focuses on the consequences of that legal conclusion. Part III describes the regulatory ramifications of security status under the Securities Act’s key operative provisions (which require, in significant part, that the offer and sale of a security must be registered or exempt from registration and the policies underlying both the registration requirement and relevant exemptions. Part IV explains why the offer and sale of crowdfunding interests under certain conditions should not require registration, and suggests the principles and potential parameters of a new registration exemption for crowdfunding interests, which could be adopted by the SEC under Section 3(b) of the Securities Act (although Congress would be charged with making some related changes to law to facilitate the overall exemption scheme). Part V offers a summary conclusion.

II. ARE CROWDFUNDING INTERESTS SECURITIES UNDER THE SECURITIES ACT?

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

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

A. Howey Explained and Interpreted

The various parts of the Howey test have been illuminated in meaningful ways in subsequent federal court opinions, including a number of Supreme Court opinions. For example, in United Housing Foundation, Inc. v. Forman, the Supreme Court better identified when an arrangement constitutes an "investment." The Forman Court focused on differentiating

24. See id.
25. See, e.g., SEC v. Edwards, 540 U.S. 389, 392–97 (2004) (holding that a sale and leaseback arrangement of payphones on the promoter's property was an investment contract); Continental Mktg. Corp. v. SEC, 387 F.2d 466, 470–71 (10th Cir. 1967) (holding that a program for breeding beavers was an investment contract); Miller v. Cen. Chinchilla Grp., Inc., 494 F.2d 414, 417 (8th Cir. 1974) (reversing the lower court's pretrial dismissal on grounds that evidence presented at trial could possibly show that a program in which investors raised chinchillas and sold the offspring to the owners at inflated prices constituted an investment contract).
26. See SEC v. W.J. Howey Co., 328 U.S. 293, 298–301 (1946) (determining that an arrangement to sell profit-sharing interests in a citrus grove was an investment contract).
27. Id. at 298–99; see also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) ("The touchstone [of an investment contract] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entreprenurial or managerial efforts of others.").
29. Id. at 300.
"consumption" and "use" from "investment," and determined that the latter occurs when "the investor is 'attracted solely by the prospects of a return on his investment.'" Thus, whether an investment exists depends on whether profits motivated the potential investor’s decision to provide funds. Because the expectation of profits is an independent component of the Howey test, we discuss profits separately below.

The U.S. Supreme Court has not defined a "common enterprise," and federal courts of appeal have taken different approaches when determining whether one exists. Depending on the jurisdiction, a business venture may be a common enterprise under Howey’s progeny if it meets one of three judicially ordained tests. Two principal types of commonality exist, one of which has two different forms.

The first type of commonality recognized in these court cases is horizontal commonality. "A horizontal common enterprise is a pool of assets . . . not separate accounts . . . ." The horizontal commonality approach focuses on the relationship among the investors and requires that there be a pooling of investors’ funds for the purpose of generating financial returns based on the success of the venture and, in some cases, a sharing of profits and losses on a pro-rata basis among investors. For example, in Howey, the purchasers were offered "an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise." The Court noted that purchasers of the land and management

31. Id. at 852–53.
32. Id. at 852 (quoting Howey, 328 U.S. at 300). Forman and other federal cases typically do not focus on the word “solely” as a part of this analysis, preferring instead to look at degrees of significance. See, e.g., Timmreck v. Munn, 433 F. Supp. 396, 402 (N.D. Ill. 1977) (“The court must therefore consider the nature of the promotion to determine whether the emphasis of the developers and their sales agents was on the ‘investment’ or the ‘consumption’ side of the real estate duality.”). The issue in Forman was whether a mandatory acquisition of stock by tenants who wished to lease an apartment in a cooperative housing project involved the purchase of securities. Forman, 421 U.S. at 840. The Court concluded that because the tenants “purchase[d] a commodity for personal consumption or living quarters for personal use,” the interests in the co-op were not securities. Id. at 858.
36. Borsani, supra note 34, at 8 (citations omitted). This approach, “as required by the Third, Sixth, and Seventh Circuits,” depends on “whether investors’ risks were pooled for a single investment purpose.” Id. at 9 (citing Deckebach v. La Vida Charters, Inc. of Florida, 867 F.2d 278 (6th Cir. 1989)).
37. Howey, 328 U.S. at 299. At least one commentator, however, believes that the investment scheme in Howey is not characterized by a pooling of investor funds. See James D. Gordon III, Defining a Common Enterprise in Investment Contracts, 72 OHIO ST. L.J. 59, 73 (2011) (“[H]orizontal commonality was not present in Howey itself because each investor
contracts had "no right of entry to market the crop; thus there [was] ordinarily no right to specific fruit. The company [was] accountable only for an allocation of the net profits based upon a check made at the time of picking."38

Vertical commonality, the other principal type of commonality for purposes of Howey's investment contract definition, focuses on the relationship between the promoter and the investors, eliminating the requirement that investors pool their funds.39 The Ninth Circuit has stated that "[a] common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."40 Thus, strict vertical commonality (as the Ninth Circuit standard has been labeled) describes a venture in which the principals or promoters do not make a profit until the investors make a profit. In other words, strict vertical commonality requires a link between investment performance and promoter remuneration.41 The promoter must have a financial stake in the investment, and the "fortunes of the investor [are] commingled with, and dependent upon the success of the promoter."42

Other courts have rejected this narrow definition of a common enterprise in favor of a more open inquiry. The resultant broad vertical commonality test merely recognizes the existence of a relationship between the promoter's efforts and the investor's profits. "[T]he requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the [promoter's efforts]."43 Accordingly, broad vertical commonality requires a relationship between investor and promoter, but does not require that the promoter actually benefit in a manner consistent with the benefit promised to the investors (i.e., the promoter's remuneration need not be dependent upon the success of the

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

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38. Howey, 328 U.S. at 296.
41. Borsani, supra note 34, at 9–10.
42. Id. "[T]he Ninth Circuit is the only circuit that follows this approach." Id at 10.
venture, but the investor’s profits must be dependent upon the promoter’s expertise and labor). Although the circuits differ on the exact scope of the “common enterprise” requirement, horizontal commonality (which often, but not always, exists regardless of the nature of any vertical commonality in a potential investment contract arrangement) is sufficient to satisfy this prong of the Howey test in most federal courts.

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

With respect to the “solely from the efforts of a promoter or a third party” prong in Howey (commonly shortened to “solely from the efforts of others”), federal circuit court decisions have established that the proper analysis is not whether the efforts of others are the exclusive determinants of the investors’ profits, but rather “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” Although the Court has not directly endorsed this relaxed interpretation, it “appears to have acquiesced in [this] formulation.” As a result, the definition of broad vertical commonality is effectively synonymous with the “efforts of others” test, conflating two of the Howey test prongs—the existence of a common enterprise and the generation of profits from the

44. Borsani, supra note 34, at 10 (citing SEC v. Cont’l Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974)).
45. Id. at 12.
47. SEC v. Edwards, 540 U.S. 389, 394 (2004) (“There is no reason to distinguish between promises of fixed returns and promises of variable returns for the purposes of the test, so understood.”).
48. Howey itself used this terminology. SEC v. W.J. Howey, 328 U.S. 293, 301 (1946) (“The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”).
49. SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973); see also SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974) (“[A] close reading of the language employed in Howey and the authority upon which the Court relied suggests that . . . we need not feel compelled to follow the ‘solely from the efforts of others’ test literally.”).
50. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAWS 19 (5th ed. 2009). As dictum, the Forman Court acknowledged the Ninth Circuit’s decision in the Glenn W. Turner Enterprises case, 474 F.2d at 482, which “held that ‘the word ‘solely’ should not be read as a strict or literal limitation on the definition of an investment contract.’” Forman, 421 U.S. at 852 n.16. Because this issue was not presented in Forman, the Court expressed no view on this matter in its holding. Id.
efforts of others—in those jurisdictions adopting broad vertical commonality.51

B. Howey Applied in Context

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

However, before applying Howey to crowdfunding interests, we note that some crowdfunding interests are styled as debt instruments. This type of instrument (separately listed under the “security” definition in Section 2 of the Securities Act as a “note, . . . bond, debenture, [or] evidence of indebtedness”52) likely would be analyzed under the “family resemblance” test established in Reves v. Ernst & Young,53 rather than the Howey test. The Reves test begins with a “presumption that every note is a security.”54 The presumption may be rebutted by reference to a Second Circuit “list of instruments commonly denominated ‘notes’ that nonetheless fall without the ‘security’ category.”55 If, however, the instrument is not among those listed,

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

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

51. See Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994) (rejecting broad commonality, and noting that under the concept, “two separate questions posed by Howey—whether a common enterprise exists and whether the investors’ profits are to be derived solely from the efforts of others—are effectively merged into a single inquiry”); Gordon, supra note 37, at 76 (“Broad vertical commonality is present whenever the first, third, and fourth prongs of the Howey test are met—i.e., when there is an investment of money with an expectation of profits solely from the efforts of others. Thus, the broad vertical commonality test eliminates the common enterprise prong of the Howey test.”).


53. See Reves v. Ernst & Young, 494 U.S. 56, 63 (1990) (establishing the family resemblance test in analyzing when “notes,” as debt instruments listed in both the Securities Act and the Exchange Act, are securities).

54. Reves, 494 U.S. 56 at 65 (footnote omitted).

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

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

Given their context, crowdfunding interests styled as equity instruments with profit-sharing components are best seen not only as investment contracts but also as securities under Section 2(a)(1) of the Securities Act as interpreted by Howey and its progeny. Our analysis breaks the Howey test into five parts or prongs. We add to that analysis a brief discussion of

56. Id. at 65–67 (citations omitted).
57. See Bradford, supra note 4, at 21–25 (engaging in an analysis of whether crowdfunding interests styled as debt instruments are securities and concluding that "crowdfunding notes that promise to pay interest to investors would probably be securities under the Reves test.").
59. The more standard framework for analysis separates the investment contract definition into three or four elements. See, e.g., Warfield v. Alaniz, 569 F.3d 1015, 1020 (9th Cir. 2009) (applying Howey in three parts but acknowledging that others use a four-part test); United Am. Bank v. Gunter, 620 F.2d 1108, 1116 (5th Cir. 1980) (referring to "application of the four-pronged Howey-Forman test"); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 (5th Cir. 1974) ("[The Howey test] subsumes within it three elements: first, that there is an investment of money; second, that the scheme in which an investment is made functions as a common enterprise; and third, that under the scheme, profits are derived solely from the efforts of individuals other than the investors.").
context. To illustrate our analysis, we use one of the crowdfunding websites featured in Table 1, 33needs, as our primary example.60 Except as otherwise noted in the analysis set forth below, we assume that U.S. law applies to the purchase of the subject crowdfunding interests.61

1. Contract, Transaction, or Scheme

Beginning with the first prong of the Howey test, the language, “contract, transaction or scheme” is seemingly broad enough to cover all crowdfunding business operations. However, we have found no court decision defining these terms in this context. Jurists and legal scholars easily pass over this component of the Howey test and consider it satisfied because of its ostensible breadth.62 In relevant part, the Howey Court notes that the overall investment contract definition it propounds originates from earlier state law opinions,63 and that it is “immaterial whether the shares in

60. See 33NEEDS, http://www.33needs.com/ (last visited Sept. 9, 2011). We chose this site as our example because it allows for a more detailed treatment of the “investment of money” part of the Howey test. In the interest of full disclosure, it must be noted here that one of us (Professor Heminway) has been in communication with the founder of 33needs.com since January 2010. We note that, at the time final edits were made to this article, the 33needs website had been taken down in anticipation of a site redesign and redevelopment “to take advantage of the likely legislative changes re equity ownership.” Email message from Josh Tetrick to Joan Heminway, Nov. 22, 2011 12.58 PM (on file with the Tennessee Law Review). The 33needs example (which was included in prior versions of the article made available on the Social Science Research Network, http://www.ssrn.com) remains a salient one, however, and we have chosen to retain it here.

61. Having assumed this, we note that the jurisdictional reach of the U.S. securities laws in this context is an unclear matter. Rule 901 of Regulation S under the Securities Act provides that “[f]or the purposes only of section 5 of the Act, the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States.” 17 C.F.R. § 230.901 (2011) (citation omitted). Under Regulation S, an offer or sale occurs outside the United States when it is made in an “offshore transaction,” which requires (among other things) that the offer not be made to a person in the United States and that any sale transaction meet other specified requirements. 17 C.F.R. § 230.903 (2011). This may not be as simple as it sounds. Moreover, despite a recent U.S. Supreme Court case, Morrison v. Nat'l Australia Bank, Ltd. 130 S. Ct. 2869 (2010), attempting to clarify the extraterritorial reach of the key antifraud provision applicable to purchases and sales of securities, Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78j(b) (2006), questions also remain as to the application of the Morrison rule in specific cases.

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

63. SEC v. W.J. Howey, 328 U.S. 293, 298 (1946). These opinions provide important background and context, but offer little in the way of content not embodied in the Howey
the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.\footnote{Id. at 299.} Moreover, as the Howey case illustrates, a unitary legal contract is not required.\footnote{Id. at 300 (noting that the plaintiffs' "respective shares in this enterprise are evidenced by land sales contracts and warranty deeds."); \textit{see also} SEC v. Edwards, 540 U.S. 389, 391 (2004) (involving the sale of payphones "packaged with a site lease, a 5-year leaseback and management agreement, and a buyback agreement"); Hocking v. Dubois, 885 F.2d 1449 (9th Cir. 1989) (involving the purchase of a condominium packaged with several rental agreements).} None of these offers definitive guidance on the meaning of Howey's first prong.

The words "transaction" and "scheme" do not have an accepted legal meaning. In common American English usage, the word "transaction" means "something transacted; especially: an exchange or transfer of goods, services, or funds;"\footnote{MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 1327 (11th ed. 2003). Similarly, \textit{Black's Law Dictionary} defines a "transaction" as: "(1) The act or an instance of conducting business or other dealings; . . . . (2) Something performed or carried out; a business agreement or exchange. (3) Any activity involving two or more persons." \textit{BLACK'S LAW DICTIONARY} 1635 (9th ed. 2009).} the word "scheme," in this context, means "a plan or program of action; especially: a crafty or secret one."\footnote{MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 1110 (11th ed. 2003). \textit{Black's Law Dictionary} defines a "scheme" as: "(1) A systematic plan; a connected or orderly arrangement, esp. of related concepts." \textit{BLACK'S LAW DICTIONARY}, \textit{supra} note 66, at 1462.} These terms have expansive meanings, and the Court tacitly embraced them in the Howey opinion in the description of its overall "investment contract" definition:

\begin{quote}
It permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.\footnote{Howey, 328 U.S. at 299 (citation omitted).} 69. For example, 33needs describes
\end{quote}

one or more promisors and one or more promisees having legal capacity to enter into the contract; at least one promisor or one promisee who is an individual party on but one side of the contract, as distinguished from membership in an entity
the investment\textsuperscript{70} process in the frequently asked questions (FAQ) part of its website:

\textbf{How do I invest?}

So simple: just click the big invest button on any company page. You’ll be asked to select your investment amount. From there, you will go through Amazon.com’s secure and uber simple checkout process.\textsuperscript{71}

Accordingly, the investment is made in the form of a standard e-commerce purchase and sale accomplished by either paying funds from a checking account or using a debit or credit card. Under U.S. law, Internet purchases generally are acknowledged to be valid, binding, and enforceable contracts if made by persons having legal capacity.\textsuperscript{72} Interestingly, the 33needs website expressly raises questions about both extraterritoriality and the legal capacity of investors.\textsuperscript{73}

\textbf{Can I invest if I’m not in the US?}

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

\ldots

\footnotesize

which may be a party on the other side; a manifestation of mutual assent by the parties who form the contract, to the terms of the contract and by each promisor to the consideration for a promise, with limited exceptions; sufficient consideration, again with limited exceptions; and a requirement that the transaction must not be one declared void by statute or by special rules of the common law.

RICHARD A. LORD, \textit{1 WILLISTON ON CONTRACTS} § 3:2, at 270–72 (4th ed. 2007) (footnotes omitted); see also 17A AM. JUR. 2D \textit{Contracts} § 19 (2004) ("The elements of a valid contract have been stated as . . . an offer, acceptance, contractual capacity, consideration, a manifestation of mutual assent, and legality of the object and of the consideration.").

70. The use of the word “investment” is not meant to convey a legal conclusion for purposes of the \textit{Howey} test or otherwise. Rather, it is the term used for purchases of interests on the 33needs website. See \textit{FAQ}, \textsc{33needs}, http://www.33needs.com/pages/faq (last visited Sept. 2, 2011) (noting in particular the response to “I’m confused. Why do you call this an investment?”).

71. \textit{FAQ}, \textsc{33needs}, \textit{supra} note 70.

72. See JEFFREY H. MATSUURA, \textsc{Security, Rights, and Liabilities in E-commerce} 185 (Artech House 2001). See generally U.C.C. § 2-204(4)(b) (2004) ("A contract may be formed by the interaction of an electronic agent and an individual acting on the individual’s own behalf or for another person.").

73. Again, “investors” is the word used on the 33needs website and its use is not intended to convey a legal conclusion. See \textit{FAQ}, \textsc{33needs}, \textit{supra} note 70.
Do investors need to be a certain age?

Investors who participate can be any age.

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

Not at all.74

Regardless of whether the purchase of crowdfunding interests constitutes a valid, binding, and enforceable contract, the purchase by funders of a crowdfunding interest qualifies as a transaction or scheme—a plan or program to finance a business or project through the exchange of funds for profit-sharing interests. Even before Howey, the Court noted that the inclusion of terms such as “investment contract” in the Securities Act evidences a legislative intent to bring “novel, uncommon, or irregular devices” under the coverage of the Securities Act in some circumstances.75 While crowdfunding is a fairly distinctive and new phenomenon, it is difficult to fathom how a financing plan or program that involves the exchange of funds for profit-sharing interests in a third-party’s venture over the Internet would not qualify as a contract, transaction, or scheme under the Howey test.

2. Investment of Money

A number of crowdfunding business models involve people spending money with the prospect of getting more money back, seemingly satisfying the second prong of the Howey test. As shown in Table 1, many crowdfunding websites offer funders a financial return on the interests purchased.76 When such a return is offered, it is usually in the form of a

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74. Id.
75. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943); see also SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (“By including an investment contract within the scope of [Section] 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by . . . prior judicial interpretation,” under which state courts had construed the term broadly “so as to afford the investing public a full measure of protection.”).
76. There are, however, many crowdfunding websites that do not offer traditional financial returns (in the form of capital appreciation or a participation in earnings) to funders. For example, Kiva is a microfinancing venture that secures loans for start-up businesses in lesser-developed countries. See How Kiva Works, Kiva, http://www.kiva.org/about/how (last visited Dec. 26, 2011). The funders receive repayments of the principal of their loans with no interest. Id. Additionally, VenCorps provides start-up capital and enables funders to earn points for their contributions, which can be redeemed for various non-financial goods and services. FAQ, VENCORPS, http://www.vencorps.com/Page/FAQ#funder (last visited Dec. 26, 2011). For example, the VenCorps store might offer an iPad to be auctioned off to funders who bid points for the product. Id. This type of funding model is
revenue-sharing or profit-sharing arrangement. Examining this bargain in isolation, there appears to be a clear income-seeking intent and motive on the part of funders.

However, dicta in the Howey case, which was subsequently cited and applied by the Court in Forman, raises a question as to whether all exchanges of money made in the hopes of getting a return are investments of money for the purpose of determining the existence of an investment contract. Specifically, the Howey Court noted that the purchasers of the land and contracts were “attracted solely by the prospects of a return on their investment.” Many crowdfunding websites raise funds to support the production of goods and services by artists and others, and these crowdfunded ventures often reward funders with free or discounted products or services created or sold by the funded business. For example, in May 2011, 33needs featured a business venture, More than Me, Inc., that “funds the education of girls in Liberia by selling laptop covers, which are made by local Liberian women.” On the 33needs website, More than Me promises investors a return of “5% of our revenue for 1 year. . . . If you invest $100 or more, you’ll get one of the first 100 laptop slip covers.”

33needs also plans to offer other benefits to investors based on the number of “impact points” investors earn in funding featured businesses. The less likely to be an investment contract under Howey. We question, however, whether the regulation of crowdfunding should turn on this difference.

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

See Forman, 421 U.S. at 852; Howey, 328 U.S. at 300.

Howey, 328 U.S. at 300.

For example, SellaBand is a crowdfunding site that supports music artists and entitles funders to “[r]eceive free downloads and other goodies artists might offer like exclusive CDs, t-shirts, free lunches etc.” How It Works, SELLABAND, https://www.sellaband.com/en/pages/how_it_works (last visited Dec. 26, 2011). Peerbackers is another website that funds start-up businesses where funders receive various “rewards or perks” at the entrepreneurs’ discretion. FAQ, PEERBACKERS, http://peerbackers.com/faq (last visited Dec. 26, 2011). Because financial rewards are strictly prohibited, the rewards are usually in the form of products created by the enterprise. Id.


Id.

FAQ, 33NEEDS, supra note 70.
hybrid nature of the benefits offered on some crowdfunding websites blurs the line between investment and consumption as set forth in Forman.\textsuperscript{84} The 33needs venture raises additional concerns about the investment of money under Howey and Forman. 33needs focuses on social enterprise funding and markets itself as a financing venture for social entrepreneurs.\textsuperscript{85}

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

Social entrepreneurs. They lead companies solving the world’s biggest needs, also known as social enterprises. You’ve heard of them, right? If not, just Google it.\textsuperscript{86}

As demonstrated above, 33needs encourages funders to finance the ventures it features based on more than a classic investment or consumption interest. It markets and sells altruism (funding a better world) and meaningfulness (the emotional satisfaction of having an individual impact):

**This is just about the money, then?**

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

**What’s the larger point, though?**

Put simply: it’s all about maximizing social and environmental impact. Nothing else matters. Thousands of entrepreneurs need a disruptive financial innovation: a way to connect with the vast pool of capital in the hands of our friends, our family, and the growing number of people who believe business-led solutions allow for a deeper, more sustained impact than old models. We think impact investing can play a crucial role in solving our world’s biggest needs. That’s why we’re here.\textsuperscript{87}

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

The hybrid nature of the motivation of purchasers of crowdfunding interests is, however, unlikely to change the conclusion that crowdfunding interests represent an investment of money. In deciding subsequent

\textsuperscript{84} See supra note 32 and accompanying text.  
\textsuperscript{86} FAQ, 33NEEDS, supra note 70.  
\textsuperscript{87} Id.
investment contract cases, federal courts generally have given little effect to the language in Howey referencing investors attracted “solely by the prospects of a return on their investment.” For example, in Teague v. Bakker, a case involving “approximately 160,000 individuals who purchased ‘Lifetime Partnerships’ from an entity known as ‘PTL’ entitling them to a short stay annually in a hotel at a vacation retreat constructed by PTL,” the court did not give dispositive weight to testimony from some purchasers that their motivation was personal use of the hotel rather than profit:

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

In Teague, the court relied on the promotional materials used to solicit purchases to find that the Lifetime Partnerships may represent an investment of money with the expectation of profit. Interestingly, the Howey Court offered a similar analysis in determining that an investment contract existed:

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

Crowdfunding websites that offer returns to their funders promote the revenue-sharing or profit-sharing components of that return. For example, each of the featured businesses on 33needs has its own page on the 33needs website that includes an “offer” to the investors. This page is where the return on investment is described. In addition, the FAQ page on the 33needs website clearly distinguishes the capital investments it seeks from donations.

89. Teague v. Bakker, 35 F.3d 978, 981 (4th Cir. 1994).
90. Id. at 988 n.12.
91. Id. at 988–89.
92. Howey, 328 U.S. at 300–01 (footnote omitted).
and loans, noting that financial rewards are a fundamental, unique part of the bargain in funding one of its ventures:94

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

We’re the only platform in the world that enables ordinary people — you, neighbor Joe, Aunt Sally, and even your dog Jake (fine, maybe not Jake) — to invest in do-good companies (called social enterprises) and earn financial rewards. For example: 20,000 people could invest, not donate, $50 each in More than Me, Inc., one of the companies raising money on 33needs.95

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

Some cases analyzing investment contracts have focused on whether the primary, rather than exclusive, purpose of the arrangement is to provide a return to funders.96 Accordingly, in the case of crowdfunding websites or crowdfunded ventures that offer both non-financial benefits and financial return, the satisfaction of the Howey test may depend upon whether the primary purpose of the arrangement is affording funders preferential access to goods or services, offering them emotional satisfaction, presenting them with an opportunity to contribute to the public good, or providing them a financial return. Although there are variations among the financing arrangements on crowdfunding websites we have reviewed, the potential financial return on the crowdfunding interests described in Table 1 as offering “hybrid returns” may have a significantly higher potential value than the non-financial interest offered.97 This value disparity may

94. FAQ, 33NEEDS, supra note 70.
95. Id. (emphasis added).
96. See Int’l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979) (holding that involvement in a mandatory pension plan was not an investment contract). The Court stated, “[l]ooking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment.” Id. (emphasis added); see also Aschenbach v. Covenant Living Centers-North, Inc., 482 F. Supp. 1241, 1244 (E.D. Wis. 1980) (“[R]esidency contracts, which are not transferrable or assignable, are entered into for the primary purpose of acquiring low cost living space, with the added feature of low cost maintenance and health care, and not for ‘profit’ in the sense intended by the Supreme Court in Howey and Forman.”).
97. For example, SellaBand offers a revenue-sharing arrangement (at the artist’s discretion) as well as music downloads, CDs, and t-shirts signed by or promoting the artist. How it Works, SELLABAND, supra note 80. However, there is no limit on the amount that an individual funder may contribute. This creates the potential for huge differences between the monetary values of the financial and non-financial interests funders may receive. For example, as a result of a large contribution, a funder on SellaBand could be entitled to a large percentage of revenue, which would have a much greater value than the non-financial
encourage funders to purchase crowdfunding interests, rather than, for example, buy goods or services from a traditional brick-and-mortar or online retailer, where a consumption interest also is involved or contribute to a charity that funds a social project, where altruism or the public good is an objective. In other words, a higher potential value of the financial rewards promised on a crowdfunding website may support the conclusion that the site is primarily offering a revenue-sharing or profit-sharing arrangement. Under these circumstances, it is hard to argue that the funder’s primary purpose in purchasing crowdfunding interests on these websites is not the investment of money.

Finally, in determining whether a contract, transaction, or scheme represents an investment of money, some courts focus on whether the arrangement subjects the funder to a loss. Under this analysis, which is sometimes seen as the equivalent of a risk capital analysis, crowdfunding interests may represent a form of financing that subjects the funder to the loss of his or her initial investment. Crowdfunding interest purchasers typically have little or no control over the success of the business they fund, and unless funds are conveyed in the form of a debt instrument, have no right to a return of their capital (although many equity-type crowdfunding interests (i.e., music downloads, CD, t-shirts, etc.).

98. See, e.g., Becks v. Emery-Richardson, Inc., No. 86-6866, 1990 U.S. Dist. LEXIS 21066, at *36 (S.D. Fla. July 6, 1990) (“Generally, an ‘investment’ in this context means that the investor commits his assets to an enterprise or venture in such a manner as to subject himself to financial loss.”).

99. See, e.g., Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985) (outlining a Ninth Circuit risk capital test that was used to determine whether notes are securities prior to the Court’s opinion in Reves v. Ernst & Young, 494 U.S. 56 (1990)). In the investment contract context under our framework, the risk capital test is typically used to assess the combination of the second, fourth, and fifth prongs of the Howey test. First Citizens Fed. Sav. & Loan Ass’n v. Worthen Bank & Trust Co., N.A., 919 F.2d 510, 516 (9th Cir. 1990). Given its substantial overlap with key parts of the Howey test, the risk capital test sometimes is seen as an alternative to the Howey test. See, e.g., Martin v. T. V. Tempo, Inc., 628 F.2d 887, 891 (5th Cir. 1980) (“Plaintiffs urge that the district court erred in failing to analyze the franchise agreement under the so-called ‘risk capital’ approach. We previously have taken note of this alternative to the Howey test . . . .”). In its modern formulation, the “risk capital” test examines four factors:

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

business models provide that capital will be returned if a stated funding threshold is not met.

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

3. Common Enterprise

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

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

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

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

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

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

With respect to vertical commonality, only broad vertical commonality exists in the typical crowdfunding model. Investor success is generally dependent on the combined efforts of the crowdfunding website and the crowdfunded venture. In most cases, a crowdfunding website (one that is unaffiliated with the crowdfunded ventures it promotes) takes a fee or

100. See infra note 102 and accompanying text.
101. See supra notes 2–3 and accompanying text. The 33needs website references the pooling of funds, classifying crowdfunding as "the collective cooperation by people who network and pool their money together." Mission, 33NEEDS, supra, note 85.
102. FAQ, 33NEEDS, supra note 70.
103. See supra text accompanying note 44.
commission once the featured venture’s funding target is achieved and has no ongoing interest in the success of that venture parallel to that of the funders. However, if a crowdfunding website takes a percentage of the featured business’s revenues or profits along the same lines as the funders, strict vertical commonality may exist.

The 33needs website is silent as to the nature of the compensation or financial benefit, if any, that it receives for promoting the featured ventures, but the principal of 33needs confirmed that 33needs takes a 5% fee from any venture that successfully reaches its funding target. The FAQ portion of the website is clear, however, about the fact that 33needs does not take an ownership or intellectual property interest in the enterprises it features. Accordingly, 33needs exhibits broad vertical commonality only.

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

4. Expectation of Profits

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

104. For example, IndieGoGo provides funding for various entrepreneurial projects and causes for which it takes 4% of the funded amount, but retains no on-going interest in the funded venture. FAQs, INDIEGOGO, www.indiegogo.com/about/faqs (last visited Dec. 26, 2011). Similarly, Kickstarter provides funding for artists’ projects and charges 5% of the funded amount, but the project’s success is entirely in the artists’ hands. FAQs, KICKSTARTER, www.kickstarter.com/help/faq (last visited Dec. 26, 2011).


106. FAQ, 33NEEDS, supra note 70 (“Does 33needs or investors on 33needs take some percentage of ownership or intellectual property in the social enterprises? Absolutely not.”).

107. See supra notes 35–36 and accompanying text.

108. See supra text accompanying notes 77–79.

109. See supra Part II.B.2.
There are some crowdfunding websites (typically sites offering debt-type interests) that offer a fixed return to funders.\textsuperscript{110} Offering this type of benefit arrangement (in lieu of revenue-sharing or profit-sharing) is sufficient to satisfy the expectation of profits prong of the \textit{Howey} test.\textsuperscript{111}

Crowdfunding websites do not typically allow funders to benefit through capital appreciation, the other type of financial return recognized as profit under the \textit{Forman} case.\textsuperscript{112} Although most sites do not address the issue, there is no apparent web-based mechanism for transferring crowdfunding interests to others. The interests, however, constitute personal property and therefore should be assignable. Moreover, with minor exception, there is no evidence that a market exists for the transfer or assignment of all or some rights in crowdfunding interests.\textsuperscript{113} However, if a market were to develop, the expectation of profits from capital appreciation also would be possible.

Those who purchase crowdfunding interests that promise a current return or capital appreciation expect profits under \textit{Howey}.

5. Solely from the Efforts of Others

The “solely from the efforts of others” prong of the \textit{Howey} test\textsuperscript{114} also is met with respect to almost every crowdfunding business. Under many crowdfunding business models, the funder serves as a passive patron while the principals of the crowdfunded venture, with some marketing or logistical support from the crowdfunding website, are responsible for the venture’s success or failure.\textsuperscript{115} In a few instances we have observed, the funder plays a minor role in selecting, promoting, or conducting the crowdfunded venture.\textsuperscript{116} Regardless of the funders’ exact level of

\textsuperscript{110} Microplace is a microfinancing operation that allows funders to contribute money in the form of a loan to entrepreneurs in less-developed countries. \textit{How It Works: Overview}, MICROPLACE, https://www.microplace.com/howitworks (last visited Dec. 26, 2011). The funder is entitled to a return of the funded amount plus interest. Id. Similarly, 40Billion provides start-up funds for businesses, on an invitation-only basis, and the funder is entitled to repayment of the principal plus interest. \textit{How It Works}, 40BILLION, www.40billion.com/how_it_works.asp (last visited Dec. 26, 2011).

\textsuperscript{111} \textit{See supra} note 47 and accompanying text.

\textsuperscript{112} \textit{See supra} note 46 and accompanying text.

\textsuperscript{113} One site that aims to facilitate a market for crowdfunding shares is Cinema Shares, which plans to allow for the purchase of fully listed, publicly tradable on NASDAQ. \textit{About Cinema Shares}, CINEMA SHARES, www.cinemashares.com/aboutCS.html (last visited Dec. 26, 2011).

\textsuperscript{114} SEC v. W. J. Howey Co., 328 U.S. 293, 300 (1946).

\textsuperscript{115} \textit{See} Belleflamme et al., \textit{supra} note 3, at 3 (“The major fraction are passive investments; i.e., investments with a promise of compensation but no direct involvement in the decision-making process or provision of time or expertise for the initiative.”).

\textsuperscript{116} For example, funders who choose to participate as “believers” on SellaBand also can support the artists of their choice in other ways:
involvement in a crowdfunded venture, the bulk of the efforts contributing to the venture's success is supplied by the principals of the crowdfunded venture, with some support (typically administrative and ministerial) from the crowdfunding website.\textsuperscript{117}

The crowdfunding website's level of engagement in the operations of the crowdfunded venture varies in different crowdfunding models. 33needs, for example, pre-screens the businesses that are featured on the site:

To date, 33needs has received over 900 applications from entrepreneurs around the world. We have a 4-person investment committee that reviews, interviews, and selects companies. Sometimes we select them individually, sometimes collectively. We look at the strength of the business model, integrity of the team, and the nature of the need being addressed. We tend to focus on urgent needs.\textsuperscript{118}

In addition, while 33needs states that the funded ventures are responsible for upholding the commitments (“offers”) they make to investors,\textsuperscript{119} it also promises that it will “be working closely with them to make sure all is right.”\textsuperscript{120}

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

\textbf{C. The Question of Context}

Under Section 2(a)(1) of the Securities Act, an investment contract is a security “unless the context otherwise requires.”\textsuperscript{121} Section 2's introductory

\begin{flushleft}
On SellaBand you can support your favorite artists by buying a part and helping them to raise the funds for a new music project (a new album, tour or the promotion of their music). . . . Join your favorite artists on their way to reach their funding goal. Promote them, stay in touch with them and help them.

\textit{How It Works}, SELLABAND.COM, \textit{supra} note 80.
\end{flushleft}

117. \textit{Id.}
118. \textit{FAQ}, 33NEEDS, \textit{supra} note 70.
119. \textit{Id.} (noting that the ventures, themselves, are “responsible for making sure [they] deliver on what they promise”).
120. \textit{FAQ}, 33NEEDS, \textit{supra} note 70.
limitation regarding context is seldom used to disqualify an instrument listed in Section 2(a)(1) from being a security. However:

courts have held that the definition of what constitutes a security need not be read literally, thereby giving meaning to the introductory language of the definition, "unless the context otherwise requires." Stressing that the Acts were aimed at preventing fraud in the securities market, the Supreme Court has stated that "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." This is the examination which must be made "in searching for the meaning and scope of the word 'security'"—"form should be disregarded for substance and the emphasis should be on economic reality."1

As the Supreme Court has explained, "[t]he test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect . . . [I]t is not inappropriate that promoters' offerings be judged as being what they were represented to be."12 For example, court opinions assessing the status of "notes" under Section 2(a)(1) have used the context limitation to find that certain notes are not securities for purposes of the Securities Act.124 The determinative factor in these cases is whether the note is a commercial instrument or an investment instrument.125 In the same vein, the Supreme Court elevated substance over terminology in United Housing Foundation v. Forman126 when it determined that interests in a housing cooperative were not securities despite the fact that the interests were labeled as "stock," one of the instruments listed in the security definition.127

124. See Hunssinger v. Rockford Bus. Credits, Inc., 745 F.2d 484, 487 (7th Cir. 1984) ("[T]his as well as other Circuits have relied upon the prefatory phrase 'unless the context otherwise requires' to exclude certain notes from the protection of the federal securities acts."); see also Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979) ("Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires'").
125. Hunssinger, 745 F.2d at 488.
127. Id. at 851 ("noting that the interests at issue lack what the Court in Tcherepnin deemed the most common feature of stock: the right to receive 'dividends contingent upon an apportionment of profits'" and also fail to "possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the numbers of shares owned; and they cannot appreciate in value." (citation omitted)).
The key to analyzing context hinges on whether the financial instrument at issue represents a financial investment vehicle. In this regard, the Supreme Court in *Reves* stated, "A commitment to an examination of the economic realities of a transaction does not necessarily entail a case-by-case analysis of every instrument, however. Some instruments are obviously within the class Congress intended to regulate because they are by their nature investments." Because the *Howey* test, as applied, includes an evaluation of a contract, transaction, or scheme as an investment of money, our analysis in Part II.B.2 already establishes the necessary context. Crowdfunding interests that include revenue-sharing or profit-sharing benefits appear to be equity-type capital investment vehicles despite the potential other benefits they may offer (e.g., consumption interests and altruistic and emotional satisfaction). Although we recognize that crowdfunding interests are unique and flexible devices, these attributes do not exempt them from regulation:

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

The analysis in this Part II demonstrates that crowdfunding interests that include a financial return are offered under terms and in courses of dealing that establish their character in commerce that are investment contracts and securities under *Howey* and its progeny.

III. FEDERAL REGULATION OF OFFERINGS OF CROWDFUNDING INTERESTS AS SECURITIES

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

A. Applicable Regulation

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

1. Registration and Related Liability and Costs

Section 5 of the Securities Act regulates the offer and sale of securities.133 In sum, Section 5 prohibits the offer or sale of securities without registration, unless an applicable exemption is available.134 An “offer for sale” or “sale” includes “every attempt or offer to dispose of, or solicitation of an offer to buy, a security . . . .”135 These terms are interpreted very broadly, making it quite easy for an offeror or seller of securities to inadvertently violate Section 5 by, for example, communicating with potential investors before filing a registration statement.136 If interests in crowdfunded ventures are securities, then the offer and sale of those interests through a crowdfunding website must be registered with the SEC, absent an applicable exemption. A parallel system of registration exists under state law.

If securities are offered or sold in violation of Section 5, Section 12(a)(1) provides the securities purchaser with a private cause of action

133. 15 U.S.C. § 77e.
134. Id.
136. See Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567, 606 (1997) (“Section 5 sweeps broadly, regulating every offer and sale of a security.”); Joseph F. Morrissey, Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005, 56 CATH. U. L. REV. 561, 568 (2007) (“Section 5(c) of the Securities Act specifically made it unlawful for any person to offer to sell or buy securities before a registration statement had been filed with the SEC.” “Section 2(a)(3) of the Securities Act defined “offer” as broadly as it could . . . .”).
against the seller, allowing for rescission of the sale, or recovery of rescissory damages if the purchaser no longer owns the securities.\footnote{137} False and misleading registration statements are actionable under Section 11 of the Securities Act,\footnote{138} false and misleading prospectuses or oral communications may result in liability under Section 12(a)(2) of the Securities Act,\footnote{139} and fraudulent conduct in connection with the offer and sale of securities may be enforced (at least by the SEC) under Section 17(a) of the Securities Act.\footnote{140} Further, those who offer and sell securities are exposed to potential liability for securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”),\footnote{141} and Rule 10b-5 under the Exchange Act.\footnote{142}

This is a heavy system of regulation. Registration of the offer and sale of securities under the Securities Act is an expensive and time-consuming proposition, and the prospect of lengthy, costly enforcement actions by private plaintiffs (in individual or class actions), the SEC, and the Department of Justice loom large. As for the federal registration requirements, an issuer must file a registration statement that includes operating and financial disclosures about the issuer, information about the securities being offered and sold, and details about the plan of distribution of those securities.\footnote{143} The costs of an initial SEC registration typically include underwriting compensation, a registration fee paid to the SEC, legal and accounting fees and expenses, printing and engraving costs, a Financial Industry Regulatory Authority filing fee, electronic filing fees when using a service for filing, stock exchange listing fees (if applicable), Blue Sky filing fees (if applicable), and transfer agent and registrar fees when the issuer retains the services of a third party to handle its stock records.\footnote{144} Although

\begin{itemize}
\item 137. 15 U.S.C. § 77l(a)(1).
\item 138. 15 U.S.C. § 77k.
\item 139. 15 U.S.C. § 77l(a)(2).
\item 140. 15 U.S.C. § 77q(a); In re Washington Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1353–54 (9th Cir. 1987).
\item 141. 15 U.S.C. § 78j(b). Although the Exchange Act has its own definition of the term “security,” the definitions under the Securities Act and the Exchange Act are substantially similar, and result in only small differences in application. \textit{See} JAMES D. COX ET AL., \textbf{SECURITIES REGULATION: CASES AND MATERIALS} 19 (6th ed. 2009) (“The ‘33 Act and the ‘34 Act have substantially similar definitions of a security.”). Furthermore, the regulatory schemes of the two acts are integrated, with the Securities Act regulating offers and sales of securities generally and the Exchange Act largely governing trading transactions on and through securities markets and market professionals. \textit{See} COX ET AL., supra, at 7 (“Whereas the Securities Act grapples with the protection of investors in primary distributions of securities, the Exchange Act’s concern is trading markets and their participants.”).
\item 142. 17 C.F.R. § 240.10b-5 (2011).
\item 143. \textit{See} 15 U.S.C. § 77g; COX ET AL., supra note 141, at 143–47.
\item 144. \textit{See} COX ET AL., supra note 141, at 156 (setting forth in Note 4 various external and internal costs of going public); 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.
certain offerings cost somewhat less because of the nature of the issuer or the offering (and offering costs are significantly higher for large and complex offerings), an initial public offering for even a small business will cost the issuer over $100,000 in fees for third-party services alone, and this figure does not include the value of the time senior management spends preparing for and marketing the offering. Small business issuers may have lower registration costs than large businesses in some regards, but the overall relative costs are high:

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

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

Add to these expenses the ongoing costs of being public, which, depending on the issuer’s assets and equity ownership, may be a long-term

L. & BUS. 1, 8–9 (2007) ("Moreover, regardless of the outcome of the offering, the costs of the registration process are heavily front-loaded. Accounting fees, attorney retainers, SEC filing fees, broker-dealer expenses, printing and road show costs are all incurred and become payable prior to the effective date of the registration statement.").

145. One commentator accurately sums up the cost situation:

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

C. Steven Bradford, Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption, 5 J. SMALL & EMERGING BUS. L. 1, 24 (2001); see also Cox et al., supra note 141, at 156 ("The estimated 2007 costs for a significant IPO are $600,000–$800,000 in fees to counsel, $400,000–$600,000 for the auditor, underwriter commissions of typically 7 percent of the offering amount, $150,000–$200,000 in printing costs, plus various filing fees . . . ."); Marvin E. Rooks, It Is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees, 11 WAKE FOREST J. BUS. & INTELL. PROP. L. 55, 66 (2010) ("The SEC’s initial public offering . . . process for even a small company (less than $20 million in revenue) takes six to nine months and costs at least $100,000 in fees for legal, accounting, audit, printing, filing fees, and underwriter commissions.") (footnote omitted).

proposition, and a small business issuer will typically find that the costs of a registered public offering (even without taking into account the prospect of private and public enforcement actions) outweigh the benefits. Registration typically takes several months (at a minimum) because of the length and complexity of the registration statement, the regulatory filing and review process, and the marketing and sales activities. As a result, issuers may miss important financing opportunities because favorable market conditions for an offering (so-called "market windows") will pass unutilized if the offering's registration statement has not yet been declared effective. Missing a market window can be especially devastating to small business issuers who can ill afford to lose the sunk costs expended in initiating and completing the registration process.

The costliness and protracted nature of the registration process are unfortunate because the registration process has a number of advantages for small businesses (as well as other issuers):

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

147. Cohn & Yadley, supra note 144, at 9 ("Once public, the company is now subject to the periodic reporting obligations of the . . . Exchange Act . . . for at least the remainder of the first year . . . . These reporting and regulatory burdens weigh extraordinarily heavily on public-traded small businesses, prompting both administrative and legislative efforts to modify such requirements for small business issuers." (footnote omitted)); see Cox et al., supra note 141, at 156 ("The publicly traded company incurs the burden of complying with the periodic reporting requirements of the '34 Act. While out-of-pocket costs may be trivial in relation to the registrant's assets or income, the more significant costs are those associated with the consciousness of operating in the public eye.").

148. See Campbell, supra note 146, at 91-92 ("Registration has never been a viable way for small businesses to raise capital. High transaction costs associated with registered offerings inevitably put registration out of the range of small businesses in search of capital. Thus, the data show that small offerings are very rarely made through SEC registration." (footnotes omitted)); Cohn & Yadley, supra note 144, at 10 ("The combined effect of the costs imposed by the registration process and the post-registration reporting system is generally more than sufficient to convince small businesses that financing through a registered public offering is a most undesirable course.").

149. See Bradford, supra note 4, at 27-28.
CROWDFUNDING

reduces the risk of a material omission of fact that would generate liability under federal antifraud rules.\textsuperscript{150}

Furthermore, with the SEC's recent approval of the NASDAQ OMX BX proposal to establish a new listings market, the "BX Venture Market,"\textsuperscript{151} registration may afford some small business issuers the prospects of accessing a formal public trading market. This market is currently anticipated to launch in 2012.\textsuperscript{152} Listed companies will be required to comply with state, as well as federal, securities laws relating to the offer and sale of securities.\textsuperscript{153}

2. Exemptions from Registration

Despite its regulatory and potential practical advantages, registration is a nonstarter for most crowdfunding websites and crowdfunded ventures because of the expense and prolonged nature of the process. For crowdfunding websites and crowdfunded ventures, as with many other small businesses, the amount of money and time required to register a securities offering will most often prohibit the offering from occurring.\textsuperscript{154} Therefore, under the current regime, the only practical means by which

\textsuperscript{150} Campbell, \textit{supra} note 146, at 92 n.55 (citations omitted); see also Stuart R. Cohn, \textit{The Impact Of Securities Laws On Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?}, 3 J. SMALL & EMERGING BUS. L. 315, 361 (1999) ("The SEC finds two principal benefits from registration—disclosure and the ability to resell securities."). But see Bradford, \textit{supra} note 145, at 28–29 (describing inconclusive benefits of registration).


\textsuperscript{154} See generally Cohn & Yadley, \textit{supra} note 144, at 10–15 (discussing how the current regulatory regime fails to adequately provide opportunities for small businesses); Schapiro Testimony, \textit{supra} note 11, at 1 ("Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations."). We note, however, that at least one crowdfunded business has pursued the registration of a crowdfunded offering. See Audience Prod., Inc., Amendment No. 7 to Form S-1 Registration Statement (Form S-1/A) (Apr. 21, 2010), available at http://www.sec.gov/Archives/edgar/data/1474227/000147422710000015/ds1a.htm. Ultimately, despite extensions of the originally established offering period, this offering was unsuccessful. In a post-effective amendment filed in August 2011, Audience Productions requested deregistration of the shares offered. See Audience Prod., Inc., Post-Effective Amendment No. 6 to Form S-1 Registration Statement (Form S-1/A) (Aug. 8, 2011), available at http://www.sec.gov/Archives/edgar/data/1474227/000147422711000018/dposam.htm.
crowdfunding websites and crowdfunded ventures can offer or sell securities is to find an applicable exemption for the security or offering.

Securities may be exempt under Section 3(a) of the Securities Act. For example, Section 3(a) of the Securities Act exempts securities issued by states and municipalities, charitable organizations, and savings and loan associations. Section 3(a) does not currently provide an exemption for crowdfunding interests.

The few possible transactional registration exemptions under the Securities Act that one would consider in connection with a primary offering of interests in a crowdfunded business include: the private offering exemption under Section 4(2); Rules 504, 505, and 506 of Regulation D; and Regulation A. However, none of these exemptions provides a feasible path for a crowdfunding website or crowdfunded venture to avoid registering the offer or sale of profit-sharing interests in the crowdfunded venture. Part III.A.2 outlines the key attributes of each of these possible exemptions and comments on the unsuitability of each for primary offerings of crowdfunding interests.

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

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

156. Id. § 77c(a)(2), (4), (5).
157. Id. § 77d(2).
158. 17 C.F.R. §§ 230.501–508 (2011) (authorized under Sections 3(b) and 4(2) of the Securities Act).
159. 17 C.F.R. §§ 230.251–263 (authorized under Section 3(b) of the Securities Act).
160. While the intrastate offering exemption, 15 U.S.C. § 77c(a)(11), may be applicable in some situations involving crowdfunding, most crowdfunded ventures seek to raise capital from investors residing in various states. Because of its unlikely applicability in this context, we do not further analyze the possible application of the intrastate offering exemption in the crowdfunding context.
Soon after the Securities Act was signed into law, the SEC’s General Counsel set forth five attributes of offerings that provide guidance on whether the offer or sale of securities is a transaction not involving a public offering under Section 4(2): the number of offerees, the relationship of offerees to each other and to the issuer, the number of units offered, the size of the offering, and the manner of the offering. The overall message was that a securities offering is more likely to be characterized as a public offering if:

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

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

In 1953, the Court decided SEC v. Ralston Purina Co., the seminal case involving the availability of the private offering exemption. In Ralston Purina, the Court refused to impose a numerical limitation as a litmus test for determining whether a public offering has been conducted. The Court’s opinion indicates that the number of offerees is relevant, but not dispositive, to this determination. Instead, the Court found that “the exemption question turns on the knowledge of the offerees.” According to the Court, “the applicability of § [4(2)] should turn on whether the

165. Id.
167. Id. at 125. In this case, Ralston Purina claimed that an offering of treasury stock to its “key employees” was not a public offering. The group of offerees, however, included any employee who wanted to participate in the offering. Id. at 121. Although the Court recognized that some offerings to employees may constitute non-public offerings, the Court determined that, absent special circumstances such as an offering to certain corporate executives, “employees are just as much members of the investing ‘public’ as any of their neighbors in the community.” Id. at 125–26.
168. Id. at 125 (“It may well be that offerings to a substantial number of persons would rarely be exempt.”).
169. Id. at 126.
particular class of persons affected needs the protection of the Act." The Court determined that where the offerees "are shown to be able to fend for themselves," they do not need the protection of the Securities Act's registration requirement, and therefore, the offering should not be characterized as a public offering for purposes of Section 4(2) of the Securities Act.

_Ralston Purina_ and its progeny have established two overarching factors that indicate whether offerees are able to fend for themselves. The first factor is the "sophistication" of the solicited investors. Offerees who possess financial and business knowledge that allows them to appreciate the risks of the investment have been considered sophisticated for these purposes. Sophisticated investors can fend for themselves if they have the appropriate type and amount of information or access to it. Accordingly, the second factor is the information or access to information provided to offerees. Sophisticated offerees provided with substantially the same information—or meaningful access to substantially the same information—as that provided in a registration statement can fend for themselves.

Decisional law after _Ralston Purina_ clarifies that access to information is meaningful when an offeree is able to obtain the information needed to

170. _Id._ at 125.

171. _Id._

172. See SEC v. Murphy, 626 F.2d 633, 646 (9th Cir. 1980) (in which the only evidence of investor sophistication offered was that 60% of the investors were represented by purchaser representatives, suggesting that "at least . . . the majority of the purchasers, if not the majority of offerees, lacked the sort of business acumen necessary to qualify as sophisticated investors"); Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680, 690 (4th Cir. 1971) (recognizing that the sophistication requirement was met where the offering was made "only to sophisticated businessmen and lawyers . . ."); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971) ("The Supreme Court in its description of a possible 'private' group in _Ralston Purina_ includes only persons of exceptional business experience . . ."). As these and other cases illustrate, the concept of sophistication is a bit fluid. See C. Howard Fletcher, III, _Sophisticated Investors Under the Federal Securities Laws_ 1988 DUKE L.J. 1081, 1084–85 (1988) ("[T]he federal courts' treatment of investor sophistication reflects a doctrine in disarray . . . [as] the courts' treatment of sophisticated investors shows little coherence or, if you will, reflects little cross-fertilization among the different settings in which the sophistication issue arises.").

173. The _Ralston Purina_ Court only references access to information. SEC v. Ralston Purina, Co., 346 U.S. 119, 127 (8th Cir. 1953). Subsequent cases in lower courts further developed this aspect of the doctrine. See Hill York, 448 F.2d at 690 ("[T]he relationship between the promoters and the purchasers and the 'access to the kind of information which registration would disclose' become highly relevant factors.") (citation omitted)). The offerees in _Hill York_ had no previous relationship with the issuer at the time of the offering and were given only a few brochures with minimal information about the issuer. _Id._ The court concluded that the offerees "could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest" in the venture because they did not possess the "information requisite for a registration statement." _Id._
make an informed investment decision. If an offeree is not actually provided information akin to that provided in a registration statement, the offeree must have access to that level of information and a relationship with the issuer that reasonably enables the offeree to take advantage of the access to ascertain the information. Therefore, if the issuer does not disclose the requisite information to the offerees, the issuer must prove that its relationship with each offeree was such that it satisfied the access requirement. The private offering exemption is not available unless both sophistication and disclosure of or meaningful access to information exists because “[s]ophistication is not a substitute for access to the information that registration would disclose.” Furthermore, disclosure of or access to important information is an empty promise without the ability to ascertain and appreciate the risks involved with the investment.

By moving away from numerical limitations and focusing on the concepts of sophistication and disclosure of or meaningful access to a prescribed level of information, the opinions in Ralston Purina and its progeny have created “doubts and ambiguities . . . by varying Section 4(2) interpretations.” To clarify some of the uncertainty surrounding the application of the Section 4(2) exemption, the SEC adopted Rule 506 as part of Regulation D under the Securities Act, a safe harbor under Section 4(2). We address the rule below. Considering only Section 4(2) and relevant decisional law, however, the twin concepts of sophistication and information would require crowdfunded ventures to ensure that all individuals who visit crowdfunding websites (who would then be offerees)

174. See Doran v. Petroleum Mgmt. Corp., 545 F.2d 893 (5th Cir. 1977). In Doran, the issuer tried to use the private placement exemption to prevent an investor from rescinding an agreement for an oil-drilling venture. Id. at 897. The court found that the investor, who had a degree in petroleum engineering and a net worth of over $1,000,000 (including holdings in 26 oil and gas platforms worth over $850,000), was sophisticated. Id. at 902. The court concluded, however, that a sophisticated investor could not have used his knowledge of business affairs to make a prudent investment decision without the information that would be contained in a registration statement. Id. Focusing on the information requirement, the court pointed out that where disclosure is shown, “the absence of a privileged relationship between the offeree and issuer would not preclude a finding that the offering was private.” Id. at 904. However, when an issuer claims the offeree had access to information, “the relationship between offeree and issuer now becomes critical, for it must be shown that the offeree could realistically have been expected to take advantage of his access to ascertain the relevant information.” Id. at 904–05.

175. Id. at 904 (“Such access might be afforded merely by the position of the offeree or by the issuer’s promise to open appropriate files and records to the offeree as well as to answer inquiries regarding material information.”).

176. Id. at 892 (citing United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967)).

177. Id. at 904–05.

178. Cohn & Yadley, supra note 144, at 22.

179. See infra Part III.A.2.b.
meet the sophistication requirements and are given access to the required information. This is impractical because (even assuming that sophistication can be sufficiently ascertained through the Internet) the costs associated with providing the appropriate level of information to offerees over the Internet (none of whom may be assumed to have a pre-existing relationship with the issuer) are high in relation to the benefit sought, which in most cases is a relatively small amount of funding. Further, "the SEC has indicated that any 'public advertising is inconsistent with a claim of private offering.'" This prohibition eliminates any hope for an open-access crowdfunding business model under the private offering exemption.181

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

Regulation D is a set of rules adopted by the SEC to provide exemptions principally for small issues and small issuers.182 The main operative provisions are Rules 504 and 505,183 adopted under the SEC's exemptive authority in Section 3(b) of the Securities Act,184 and Rule 506,185 adopted under Section 4(2) of the Securities Act.186 Each exemptive rule has unique attributes, but there is some overlap in the requirements. Common to all three rules, however, are three unifying principles. First, offerings made within six months of each other may be integrated and considered to be a single offering if they have certain specified common characteristics.187 Second, securities acquired in Regulation D offerings are considered restricted securities for purposes of the Securities Act and cannot be resold absent registration or the availability of an applicable exemption.188 Third, except in limited circumstances under Rule 504, issuers and their agents may not offer or sell securities under Regulation D using "any form of general solicitation or general advertising."189

180. HAZEN, supra note 163, § 4.24 (footnote omitted).
181. See infra Part III.A.2.b. (discussing the prohibition of general advertising).
182. HAZEN, supra note 163, § 4.19[1].
184. 15 U.S.C. § 77c(b) (2006). Section 3(b) allows the SEC to pass rules and regulations exempting "any class of securities . . . if it finds that the enforcement of [the Securities Act] is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." Id. The maximum aggregate amount of any offering exempted under Section 3(b) is $5,000,000. Id.
185. 17 C.F.R. § 230.506.
187. 17 C.F.R. § 230.502(a) (commonly referred to as "integration").
188. 17 C.F.R. § 230.502(d).
189. 17 C.F.R. § 230.502(c).
Rule 504 provides an exemption for certain offerings not exceeding an aggregate of $1,000,000 within a twelve-month period.\(^{190}\) This exemption places no limits on the number of offerees or purchasers, and does not require the issuer to provide specific affirmative disclosure.\(^{191}\)

Rule 505 provides an exemption for offerings with a maximum aggregate offering price of $5,000,000 within a twelve-month period.\(^{192}\) The rule limits the number of purchasers to thirty-five, not including "accredited investors," a term that generally refers to entities and individuals who are presumed to be able to bear the financial risk of the total loss of their investment (e.g., institutional investors and high-net-worth individuals).\(^{193}\) Additionally, Rule 505 requires disclosure of specific financial and non-financial information to any securities purchasers who are not accredited investors.\(^{194}\)

Rule 506 is a Section 4(2) safe harbor included in Regulation D.\(^{195}\) Because it is not based on the SEC's authority to grant exemptions under Section 3(b), Rule 506 does not limit the maximum aggregate size of an

\(^{190}\) 17 C.F.R. § 230.504(b)(2) (commonly referred to as "aggregation").

\(^{191}\) See 17 C.F.R. § 230.504(b) (apart from the exclusion of public companies, investment companies, and specified development stage companies, the only conditions that must be satisfied under this rule—other than the applicable conditions under Rule 502—relate to the $1,000,000 aggregate limitation on offering size).

\(^{192}\) 17 C.F.R. § 230.505(b)(2)(i). Like Rule 504, Rule 505 is not available for offerings by investment companies. Id. § 230.505(a).

\(^{193}\) 17 C.F.R. at § 230.505(b)(2)(ii). See Rule 501, 17 C.F.R. § 230.501(a), (e) (excluding accredited investors in calculating the number of purchasers for purposes of Rule 505 and defining "accredited investor" to generally include: banks; savings and loan associations; insurance companies; employee benefit plans; private business development companies; insiders of the issuer of the securities; any individuals whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds $1,000,000; and any person with individual income of greater than $200,000, or $300,000 joint income with a spouse, in each of the two previous years).

\(^{194}\) 17 C.F.R. §§ 230.502(b)(1), 230.505(b)(1). Rule 505(b)(1) incorporates by reference the requirements of Rule 502, and Rule 502(b)(1) mandates the disclosure to non-accredited investors of various financial and non-financial information for offerings made under Rules 505 and 506. Id.

\(^{195}\) HAZEN, supra note 163, § 4.20[1]. Section 4(5) (formerly denominated Section 4(6)) of the Securities Act also covers offerings of the kind exempted under Rule 506, see supra note 186, but became outdated and superfluous when the more detailed safe harbor provisions of Rule 506 were adopted. See COX ET AL., supra note 141, at 286 ("Section 4(6) reflected congressional dissatisfaction with the state of limited offering exemptions in the early 1980s. The SEC responded with the adoption of Regulation D, rendering the statutory exemption of little, if any, use today."); Gary M. Brown, Securities Act Registration Exemptions, in 1 UNDERSTANDING THE SECURITIES LAWS, 209, 217 (Practising Law Institute 2009) ("Among other things, Regulation D incorporates the accredited investor concept of section 4(6) into a more useful exemption, making the free-standing statutory section largely superfluous.").
offering that is exempt under its provisions. Like Rule 505, Rule 506 specifies that no more than thirty-five non-accredited investors may purchase the securities and requires the same affirmative disclosures to all non-accredited investors. Consistent with its roots in Section 4(2), Rule 506 requires that that each non-accredited investor or the non-accredited investor’s “purchaser representative” meet a minimum sophistication requirement or that the issuer “reasonably believes” immediately prior to making a sale that each non-accredited purchaser or purchaser representative meets that sophistication requirement.

The most serious obstacle to using Regulation D to exempt crowdfunded offerings from registration is its overall prohibition of general solicitation and advertising. In fact, “[t]here is no greater impediment to the ability of small companies to raise capital under the securities laws.” The ban on general solicitation and advertising is a substantial obstacle because the SEC has interpreted this restriction very broadly by construing “‘general solicitation’ to include offers to any person with whom the issuer, or the issuer’s agent, has not had a prior relationship.” Rules 505 and 506

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196. See supra note 184 and accompanying text.

197. 17 C.F.R. § 230.506(b)(2)(i); see also supra note 193 and accompanying text (regarding the parallel requirement in Rule 505).

198. 17 C.F.R. §§ 230.502(b), 230.506(b)(1); see also supra note 194 and accompanying text (regarding the parallel requirement in Rule 505).

199. 17 C.F.R. § 230.506(b)(2)(ii) (requiring that each non-accredited investor, or his or her purchaser representative, have “such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment,” or that the issuer “reasonably believe” that the purchaser meets that requirement).

200. See Cohn & Yadley, supra note 144, at 11 (“The SEC’s ban on general advertising and general solicitation in private offerings . . . eliminates the potential of the internet to attract investors . . .”).

201. Id. at 36; see also sources cited infra note 357 (arguing for dismantlement of the ban on general solicitation and general advertising). This prohibition also applies to the private offering exemption under Section 4(2), discussed supra Part III.A.2.a. The only transactional exemptions that are not subject to this restriction are the intrastate offering exemption under Section 3(a)(11), 15 U.S.C. § 77c(a)(11) (2006), Rule 147, 17 C.F.R. § 230.147 (2011), and Regulation A, 17 C.F.R. §§ 230.251-263, discussed infra Part III.A.2.e.

202. Cohn & Yadley, supra note 144, at 41 (citations omitted). In examining a case where offerors engaged in a general solicitation by sending materials to an unknown number of people with whom the offerors did not have a pre-existing relationship, the SEC stated:

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

In re Kenman Corp., Exchange Act Release No. 34-21962, 32 SEC Docket 1352-1 (Apr. 19,
completely prohibit general solicitation and advertising. Rule 504 permits this manner of offering only if the issuer complies with applicable state law that provides adequate investor protection.

In almost all cases, crowdfunding websites exist to invite the general public—the crowd—to help fund small business ventures. Their purpose is to allow ventures to access capital that they would not be able to access without using the crowdfunding website. If ventures seeking funding were able to raise the necessary capital from those with whom they have a prior relationship, they have no need for crowdfunding. Thus, the nature of crowdfunding requires the use of general solicitation and advertising. Screening devices, such as password-protected access to the crowdfunding website, are impractical in this environment. Accordingly, the typical crowdfunded venture is precluded from using the exemptions under Rules 505 and 506. Exemption under Rule 504 may be available, but only if the issuer’s offering meets the state law exemption requirements set forth in Rule 504(b)(1). Assuring compliance with Rule 504 for a crowdfunded venture is not straightforward. It may be difficult to determine the states in which crowdfunding interests are offered and sold, and assuming that the applicable state laws meet the proper threshold level of investor protection,

203. 17 C.F.R. §§ 230.502(c), 505(b)(1), 506(b)(1).
204. 17 C.F.R. § 230.504(b)(1). Rule 504(b)(1) requires that the issuer comply with state laws compelling public filing or delivery of disclosure documents before the sale of securities or that the securities be sold exclusively according to state law exemptions that allow for general solicitation to accredited investors. Id.
205. When this article was in draft form, we noted that one crowdfunding website, Profounder, only allowed investors who were invited by the small business owner seeking the funding. In that case, the crowdfunding website’s primary function is to market the small business’s products and performing administrative work. Although the website facilitates fundraising by giving the small business owner a platform from which to promote the business, Profounder’s fundraising strategy is not based on allowing the small business owner to access more sources of capital; it is based on giving the small business owner a more effective strategy for tapping those resources. For Entrepreneurs: FAQs, Profounder, www.profounder.com/entrepreneurs/faqs (last visited Sept. 1, 2011). The Profounder principals were forced to redesign the Profounder business model after a recent cease and desist order from the California Department of Corporations regarding Profounder’s status as an unlicensed broker dealer in the state. See Angus Loten, Crowd-Funding Brings Unease, Wall St. J. Online, Nov. 17, 2011, http://online.wsj.com/article/SB10001424052970203611404577042333598282986.html?mod=WSJ_SmallBusiness_LEADNewsCollection (last visited Dec. 26, 2011). The current version of the website has more of an educational and supportive mission. See, e.g., Frequently Asked Questions, Profounder, https://www.profounder.com/faq (last visited Dec. 26, 2011).
206. See Belleflamme et al., supra note 3, at 5 (“Raising funds by tapping a general public (or the crowd) is the most important element of crowdfunding. This means that consumers can volunteer to provide input to the development of the product, in this case in form of financial help.”).
207. See 17 C.F.R. § 230.504(b)(1).
the cost of complying with multiple state laws could be high, if not prohibitive.

The ban on general solicitation and advertising is a veritable showstopper for ventures contemplating the use of a Regulation D exemption for crowdfunding or other Internet offers and sales.208 However, the ban is not the only obstacle that issuers face in exempting crowdfunding offerings from registration under Regulation D. The thirty-five purchaser limit under Rules 505 and 506 also is an impediment. Information available on crowdfunding websites leaves open the possibility that each venture will be funded through the purchase of interests by more than thirty-five entities and individuals.209 We can safely assume that many, if not most, purchasers of crowdfunding interests are not accredited investors (i.e., many or most are neither institutional investors nor high-net-worth individuals). If more than thirty-five distinct non-accredited investors purchase crowdfunding interests in a particular venture, the offering would not qualify for an exemption under Rule 505 or Rule 506.210 Even if fewer than thirty-five non-accredited investors were to acquire crowdfunding interests in an offering meeting the general solicitation and advertising requirements, preparation of the disclosure documents required for non-accredited investors under Rules 505 and 506 likely would be cost-prohibitive.211

An additional hurdle exists with respect to complying with the sophisticated investor requirements in Rule 506. It is unlikely that all purchasers of crowdfunding interests—as members of an undifferentiated Internet-based crowd—would meet the sophistication standards or have access to a qualified purchaser representative.

For these reasons, Rules 504, 505, and 506 are ill suited to exempt small-dollar-value Internet offerings to the masses from the registration requirements of Section 5 of the Securities Act. Regulation D fails to provide a viable exemption option for crowdfunded businesses.


209. For example, a crowdfunded venture that has a target goal of $15,000 and provides information on rewards for contributions in $10, $30, $50, and $100 increments may require as many as 1,500 investors to reach the funding target. If an individual was allowed to contribute less than $10 (for example, if the minimum contribution is $1), it is possible that there could be as many as 15,000 investors involved in reaching the venture’s funding target.

210. See supra note 197 and accompanying text.

211. See 17 C.F.R. § 230.502(b)(2). In some instances, the disclosure may require the same kind of financial non-financial information contained in a registration statement.
c. Regulation A

Regulation A exempts offerings not exceeding $5,000,000 within a twelve-month period, provided that the issuer offers the securities using an offering statement on Form 1-A, a filing similar limited registration statement, and an offering circular, a disclosure and selling document similar to the traditional Section 10 prospectus that forms a part of the registration statement in offerings registered under the Securities Act. The offering circular is a “rather full disclosure document . . . complete with financial statements prepared in accordance with generally accepted accounting principles, filed and reviewed by the SEC in a manner similar to the filing and review of registration statements.” Absent from Regulation A, however, are the prohibitions against general solicitation and advertising, limitations on the number of investors, and investor qualification standards.

Although Regulation A alleviates many of the burdens imposed by Regulation D and has been used for at least one early Internet-based direct public offering, the expense of producing the offering circular, in addition to the costs associated with state securities law compliance, makes this exemption too costly for many crowdfunded ventures. Therefore, Regulation A fails to provide a practical exemption from federal securities laws for crowdfunded ventures.


213. Cohn & Yadley, supra note 144, at 28 (citations omitted); see also Campbell, supra note 146, at 105 (“Although less extensive than the corresponding disclosures required in a prospectus in a registered offering, the narrative disclosures in an offering circular are substantial.” (footnote omitted)).

214. 17 C.F.R. § 230.251. Rule 251 acknowledges that the exempted offering is a “public offer or sale of securities.” Id. Therefore, there is no need to limit general solicitation and advertising, assess accredited investor status or examine investors' sophistication because the exemption presupposes a public offering.


216. See Campbell, supra note 146, at 105–10. In 1997, the average cost of a Regulation A offering was $40,000 to $60,000, and the average cost of a registered offering using Form S-1 was between $400,000 and $1,000,000. HAZEN, supra note 163, § 4.17[1]. Although mini-registration under Regulation A costs less than a registered offering, the expense of a Regulation A offering will often still be more than the amount of capital that the crowdfunding venture seeks to raise. Thus, “the Regulation A procedure ‘has for the most part become too cumbersome and expensive for small financings in an enterprise’s early years.’” Cohn & Yadley, supra note 144, at 28 (quoting Julian M. Meer, The Private Offering Exemption Under the Federal Securities Act – A Study in Administrative and Judicial Contraction, 20 SW. L.J. 503, 504 (1966)).
3. Whose Conduct is Regulated?

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

As earlier noted, Section 5 regulates the offer and sale of a security. Different categories of persons with different roles in securities transactions are recognized under the 1933 Act as persons who may offer or sell securities. Paramount among them is the issuer. As a general matter, the issuer must register securities for offer and sale. Section 2 of the 1933 Act defines an issuer as "every person who issues or proposes to issue any security . . . ." Under this vague definition, either the crowdfunded venture or a crowdfunding website that promotes a crowdfunded venture could be an issuer. In SEC v. Murphy, the Ninth Circuit offered that, for purposes of determining the issuer of securities in a limited partnership, the issuer was the "entity about which the investors needed information." The court limited its guidance in Murphy to situations involving limited partnerships and left for another day the issue of whether additional individuals or entities with information material to the investment decision would be a securities issuer. This definitional guidance may best support

217. The analysis also does not address the potential effects of applicable liability provisions under the Securities Act and the Exchange Act.

218. In limiting our analysis here to matters under the Securities Act, we recognize that we fail to address other important potential roles that crowdfunding websites may occupy in securities transactions. See Bradford, supra note 4, at 32–51 (analyzing crowdfunding websites as potential exchanges, brokers, or investment advisors); Hazen, supra note 7, at 15–16 (analyzing the status of crowdfunding intermediaries); Bradford, Peer-to-Peer Lending, supra note 7 (“If the sites are offering securities, the sites themselves could be brokers, or even exchanges, within the meaning of the Securities Exchange Act. Alternatively, it is at least possible that crowd-funding sites are investment advisers subject to regulation under the Investment Advisers Act.”).


220. 15 U.S.C. § 77f(a) (“Any security may be registered with the Commission . . . by filing a registration statement in triplicate, at least one of which shall be signed by each issuer . . . .” (emphasis added)).


222. 626 F.2d 633 (9th Cir. 1980).

223. Id. at 643–44.

224. Id. at 644.
labeling the specific crowdfunded venture as the issuer. That result seems intuitively correct, because a profit-seeking crowdfunder needs information about the venture being funded to assess the desirability and financial promise of an investment in that venture.

The conclusion that specific crowdfunded ventures are Securities Act issuers, however, does not foreclose the conclusion that crowdfunding websites also may be issuers. In fact, decisional law explicitly recognizes the possibility that multiple entities may act as "co-issuers." For example, the concept of co-issuers was implicitly recognized in Howey, where the Court found that two affiliated companies violated Section 5 by offering a land sales contract and a related service agreement for that land. Co-issuer status among affiliates was also implicitly recognized in SEC v. Edwards, a case involving a corporation and its subsidiary that sold payphones and offered a five-year leaseback and management agreement in conjunction with the sales. Thus, where affiliated companies act together to offer or sell an investment contract that constitutes a security, both entities will likely be considered co-issuers of those securities.

However, in many crowdfunding arrangements, the crowdfunded venture and the crowdfunding website are not affiliated. This should not make a difference in whether the two are offering and selling securities for purposes of the Securities Act. The D.C. Circuit's opinion in SEC v. Life Partners, Inc. provides limited support for the proposition that two unaffiliated entities working together to offer a security will be similarly regulated for purposes of the Securities Act's registration requirements. In Life Partners, Life Partners, Inc. ("LPI") offered viatical settlements to investors and, along with Sterling Trust Company, an independent escrow agent acting for LPI, performed post-purchase administrative functions to ensure that investors collected on the settlements. The court determined that all prongs of the Howey test other than the "efforts of others" prong

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225. SEC v. Datronics Eng'rs, Inc., 490 F.2d 250, 254 (4th Cir. 1973), cert. denied, 416 U.S. 937 (1974). Datronics was an engineering company that spun off unregistered shares of nine new merger-corporations. Id. at 252-53. The court determined that "[c]learly, in these transactions the merger-corporation was an issuer; Datronics was a purchaser as well as a co-issuer . . . ." Id. at 254. In fact, the 1933 Act definition expressly recognizes the possibility of more than one issuer. See supra note 221 and accompanying text.

226. SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946); see also supra note 28 and accompanying text.


229. Viatical settlements are financial arrangements through which an investor purchases an interest in the life insurance policy of a terminally ill individual (typically an AIDS patient) at a twenty to forty percent discount. Id. at 537. This arrangement provides the patient with cash, and the investor's profit is the difference between the discounted price paid for the policy and the death benefit collected from the insurer. Id.

230. Id. at 540.
were satisfied.\textsuperscript{231} An important aspect of this decision as it relates to those regulated under Section 5 of the Securities Act is that the court analyzed the efforts of two unaffiliated entities together.\textsuperscript{232} Specifically, the court recognized that two separate entities can work together in such a manner that their functions are inseparable for purposes of determining whether a security is being offered. Because investors would need information about both parties, each must comply with the Securities Act’s registration requirements. Both parties, even if unaffiliated, should be treated as co-issuers where their efforts are inseparable and integral to the offering or sale of the contract, transaction, or scheme that constitutes a security under the Securities Act. Accordingly, in some circumstances, crowdfunded ventures and crowdfunding websites may be acting in concert in a manner that makes them co-issuers.

An alternative to characterizing the crowdfunded venture and the crowdfunding website as co-issuers is to treat the crowdfunded venture as an issuer and the crowdfunding website as an underwriter. “Underwriter status subjects applicable parties to the provisions of Section 5 and results in liability exposure for material misrepresentations and nondisclosures contained in the registration statement.”\textsuperscript{233} The Securities Act includes a definition of “underwriter”:

> The term “underwriter” means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . . \textsuperscript{234}

This definition encompasses any party “who offers or sells for an issuer in connection with a distribution.”\textsuperscript{235} Courts have generally followed the Second Circuit’s reasoning in \textit{Gilligan, Will & Co. v. SEC}, which states that a distribution is synonymous with a “public offering,” as that term is defined in \textit{Ralston Purina}.\textsuperscript{236} In other words, if investors in an offering need the protection of the Securities Act, the offering is a distribution. Someone who offers or sells securities for an issuer in that offering, or who participates in that offer or sale, is an underwriter under the Securities Act.

A common function of crowdfunding websites is to provide each featured crowdfunded venture with access to a base of investors that may be willing

\textsuperscript{231} Id. at 542–45.
\textsuperscript{232} Id. at 546.
\textsuperscript{233} MARC I. STEINBERG, UNDERSTANDING SECURITIES LAWS 175–76 (5th ed. 2009).
\textsuperscript{235} COX ET AL., supra note 141, at 339.
\textsuperscript{236} See \textit{Gilligan, Will & Co. v. SEC}, 267 F.2d 461, 466–67 (determining that the “public offering” issue is “dispositive of the question whether petitioners ‘purchased . . . with a view to . . . distribution”’).
to purchase interests in that venture and to assist in promoting the venture to those potential investors. In this sense, crowdfunding websites perform much the same traditional function that investment banks play when they serve as underwriters in prototypical underwritten public offerings: the identification of potential investors and the promotion of the issuer and the securities being offered and sold.237 These crowdfunding websites apparently offer or sell securities for an issuer—the crowdfunded venture—in that offering (or at least participate in that offer or sale).

Of course, investment banks serving as underwriters in public offerings typically act as conduits for securities distribution by purchasing the securities from the issuer and reselling them to the public. But activity as a conduit for the securities is not required; activity as a promoter is sufficient to establish underwriter status. In SEC v. Chinese Consolidated Benevolent Ass'n,238 the defendant association merely solicited purchase orders for the securities and engaged in limited ministerial activities in connection with the sale of Chinese government bonds, yet the court ruled that the defendant was an underwriter. The court referenced the relevant language from the Securities Act:

[T]he words "$\text{[sell]}$ for an issuer in connection with the distribution of any security" ought to be read as covering continual solicitations, such as the defendant was engaged in, which normally would result in a distribution of issues of unregistered securities within the United States. Here a series of events were set in motion by the solicitation of offers to buy which culminated in a distribution that was initiated by the defendant. We hold that the defendant acted as an underwriter.239

The offering-related tasks that the association undertook in Chinese Consolidated Benevolent Ass'n were similar to tasks that crowdfunding websites perform. As an underwriter, the crowdfunding website could be liable for Section 5 violations, even if it is not a co-issuer.240

237. We note that people who perform these functions also may be deemed finders, who may be classified as brokers for purposes of the Exchange Act. See Bradford, supra note 4, at 33–43; Hazen, supra note 7, at 16; Brumberg, Mackey & Weil, P.L.C., No-Action Letter (May 17, 2010), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf; see also John L. Orcutt, Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting, 37 ARIZ. ST. L.J. 861, 897–920 (2005) (describing the role and legal status of finders in securities offerings). We also note that crowdfunding websites may perform additional functions (including post-sale administrative functions) that are not easily classified as underwriting or finding services. See, e.g., text accompanying supra note 230 (describing this kind of activity in the Life Partners case).
238. 120 F.2d 738 (2d Cir. 1941).
239. Id.
240. Accord Hazen, supra note 7, at 15–16.
The doctrine of participant liability, as fashioned by judicial decisions, supports regulation of the conduct of both the crowdfunded venture and the crowdfunding website under the Securities Act as offerors or sellers of securities. Under this doctrine, Section 5 liability attaches to an individual or entity that has a "significant role" in the offer or sale of securities. A "significant role" has been defined to "include one who is both a 'necessary participant' and a 'substantial factor' in the sales transaction." Where an offering participant is both a necessary participant and a substantial factor in an offering that violates Section 5, that participant is liable for the violation. This liability apparently is a form of underwriter liability, because an individual or entity who has a "significant role" in an offering is a participant in a distribution of securities by an issuer and, therefore, an underwriter. Under participant liability, there is no question that Section 5 compliance and liability will attach to both the crowdfunded venture and the crowdfunding website. Both are necessary participants in the offering; there would be no offer or sale of a crowdfunding interest without the crowdfunded venture, and the crowdfunding website is the essential vehicle for the offer and sale of the crowdfunding interests. Moreover, crowdfunding websites may be involved in the distribution of the crowdfunding interests offered on their sites in many ways other than as a fundraising host site for crowdfunded ventures. Examples of this involvement include: screening the projects prior to offering the investment to the public, making promotional videos or designing individual web pages for the crowdfunded ventures, serving as conduits for invested funds, collecting cash from the crowdfunded venture and distributing it to investors in accordance with the profit-sharing or revenue-sharing components of the crowdfunding interests promised to investors at the time.

241. SEC v. Phan, 500 F.3d 895, 906 (quoting SEC v. Murphy, 626 F.2d 633, 652 (9th Cir. 1980)).
242. Id.
243. See SEC v. Allison, No. C-81-19 RPA, 1982 WL 1322, at *3 (N.D. Cal. Aug. 11, 1982) ("When, as in this case, a defendant’s actions were necessary to and a substantial factor in an illegal securities distribution, the defendant is a participant and thus an underwriter irrespective of the defendant’s intent." (citing Murphy, 626 F.2d at 648–50)).
244. For example, MicroVentures pre-screens all business ideas to evaluate whether the business meets the criteria to be listed on the site. See Investors: Frequently Asked Questions, MICROVENTURES, http://www.microventures.com/investors/faq (last visited Dec. 26, 2011). Some factors include the company’s business plan, business experience of the company’s leaders, how the business will use the funds, and the risk to investors. Id.
245. ProFounder, for example, formerly created individual fundraising websites to market the business ventures that were selected for funding. For Investors: How it Works, PROFOUNDER, http://www.profounder.com/entrepreneurs (last visited Sept. 1, 2011).
246. Microfinancing enterprises, such as Kiva, match investors’ funds to microfinancing institutions in less developed countries, which provide funding to the principal. How Kiva Works, www.kiva.org/about/how (last visited Dec. 26, 2011).
the interests were purchased, and performing accounting and other ministerial functions for crowdfunded ventures. Both the crowdfunded venture and the crowdfunding website are substantial factors in the sales transaction because both work together to provide potential and actual investors with a financial interest in the underlying venture. In the prototypical crowdfunding model, the principals behind the crowdfunded venture create and manage the business or project needing funds while the crowdfunding website attracts investors, supports them in their chosen investments, and administers the relationship between the crowdfunded venture and its investors. The doctrine of participant liability supports imposing the requirements of Section 5 of the Securities Act on both crowdfunded ventures and crowdfunding websites.

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

B. Policy Underpinnings

The system of regulation described above serves two overarching policies: protecting investors and maintaining market integrity. These policies are effectuated principally through doctrinal rules that provide for mandatory disclosure and liability for noncompliance, material misstatements and omissions, and fraud. However, Congress and the SEC also have used substantive regulation of constituents and conduct to

247. Appbackr facilitates the development and sale of newly created mobile apps on the Apple App Store. Appbackr, like most crowdfunding sites with revenue-sharing or profit-sharing arrangements, acts as the intermediary between funders and principals. See How Does it Work?, APPBACKR, http://www.appbackr.com/static/learnMore (last visited Dec. 26, 2011) (“We act as the intermediary between developers and backers.”).

248. Fansnextdoor, which seeks investments from fans to fund creative ventures, retains 3% of the funds raised, for which it provides “webmastering services, web maintenance, rewriting and translations [EN-FR] when it is necessary.” What is fansnextdoor?, FANSNEXTDOOR, http://en.fansnextdoor.com/help/how-it-works (last visited Dec. 26, 2011). Additionally, Fansnextdoor states that “[w]e . . . also . . . adjust at a certain level the steps of project creators, and . . . help you communicate during and after the project . . . .” Id.

249. See supra notes 244–48 and accompanying text.

250. See supra notes 7, 218, 237.

251. See, e.g., Bradford, supra note 4, at 32–51 (discussing the status of crowdfunding websites under federal securities laws).

effectuate investor protection and maintain market integrity, particularly since the adoption of the Sarbanes-Oxley Act of 2002.253

Registration is the vehicle for mandatory disclosure under the Securities Act. Liability results from a failure to register offers or sales of securities and from fraudulent or other objectionable activities (e.g., material misstatements or omissions in registration statements and prospectuses) in connection with the registration requirement.254 Congressional and SEC rulemaking and decision-making under the Securities Act focuses on supporting investor protection and market integrity in this context. For example, the SEC’s general exemptive authority under the Securities Act is subject to the requirement that the exemption be “necessary or appropriate in the public interest, and . . . consistent with the protection of investors.”255 The Securities Act also imposes market-oriented requirements on the SEC’s rule-making authority.256

The various types of statutory and regulatory exemptions under the Securities Act are rooted in different subsidiary policies consistent with the protection of investors and markets. For example, as the Court recognized in the Ralston Purina case,257 it appears that Congress intended Section 4(2) to allow for offerings that are limited in character in a way that makes the Securities Act’s registration and liability protections unnecessary for maintaining adequate investor and market protections:

253. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (“The Securities Act . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.”); Susanna Kim Ripken, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, 58 BAYLOR L. REV. 139, 142–43 (2006) (describing substantive regulation under Sarbanes-Oxley). Mandatory disclosure serves to inform investor decision-making and enhance the efficiency of the market. See HAZEN, supra note 163, at 168–69; Ripken, supra, at 145 (“For the last seventy years, federal securities legislation in general has consistently relied on the philosophy of disclosure as the primary tool for protecting investors and regulating the securities market.”).

254. See supra notes 137–42.


Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Id.

257. See supra notes 170–71 and accompanying text.
The legislative history is of little help except insofar as the general tone may be set by the House Committee's reference to this exemption as permitting "an issuer to make a specific or an isolated sale of its securities to a particular person," and to the exemption generally as directed to transaction "where there is no practical need for [the bill's] application or where the public benefits are too remote."\(^{258}\)

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

A perennial conundrum of the securities laws is how to treat small businesses fairly. Historically, considerable evidence has demonstrated that a substantial proportion of securities fraud is committed by the promoters of new, speculative firms. To fully exempt small business from the reach of the securities laws would deprive investors of protection in some of the instances where investors need protection most. On the other hand, there is no question that when small firms issue new securities they pay a proportionately higher price for underwriting compensation (the primary expense), accounting, legal, and filing costs than larger businesses. For some small firms, the costs of a public securities distribution are prohibitive. Unless it is national policy to give the large business firms advantages over the small in capital formation, it is essential to create compensatory programs to stimulate the financing of small firms.\(^{259}\)

By its express terms, Section 3(b) is constrained by the overall policy aims of the Securities Act. Section 3(b) only authorizes the SEC to adopt exemptions for offerings with an aggregate value of $5,000,000 or less, and only "if it finds that the enforcement of this title [the Securities Act] with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."\(^{260}\) Regulation A is an example of SEC rulemaking that effectuates these purposes. Regulation D, which relies on both Section 4(2) and Section 3(b) of the Securities Act for its statutory authority, encompasses the underlying policies of both sections by efficiently combining and enhancing earlier registration exemptions adopted under Sections 3 and 4 of the Securities Act.\(^{261}\) Where does crowdfunding fit in?

Crowdfunded offerings, as currently conducted, are not private offerings; by their nature, crowdfunded offerings are not limited offerings (in terms of their ability to reach potential investors) and are not isolated

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\(^{258}\) Loss & Seligman, supra note 252, at 395.

\(^{259}\) Id. at 387.


\(^{261}\) Hazen, supra note 163, at 418–19.
offers and sales of securities. There may be no practical need for application of the Securities Act’s registration scheme or the registration regime’s public benefits may be too remote for crowdfunded offerings of a relatively small number of units or offerings that are small in aggregate dollar value. In other words, registration of crowdfunded offerings may not be necessary in the public interest and for the protection of investors. Crowdfunded offerings typically are small in size—with aggregate offering values significantly lower than the $5,000,000 maximum for SEC exemptions under Section 3(b) of the Securities Act. Accordingly, considering that the existing regulatory framework is unfriendly to crowdfunded offerings and assuming that crowdfunding is an activity that is desirable and consistent with the policies of investor protection and maintenance of market integrity, it seems appropriate to consider an exemption from registration for crowdfunded offerings.

IV. EXEMPTING CROWDFUNDING OFFERINGS FROM SECURITIES ACT REGISTRATION REQUIREMENTS

Positing that crowdfunding may be desirable and that a registration exemption may be appropriate, this Part first articulates an argument for providing a registration exemption for crowdfunding and then proceeds to propose elements of a possible crowdfunding exemption.

A. Why Consider an Exemption for Crowdfunding?

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

262. Not much empirical data yet is available on crowdfunded ventures and offerings. However, a recent study by two Belgian business scholars showed that the mean amount of funds raised by the 33 crowdfunded ventures for which finding data was available was $3.5 million, and the median amount of funds raised was under $29,000. Belleflamme et al., supra note 3, at 17 (Table 2).

263. Because “[c]rowdfunding is a market of and for the participants,” some traditional financial intermediaries may be shut out of this sector of the capital formation process. Lawton & Marom, supra note 4, at 162. No doubt, however, new support roles for crowdfunding will develop as the industry matures. Crowdfunding sites like 33needs are new forms of financial intermediation. See Belleflamme et al., supra note 3, at 4. We make no attempt here to assess the various social and economic tradeoffs among transaction participants that inevitably will occur as crowdfunding further develops. See generally Lawton & Marom, supra note 4, at 167–72 (describing a few ways in which traditional
CROWDFUNDING

1. Perceived and Actual Advantages of Crowdfunding

Crowdfunding may solve a key problem that small businesses have in funding their operations: locating a sufficient number of potential and actual investors in a cost-effective manner. Most people seeking to fund businesses and projects, especially younger entrepreneurs, do not have relationships with enough entities and individuals to create a stable source of venture capital without third-party assistance. In addition, these same venturers often have few connections to people who can find investors for them (and even if they do have these connections, they are unlikely to have the funds necessary to retain these individuals and access their services). The Internet has made locating investors much more efficient:

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

Crowdfunding enables entrepreneurs to more quickly and easily identify supporter-investors who are willing and able to fund their businesses or projects. These investors may be more likely to be engaged with, and even passionate about, the ventures they are funding than repeat players in the seed, angel, or venture capital game. Many of these investors are not otherwise involved in funding business ventures and were an untapped source of small business capital prior to the advent of crowdfunding. Crowdfunding gives these investors a way to participate in corporate finance that they may not otherwise have. Specifically, crowdfunding provides a new outlet for the capital of ardent consumer-finance professionals could engage with crowdfunding). That analysis must wait for another day.

264. See Campbell, supra note 146, at 89 (“Usually, company employees do not know where to find potential investors”). Cf. id. at 81 (“[S]mall businesses face daunting economic and structural conditions when they enter the capital markets. External capital for them is hard to find and expensive to acquire.”).

265. Id at 81. (“The absence of financial intermediation services for small businesses means that they are almost always on their own to find investors; their small capital needs mean that their relative offering costs are often sky high.”).

266. LAWTON & MAROM, supra note 4, at 55; see also Belleflamme et al., supra note 3, at 6 (“[T]he development of Web 2.0 is a critical ingredient that has facilitated the access to the ‘crowd.’ Roughly speaking, Web 2.0 is a Web-as-participation-platform that facilitates interaction between users. This structure is crucial for entrepreneurs to be able to easily reach networks of investors or consumers.” (footnote omitted)).
investors on the Internet, where these potential funders spend much of their time. Because of their particularized interest in the ventures they choose to fund and their Internet savvy, investors in crowdfunded ventures may choose to fund businesses and projects different from those funded through more traditional capital-raising methods. These crowdfunded ventures may be more welfare-enhancing or more successful in their relevant product or service markets than businesses and projects funded through standard venture capital financings.

Crowdfunding also has the potential to help stimulate the economy through the efficient financing it provides to some small businesses. Small businesses have the capacity to be an engine of economic growth by creating jobs—and providing hope. However, the difficulty that small businesses have in funding their operations has worsened as a result of the current economic crisis. Crowdfunding may help generate the capital small businesses need to commence or continue operations, which in turn, fuels economic growth. For example, veteran crowdfunding site IndieGoGo is among the participants in Startup America, a White House initiative

267. See Belleflamme et al., supra note 3, at 28 ("Compared to other means of financings, crowdfunding opportunities exhibit several important differences that are likely to affect risk-return profile of investors and motivations for providing money to crowdfunders.").

268. See LAWTON & MAROM, supra note 4, at 55 ("[W]ith the hyper-awareness and immersion that comes from using these modern [social networking] tools, many individuals in the crowd have a much better chance of screening and picking the best and most interesting new projects."); Belleflamme et al., supra note 3, at 28 (Crowdfunding "is a unique way to validate original ideas in front of a specifically targeted audience. This may in turn provide insights into market potential of the product or service offered.").

269. See Campbell, supra note 146, at 81 (footnote omitted) ("Society needs small businesses. They are vital to our national economy, both qualitatively and quantitatively. They account for as much as 40% of our total economic activity and provide consumers with many of the services and products that are essential in our day-to-day lives."); id. at 84–86 (chronicling the social and economic importance of small business); Orcutt, supra note 237, at 861–62 (referencing information from the U.S. Small Business Administration Office of Advocacy); William K. Sjostrom, Jr., Relaxing The Ban: It's Time To Allow General Solicitation And Advertising In Exempt Offerings, 32 FLA. ST. U. L. REV. 1, 1 (2004) ("Small businesses play a pivotal role in the United States economy. 'They are the foundation of the Nation's economic growth: virtually all of the new jobs, 53 percent of employment, 51 percent of private sector output, and a disproportionate share of innovations come from small firms.'" (footnote omitted)); Katherine Reynolds Lewis, Crowdfunding Promoted to Help Small Businesses, FISCAL TIMES (Apr. 17, 2011), http://www.thefiscaltimes.com/Articles/2011/04/17/Crowdfunding-Promoted-to-Help-Small-Businesses.aspx ("President Obama launched Startup America to encourage entrepreneurship, stressing that small businesses traditionally have been the engine of job creation, and Federal Reserve Board Chairman Ben Bernanke regularly talks up his concern for small businesses and keep tabs on small business funding.").

270. See Lewis, supra note 269.

271. See Colleen DeBaise, Kickstarting Entrepreneurship with "Startup America,"
that features small business as a driver of economic recovery in the United States.\textsuperscript{272}

2. Perceived and Actual Disadvantages of Crowdfunding

Currently, "crowdfunding is in a very early and noticeably unsettled state."\textsuperscript{273} Comprised of a rapidly changing set of Internet business models, crowdfunding may be less transparent and more intangible to investors and regulators. Promoters of crowdfunding interests often are anonymous individuals and unknown entities. Moreover, in its prevalent current form as a small business start-up financing method, crowdfunding shares many of the overall negative attributes of small business and start-up capital formation.\textsuperscript{274}

There are many traps for the unwary in this relatively new, rapidly developing, faceless transactional environment. Small businesses, especially start-ups, fail at a relatively high rate, and investors are likely to lose all of their investment.\textsuperscript{275} In fact, it may be easier for investors who


\textsuperscript{273} LAWTON \& MAROM, supra note 4, at 71.

\textsuperscript{274} See, e.g., Jill E. Fisch, Can Internet Offerings Bridge The Small Business Capital Barrier?, 2 J. SMALL \& EMERGING BUS. L. 57, 58-64 (1998) (summarizing many of these attributes).

\textsuperscript{275} LAWTON \& MAROM, supra note 4, at 180–81 ("The risk-reward curve in the startup world is quite well established. . . . At the risk of sounding too general, a lot of time most of the investment is lost . . . ."); id. at 58 ("Companies with small capitalizations present disproportionate risks of . . . business failure"); Brian Headd, et al., What Matters More: Business Exit Rates or Business Survival Rates?, 3, http://www.ces.census.gov/docs/bds/Exit%20Rates%20or%20Survival%20Rates.pdf ("The one-year survival rates for establishments born to firms started in 2004 was 76.4 percent and the five-year survival rates for establishments born to firms started in 2000 was 50.7 percent." (footnote omitted)). The U.S. Small Business Administration cites to the following findings about the survival of new firms, based on the same data used by Headd, supra:

Seven out of 10 new employer firms last at least 2 years, half at least 5 years, a third at least 10 years, and a quarter stay in business 15 years or more. Census data report that 69 percent of new employer establishments born to new firms in 2000 survived at least 2 years, and 51 percent survived 5 or more years. Survival rights were similar across states and major industries. Bureau of Labor Statistics data on establishment age show that 49 percent of establishments survive 5 years or more; 34 percent survive 10 years or more; and 26 percent survive 15 years or more.

lack corporate finance expertise or knowledge of relevant industries to lose their savings through online investments.\textsuperscript{276} The SEC provides specific guidance to retail investors engaging in online trading:

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

With the click of a mouse, you can buy and sell stocks . . . . Although online trading saves investors time and money, it does not take the homework out of making investment decisions. You may be able to make a fast trade, but making wise investment decisions takes time. Before you trade, know why you are buying or selling, and the risk of your investment.\textsuperscript{277}

Moreover, the Internet may over-inform and, as a result, obfuscate or bury important information in connection with securities offerings.\textsuperscript{278} The Internet’s capacity for encouraging suboptimal decision-making and the perceived higher probability of investor losses are real concerns. However, the Securities Act is not designed and does not exist to protect all investors from losing their money in all circumstances; the Securities Act is not an insurance policy against investor losses.\textsuperscript{279} An insurance policy of that kind is neither realistically possible nor universally desirable.\textsuperscript{280}

\footnotesize{\textsuperscript{276} See Lawton \& Marom, supra note 4, at 180 (noting that people commonly are concerned about “unsophisticated investors losing all of their money” in crowdfunding interests); Stephen J. Choi, Gatekeepers and The Internet: Rethinking The Regulation of Small Business Capital Formation, 2 J. SMALL \& EMERGING BUS. L. 27, 37–38 (1998) (“With the increase in the number of active investors on the Internet comes a corresponding increase in potentially unsophisticated investors. . . . Because fraudulent issuers may sell securities with greater ease over the Internet, these investors are at risk.” (footnote omitted)); Fisch, supra note 274, at 58 (“[R]isks may be magnified by Internet-based securities transactions. The low cost and wide distribution of Internet offerings makes the Internet an easy vehicle for fraudulent securities transactions.” (footnote omitted)).


\textsuperscript{278} See Troy A. Paredes, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 WASH. U. L. Q. 417, 419 (2003) (“Studies show that at some point, people become overloaded with information and make worse decisions than if less information were made available to them.” (footnote omitted)).

\textsuperscript{279} See, e.g., in re Williams Sec. Litig.—WCG Subclass, 558 F.3d 1130, 1137 (10th Cir. 2009) (“The securities laws are not meant to ‘provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.’” (citation omitted)); Margaret V. Sachs, Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets, 81 TUL. L. REV. 473, 485 (2006) (noting that the materiality standard applicable to liability actions under, among other provisions, Section 17(a) of the Securities Act bases investor protection on the reasonable investor—"someone
A more specific concern is the capacity for fraud in crowdfunding.\(^{281}\) Fraud protection is a focus of the Securities Act, and the Internet is a common vehicle for securities fraud.\(^{282}\) Additional regulation is unlikely to significantly change this. As a result, the SEC has directed efforts toward investor education. For example, the SEC has a web page devoted to Internet fraud.\(^{283}\) Also, small businesses may be disproportionately involved who grasps market fundamentals”).

280. The law’s protection of people who unwisely part with money varies depending on context, and is based on a balancing of relevant policy interests. For example, crowdfunding advocates and analysts note the lack of parallel regulation of crowdfunding, gambling, and charitable solicitations, each of which may result in the loss of some or all of the funds conveyed by the people providing money. See Lawton & Marom, supra note 4, at 179–80 (noting that people can gamble away $5,000 without question, but cannot similarly invest $5,000 because of existing “American SEC regulation”); Angus Lotan, Crowdfunding Sites Eye Boom, WsJ.com (May 12, 2011), http://online.wsj.com/article/SB10001424052748703806304576245360782219274.html (“Until now, U.S. regulations permitted these [crowdfunding] sites only to facilitate donations—not purchases of equity stakes.”); Gus G. Sentementes, Crowdfunding Allows Everyone to Be an Arts Patron, Balt. Sun (June 13, 2011), http://articles.baltimoresun.com/2011-06-13/business/bs-bz-crowdfunding-websites-20110613_1_arts-organizations-crowdfunding-arts-spending (describing charitable fundraising through crowdfunding and noting that “[f]ederal regulations prohibit fundraisers from using the websites to sell shares in projects to entice investors looking for a financial return”).

281. Lawton & Marom, supra note 4, at 180 (indicating concern about crowdfunding’s “potentials for fraudulent fund raising activities”). See generally Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Calif. L. Rev. 279, 308 (2000) (“Allowing truly unsophisticated investors to purchase securities of small speculative businesses, however, may lead to both mistake and fraud.”).

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

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

Fisch, supra note 274, at 80 (footnotes omitted).

in securities fraud. The SEC has recognized and reacted to the capacity for fraud in the market for securities of small businesses. However, this enhanced potential for small business fraud does not mean we should ban, thwart, or unduly constrain securities offerings by small business issuers, even if those offerings occur over the Internet:

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

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

In order for the securities markets to work, it is critical to maintain investor trust in the integrity of the market because this trust is the foundation on which the markets are built. Without a broad-based investor

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286. Dale A. Oesterle, The High Cost Of IPOs Depresses Venture Capital in the United States, 1 ENTREPREN. BUS. L.J. 369, 379 (2006) (footnote omitted); see also Bradford, supra note 145, at 30 (“There may be more fraud in small offerings, or at least proportionately more, but that does not refute the basic argument: as long as many small offerings are legitimate, there is some offering amount below which registration, or any conditional exemption, is inefficient.”) (footnote omitted); id. at 34 (“The SEC’s concern with microcap fraud is laudable, but the Commission should not penalize all small business issuers for the misdeeds of a few. The answer to fraud lies in aggressive use of Rule 10b-5 and other antifraud rules, not in a prophylactic bar that ensnares even the smallest, least sophisticated businesses.”).
perception of legitimacy, people will not invest in the market, but put their money elsewhere, in "gold or real estate, or under their mattresses."  

The relative ease with which an unsophisticated investor may lose money in investments with small business issuers, the high rate of securities fraud in the small business context, and the anonymity of the Internet may give us pause about extending exemptive relief to crowdfunded offerings. However, crowdfunding has the capacity to fuel small business growth and satisfy the demand for a securities market that serves the everyman. Moreover, crowdfunding is a social and economic force not to be ignored: "Just how encompassing crowdfunding is, speaks to the enormity of its potential for economic and social impact. In the same way that social networking changed how we allocate time, crowdfunding will change how we allocate capital." Accordingly, we believe that crowdfunding should be encouraged and crowdfunded offerings should be exempt from registration under the Securities Act; however, because it comes with both positive and negative consequences, a crowdfunding registration exemption should be cautiously pursued and appropriately tailored to accentuate the positive and minimize the negative.

B. The Contours of a Possible Crowdfunding Exemption

In an effort to take away unnecessary legal and regulatory barriers to crowdfunding while, at the same time, maintaining investor and market protections, we begin by establishing foundational principles and considering appropriate rulemaking options and processes. With these principles, options, and processes in mind, we then outline the possible parameters of a crowdfunding exemption from registration. The remainder of this Part sets forth those principles, options, processes, and parameters as a basis for further dialogue and action.

1. Foundational Principles

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

- Limit investor risk;
- Optimize fraud protection;
- Enhance informational transparency;
- Foster standardization of disclosures and enforcement;
- Constrain regulatory costs; and

287. Ripken, supra note 253, at 194 (footnote omitted).
288. LAWTON & MAROM, supra note 4, at 1.
The first three of these principles derive directly from the policies underlying the Securities Act described in Part III.B. As corollaries of the Securities Act's investor protection and market integrity maintenance objectives, these principles are central values for any variance in the current securities regulation scheme. Among other things, the mandatory disclosure rules exist to promote transparency for the protection of investors, prevent fraud, and promote the perception (if not the reality) of fair and honest markets. Moreover, the three initial principles go to the heart of the matters described in Part IV.A.2 as regulatory concerns applicable to crowdfunding: specifically, unease about the relationship between Internet offerings and investor losses and higher probabilities of fraud in small business capital formation. Transparency—meaning not necessarily more disclosure, but more targeted, simple, easy-to-access disclosure—should support more effective transmission of information to the potentially inexperienced or less experienced Internet investors that are among those attracted to crowdfunding. In addition, transparency should help limit cases of fraud to crowdfunded businesses that are affirmative bad actors whose conduct is not likely to be deterred by ex ante regulation and must be punished by ex post enforcement.

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


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

291. See supra Part IV.A.2.

292. See Lotan, supra note 280 (noting that “crowd-funding sites advertise start-ups to a broad audience, and could easily attract people who shouldn’t be involved in speculative offerings”).
Absent standardization of disclosure requirements, such as those provided by the SEC, there will remain "grave uncertainty about outcomes because such matters as intent and negligence need to be sorted out in court." By contrast, the securities regulatory system is standardized, which makes disclosure more efficient.

The standardization of disclosure and enforcement rules is a central benefit for securities regulation and a key reason why private contracting cannot as efficiently protect the investor.293

Although a number of respected law and economics scholars advocate voluntary disclosure rather than mandatory disclosure,294 because standardized disclosures exist for issuers outside the crowdfunding context (e.g., through registration requirements and Regulations D and A295), we also include standardization as a foundational regulatory principle here. We want to be clear, however, that fostering standardization does not necessarily require homogenization or the imposition of weighty line-item disclosure rules.

Finally, our listed foundational principles recognize that it is important, in our attempt to both promote crowdfunding and protect investors and markets, not to impose on regulators or market participants a level of cost that is perceived to be so prohibitively high that the proposed regulatory solution is not feasible for regulators or represents a disincentive for issuers or investors. The cost of complying with regulatory change is an important consideration. Certain costs, such as the resources devoted to completing necessary filings and disclosures, are obvious.296 However, the assessment of those costs in a crowdfunding context may be difficult, especially in light of crowdfunding's varied forms and relatively short track record. Moreover, current regulatory cost-benefit analyses for federal agency rulemaking may not be as broadly applicable as they should be or, when applicable, may be unavailing for other reasons.297 Accordingly, additional means of assessing

295. See supra notes 143, 194, 213 and accompanying text.
296. See supra note 124 and accompanying text.
the costs and benefits of a crowdfunding exemption should be identified, explored, and potentially used to supplement existing methods.\textsuperscript{298} These additional cost-benefit analyses should take account of the costs associated with the fact of a change in legal rule, in addition to costs associated with the specific substantive attributes of the proposed new rule.\textsuperscript{299} These legal transition costs frequently go unnoticed and unaccounted for in assessing the overall costs associated with a new legal rule:

What has been overlooked is the friction inherent in change itself. Whatever one's normative perspective, a legal system will incur costs simply in adjusting to the existence of a new legal norm. These will arise, for instance, from the need to learn about the content of new law, as well as from an increased risk of uncertainty about its meaning and effect. Changes in legal directives likewise will compel intraparty adjustments and have subtle effects on interparty relationships forged around the old legal order. Indeed, transition costs reflect a systemic phenomenon. Although in differing degrees, they will arise from legal change in all fields, with all lawmaker structures (whether statutory, administrative, or judicial), and for all types of reform (regulatory, deregulatory, and so on).\textsuperscript{300}

These costs are inevitable in any legal rule change, but can be greater in some rule changes than others.\textsuperscript{301} In the case of a possible new crowdfunding registration exemption, legal transition costs may be borne by regulators, issuers, investors, and others and may include:

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

\textsuperscript{298} See, e.g., Bradford, supra note 145, at 30–33 (modeling the costs and benefits of registration or partial regulation, and exemption).


\textsuperscript{300} Id. at 793.

\textsuperscript{301} Id. at 816.
forms or business practices, in giving erroneous advice on the application of the new exemption, or in conducting their crowdfunding businesses; and

• those suffered by the SEC in administering and applying the new exemption.\textsuperscript{302}

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

2. Rule-Making Options and Processes

Having established the basic values that should underlie any proposed changes to crowdfunding regulation, we next consider the options and process for creating a new registration exemption for crowdfunding consistent with those values. Several possible paths are immediately apparent. Because we assume that profit-sharing crowdfunding interests are securities under the Securities Act and that regulatory change is required to serve our interest in facilitating crowdfunded offerings,\textsuperscript{303} we excluded maintenance of the status quo (in which no registration exemption is available) as a possible regulatory option.

The first possible regulatory option is to treat crowdfunding as a completely new and distinct business model and regulate it separately from other capital formation activities. The most simple and comprehensive way to accomplish this would be for the SEC to provide, by regulation or interpretive guidance, that crowdfunding interests are not securities for purposes of the Securities Act and the Exchange Act.\textsuperscript{304} Absent further regulation or guidance, this approach would render the registration requirement in Section 5 of the Securities Act\textsuperscript{305} inapplicable to crowdfunded offerings. This method of facilitating crowdfunding would minimize costs to issuers, investors, and the SEC because it leaves any regulation of crowdfunding to the market. This course of action may, however, present more perceived or actual risk to funders and create moral hazard by decreasing protections against fraud (since antifraud statutes and

\textsuperscript{302} Id. at 850–52 (describing and illustrating the various forms of legal transition costs on which this list is based).

\textsuperscript{303} See supra Part IV.A.

\textsuperscript{304} See supra Part II. Although the definition of a security differs under the Securities Act and the Exchange Act, we believe that treating the two definitions similarly in this context makes sense because the current definitions are substantially the same, and the regulatory environments are interwoven. See supra note 141.

\textsuperscript{305} See supra notes 133, 135 and accompanying text.
rules under federal securities regulation would be inapplicable). Moreover, while the effects of market self-regulation on informational transparency and the standardization of disclosure and enforcement may be theorized in this context, they are unclear.

One way to address the uncertainties created by deregulating the offer and sale of crowdfunding interests under the federal securities laws is by regulating those transactions under another one or more existing areas of law (e.g., through gambling regulation or the regulation of charitable donations) or by regulating them under a new scheme of regulation created especially for crowdfunding. If this option were pursued, existing regulatory frameworks would likely have to be significantly modified to comply with our articulated principles of regulatory change, and creation of a new regulatory scheme consistent with these principles would consume significant time and resources. Both of these options—modifying and using a pre-existing regulatory scheme and creating a new regulatory scheme—increase regulatory costs and costs to issuers and investors. These options also would have to be designed and implemented to optimize fraud protection, enhance informational transparency, and foster disclosure and enforcement standardization.

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

Of course, this path is not as easy as it sounds. As we noted earlier, crowdfunding incorporates a variety of different business models, and it

306. Prosecutors, federal agencies, and aggrieved investors still may have paths to enforcement under state securities (or “blue sky”) laws and regulations as well as federal and state fraud law outside the securities fraud context. See David M. Cielusniak, Note, You Cannot Fight What You Cannot See: Securities Regulation on the Internet, 22 FORDHAM INT’L L.J. 612, 634–35 (1998). These other fraud actions may or may not have desirable remedies or advantageous claim elements for public enforcement authorities or a particular aggrieved private investor, however. By cutting down the number of potential enforcement avenues, perceptions of both investor protection and market integrity may suffer.

307. For a brief “take” on the gambling and securities analysis of crowdfunding on the music industry, see Tim Kappel, Comment, Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?, 29 LOY. L.A. ENT. L. REV. 375, 382–83 (2009); see also Hazen, supra note 7, at 1, 20 n.29.

308. See supra note 4 and accompanying text; see also LAWTON & MAROM, supra note 4, at 201 (“It’s worth noting that there are many categories of crowdfunding, and it
CROWDFUNDING

is still a new phenomenon with uncertain advantages and disadvantages. Experience in crowdfunding is dispersed and disparate, and no individual or group of individuals in the SEC is likely to have sufficient expertise to piece together an appropriate exemptive solution:

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

Accordingly, it seems prudent to engage those involved in crowdfunding in the regulatory discussions in a meaningful way before Congress passes legislation that legalizes crowdfunded offerings of securities or the SEC publishes a rule proposal as part of the notice-and-comment process required under the U.S. Administrative Procedure Act ("APA"). SEC Chairman Mary Schapiro embraced this idea in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act and is again embracing it in the context of reforms to small business capital formation (of which crowdfunding regulation may become a part). We endorse this approach.

not be appropriate to apply the same disciplines across them all.".

309. See supra Part IV.A.

310. See LAWTON & MAROM, supra note 4, at 198. Although two industry researchers suggest self-regulation of crowdfunding, see id. at 198–202, we are not persuaded that this is a wise course of action given the foundational principles we articulate supra Part IV.B.1. Our discussion supra in Part IV.B.2 is instructive in this regard. Even these two researchers offer that regulators should be involved in the process. Id. at 198–99. The question is who controls, monitors, and enforces the regulation.

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

312. See Schapiro Testimony, supra note 11 (noting that, in conducting a review of the regulation of small business capital formation, the SEC "will gather data and seek input from many sources, including small businesses, investor groups, the public-at-large, and a new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming, so that we consider a variety of viewpoints."); Mary L. Schapiro, Chairman, SEC, Remarks Before the Society of American Business Editors and Writers (Apr. 8, 2011), http://www.sec.gov/news/speech/2011/spch040811mls.htm (reflecting on regulatory efforts undertaken by the SEC under Dodd-Frank and noting that "[q]uality rules can't evolve in a Washington bubble. We understand the impact our actions can have on the financial markets, on companies large and small, and on individual lives. This understanding drives us to hear a wide range of opinions, and consider every view as we move forward to carry our mission . . . .").
The involvement of crowdfunded businesses, promoters, and investors in the creation of a crowdfunding exemption may have more than a substantive advantage, however. There may be positive cognitive effects to employing industry participants in the regulation process. There is a proven value, in the form of buy-in, when members of a group are asked to comply with direction by members of their in-group. In addition, introducing non-SEC personnel into the regulatory decision-making process may mitigate the effects of bounded search, bounded rationality, groupthink, and other operative behavioral biases. A regulatory process that achieves buy-in to mutually acceptable rules and engages fresh, proactive decision-making by incorporating regulated businesses into the rulemaking process early may better serve the foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, and standardizing disclosure and enforcement. Positive effects on costs also may result.

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

315. See Choi, supra note 276, at 40 ("Regulators may also be subject to possibilities of regulatory capture from the very groups that the regulators seek to regulate."); Saule T. Omarova, Wall Street as Community of Fate: Toward Financial Industry Self-Regulation, 159 U. Pa. L. Rev. 411, 463 (2011) ("Regulatory agencies in charge of the financial services sector often display strong signs of industry capture and increasingly engage in nontransparent and highly informal rulemaking that falls outside public scrutiny and tends to favor the industry."). See generally Wendy E. Wagner, Administrative Law, Filter Failure, and Information Capture, 59 Duke L.J. 1321 (2010) (describing and illustrating the role of information capture in agency rulemaking and enforcement).
initial regulatory response—even with industry input—would be able to fully anticipate the actions and reactions of industry participants.\footnote{316}

3. Substantive Elements of a Proposed Exemption

In a July 1, 2010 petition to the SEC, the Sustainable Economies Law Center ("SELC") advocates adopting a rule that would provide a registration exemption for offerings up to $100,000, with a maximum of $100 per investor.\footnote{317} With crowdfunded ventures as the target of this exemption, the petition specifies that the entity seeking funding, which the SELC refers to as the "offeror," must be an individual residing in the United States and may only have one offering open at a time.\footnote{318} In its petition, the SELC asserts that such an exemption will promote entrepreneurship and allow small businesses to raise equity rather than debt.\footnote{319} According to the SELC, these are both desired consequences, as they will stimulate economic recovery.\footnote{320} The SELC petition concludes by noting that Section 3(b) and Section 4(2) are possible sections under which the rule could be promulgated, but acknowledges that if the rule is created under Section 4(2), no general solicitation or advertising will be permitted.\footnote{321} SEC Chairman Mary Schapiro references the petition in her
April 2011 letter to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform of the U.S. House of Representatives. 322

The SELC petition caught the attention of both crowdfunding advocates and the SEC, 323 and it has served a valuable role as a catalyst of efforts for change. 324 Although the petition includes certain key tenets of a possible crowdfunding exemption, it represents a unilateral, incomplete response to the issues crowdfunding raises under the Securities Act. In particular, while the inclusion of aggregate and per-investor caps has merit as a risk-reduction device, we are believe that more can be done in this regard at a relatively low cost to the SEC, issuers, and investors. Moreover, the SELC proposal does not address fraud protection, informational transparency, or disclosure and enforcement standardization. As discussed in Part IV.B.1, we believe that these principles are central to an appropriate, successful regulatory response. For example, we find it unacceptable for a crowdfunding regulatory exemption to leave those who invest a small dollar value in a venture to fend for themselves, 325 even though we allow individuals to bear the loss of the same amount of funds in gambling transactions or as financially ill-advised charitable donations or consumer purchases. 326 Generally, that approach would neither promote nor support market integrity, even if investor protection is deemed unnecessary for those advancing a small amount of capital. Finally, the SELC petition does not address a means for engaging crowdfunding participants in the process of constructing the exemptive proposal 327 (although crowdfunding issuers, investors, and advocates would have the opportunity to participate in the overall regulatory effort through the notice-and-comment process under the APA, as earlier noted 328).

We also are aware of three other proposals (one being an article cautioning against the establishment of a crowdfunding exemption without

322. See Issa Letter, supra note 9.

323. Id.

324. See Bradford, supra note 4, at 52–53 (citations omitted).

325. See Bradford, Crowdfunding Blog, supra note 9 ("Obviously, an offering isn’t any safer just because a large number of people invest small amounts. And people who invest small amounts aren’t necessarily sophisticated enough to protect themselves; in fact, smaller investors are probably less sophisticated on average."). We are mindful, however, that the more limited protections afforded to accredited investors under Regulation D rely on the ability of accredited investors to bear the potential loss of their entire investment. See supra notes 193, 198 and accompanying text; see also Bradford, Crowdfunding Blog, supra note 9 (noting that the “argument for an exemption if investors can afford to lose the money isn’t as novel as it sounds. It essentially underlies Regulation D’s designation of investors as ‘accredited’ if they meet specified income or net worth limits.").

326. See supra note 280.

327. See supra notes 311–15 and accompanying text.

328. See supra note 311 and accompanying text.
a mandatory disclosure component), each of which appears in an article authored by a fellow law scholar at or about the time this article is being published.\textsuperscript{329} Other proposals also have been advanced, and likely will continue to be advanced, on both formal and informal bases.\textsuperscript{330} Each proposal has attributes common to others, and each proponent makes important arguments. Although we believe there is value in reading and considering each of these proposals in the regulatory process, we do not support any of them as a precise template for congressional or SEC rulemaking.

As earlier indicated in this article, the U.S. Congress has begun to take action.\textsuperscript{331} Both the bill passed in the U.S. House of Representatives in November 2011 and the Bill under consideration in the U.S. Senate at the time this article went to press call for a specific crowdfunding exemption. Yet, there are significant differences between the two bills. The House bill sets an aggregate offering limit of $1,000,000 ($2,000,000, if the issuer furnishes investors audited financial statements) and a per-investor cap of the lesser of $10,000 or 10\% of the investor's annual income.\textsuperscript{332} The Senate bill caps the maximum aggregate offering price at $1,000,000 and sets a per-investor limit of $1,000.\textsuperscript{333} The Senate bill requires that securities be issued through an intermediary, but the House bill does not.\textsuperscript{334} Both bills require certain disclosures, restrict resales of the subject crowdfunding interests, and incorporate "bad boy" disqualifiers.\textsuperscript{335}

Each proposal and bill has merits and flaws, and no doubt each will develop further after this article goes to press. In our view, however, the collaborative process we suggest in Part IV.B.2 represents a constructive and optimal approach to determining the specific terms of a proposed registration exemption for crowdfunding interests that is consistent with the

\textsuperscript{329} See Bradford, supra note 4; Hazen, supra note 7; Pope, supra note 215.

\textsuperscript{330} See Bradford, supra note 4, at 3, 51–56.


\textsuperscript{332} H.R. 2930, 112th Cong. § 2(a) (2011) [hereinafter H.R. 2930], available at http://thomas.loc.gov/home/thomas.php (actual bill text may be accessed by searching for appropriate bill number).

\textsuperscript{333} S. 1791, 112th Cong. § 2(3) (2011) [hereinafter S. 1791], available at http://thomas.loc.gov/home/thomas.php (actual bill text may be accessed by searching for appropriate bill number).

\textsuperscript{334} H.R. 2930, supra note 332.

\textsuperscript{335} Id.; S. 1791, supra note 333.
foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, fostering disclosure and enforcement standardization, constraining regulatory costs, and minimizing costs to issuers and investors—principles of regulation that we believe will allow the proper balance of governmental and market-based regulation. 336

We also suggest that those engaged in crafting an appropriate exemption consider proposing a new rule-based exemption using some or all of the following general substantive attributes:

- Limit and tailor the exemption to Internet offerings;
- Do not allow foreign issuers, investment companies, or public companies (i.e., issuers who do not have a class of securities registered under Section 12 of the Exchange Act337) to use the exemption;
- Permit general solicitation and general advertising;
- Limit the aggregate offering price for each crowdfunded venture to a specified dollar amount (e.g., $100,000, $250,000, or possibly even lower thresholds for some types of exempt offerings338) over a twelve-month period;339
- Limit the aggregate dollar value of crowdfunding interests that a single investor may purchase in a single crowdfunded venture (e.g., $100 or $250) in a single offering or over a specified period,340 unless

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


338. Regulation A formerly permitted offerings of up to $100,000 with limited required mandatory disclosures. See 17 C.F.R. § 230.257 (1991). Moreover, early guidance from the SEC’s General Counsel noted that small aggregate offering size is a characteristic of a private placement exempt from registration under Section 4(2). See SEC General Counsel Letter, supra note 164. Also, we note that one academic proposal would limit the use of an exemption to “microstartups”—businesses “in which one or two creative people have an idea for a product or service that can be developed, launched, and marketed for a few thousand dollars.” Pope, supra note 215, at 975.

339. We do not, however, suggest that the SEC consider whether twelve months is the appropriate aggregation period. See infra notes 346–48 and accompanying text.

340. Those crafting the regulatory exemption must be mindful of the relationship between the per-investor and per-offering caps, because crowdfunded ventures and crowdfunding websites will not want to trigger registration requirements under Section 12(g)(1) of the Exchange Act, 15 U.S.C. § 78l(g)(1) (2006), and Rule 12g-1, 17 C.F.R. § 240.12g-1 (2011). Together they require registration under the Exchange Act if an issuer has a class of equity securities held by at least 500 people and at least $10,000,000 in total assets. See Pope, supra note 215, at 996–97. Many business ventures that we envision using a crowdfunding registration exemption under the Securities Act would not have sufficient total assets to trigger registration under the Exchange Act. However, regulators must give attention to this issue.
the investor is an accredited investor or sophisticated (as those concepts are defined and used in Regulation D);

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

We expect that the precise combination of these attributes that will best effectuate desired foundational principles will be the subject of significant discussion and debate among participants in the regulatory process. Our approach encourages a balancing of issuer, investor, and regulatory interests in a manner similar to that involved in federal consumer protection regulation. The overall analogy to consumer protection is too complex to explore in any depth here. Suffice it to say, however, that there are both commonalities and differences in selling securities and other products at similar price points over the Internet. In determining the substantive

341. For this Part IV.B.3, we treat crowdfunding websites as co-issuers for most purposes. See supra Part III.A.3. By imposing regulation on crowdfunding websites as well as crowdfunded ventures, crowdfunding websites should be incentivized to engage in rigorous pre-screening of the crowdfunded ventures they host and promote. We note, however, that for our solution to work in this co-issuer context, a number of details would need to be addressed. For example, as we note earlier in this list of potential substantive attributes, any aggregate offering cap would have to apply to each crowdfunded venture, and not to each crowdfunding website (because there are crowdfunding websites that host and promote the securities of multiple crowdfunded ventures). Alternatives exist to treat the crowdfunding websites as brokers, investment advisors, exchanges, or other investor fiduciaries. See supra note 250 and accompanying text. The issue of how to treat promoters of small business offerings has been on the SEC’s radar screen for quite some time. See Cohn & Yadley, supra note 144, at 61–63.

342. One commentator explained this balancing well in the context of the consumer protection regulation of ecommerce transactions:

Government has an interest in ensuring that e-consumer confidence reinforces e-commerce as a viable commercial medium, benefiting both e-businesses and e-consumers. . . . Yet, government e-commerce action must be calculated and targeted, balance market and social policies in the process, take the Internet mechanism into consideration and not eliminate e-commerce’s attraction—efficiency, low cost, easily accessible consumer base and the simultaneous nature of business transactions.


343. Securities regulation in the crowdfunding context may be seen as a specific form of consumer protection, emphasizing investor protection policy over market protection and
attributes of an appropriate exemption for crowdfunding, we suggest that rule makers examine the interactions among those attributes in the context of the policies underlying federal securities regulation while, at the same time, keeping overall consumer protection principles in mind. The remainder of this Part IV.B.3 sets forth further thoughts that may be relevant to a consideration of those interactions.

Ultimately, we are not convinced of the need for Congress to act on a crowdfunding exemption under the Securities Act (although Congress will likely need to take parallel action on other securities regulation issues in order to effectuate the exemption in full344). Although a thorough comparative institutional analysis is beyond the scope of this article, we note that existing regulation offers ample opportunity for the SEC to act without a grant of additional congressional authority (and, presumably, at a lower aggregate cost) and that the SEC’s overall competence and relative independence make it a desirable rule maker in this context.345 Specifically, we contemplate that the SEC would use its exemptive authority under Section 3(b) of the Securities Act346 to promulgate this exemption, which could be included in Regulation D as, e.g., Rule 504A, or in a new parallel regulation modeled after Regulation D (perhaps denominated Regulation CF). The concepts of integration347 and aggregation348 applicable to Rule 504 and 505 offerings under Regulation D also would be applicable to exempt crowdfunded offerings, although we recommend that the SEC consider shortening the periods for each, consistent with its rule-making authority under Section 3(b) and Section 28 of the Securities Act.349 By working within the existing regulatory framework for Section 3(b)

promotion. See Dee Pridgen & Richard M. Alderman, Consumer Protection and the Law: 2009–2010 Edition § 1:1 (West 2009) (noting a common “philosophy that the government should play a role in assuring that consumers are not unfairly taken advantage of in the marketplace.”). The commonalities between securities regulation in this context and consumer protection regulation in the crowdfunding context extend to, among other things, protections against fraud, deceit, misrepresentation, and deceptive and unfair practices. See generally id. at §§ 2:1, 3:1 (describing these regulatory areas under consumer protection law).

344. See infra notes 388–89 and accompanying text.
346. See supra note 184.
347. See supra note 187 and accompanying text.
348. See supra note 190 and accompanying text.
exemptions under Regulation D, regulatory costs should be less than if new regulations were created from whole cloth.

The substantive characteristics set forth above are designed to operate in the limited context of very small Internet-based offerings for relatively small U.S. issuers—a context in which crowdfunding has its perceived maximum net advantages under current circumstances and in which U.S. law applies. Although the substance of our proposal may be faulted for representing a somewhat timid response, it is “much better than nothing.”

We may be wrong, but given the relatively novel nature of crowdfunding and the existing state of the SEC, we believe that a conservative initial approach is warranted. There may come a day on which it would be appropriate to extend a crowdfunding exemption to larger offerings in wider contexts; however, we are concerned that the multiplicity of crowdfunding models and flux in current crowdfunding platforms make it too difficult to fashion a wider exemption that adequately limits investor risk and optimizes fraud protection. There also may be a future time at which it would be advisable to initiate an overhaul of all small business capital formation regulation. The current investor-protection focus of the SEC and its lack of adequate funding make this an improbable current objective. Accordingly, as a more limited approach, we suggest an Internet small issuer exemption that limits the aggregate dollar value of offerings covered, and we recommend limiting the availability of the exemption to non-public U.S. issuers that are not investment companies using open-access websites to enhance their base of prospective and actual funders.

350. See supra Part IV.A.1.

351. LAWTON & MAROM, supra note 4, at 188 (noting that “from a macro view, exemptions like this can be counter-productive, and in fact might hold back crowd-funding’s potential”).

352. Professor Thomas Lee Hazen takes an even more conservative approach than the one we suggest here. In general, Professor Hazen does not favor the creation of a new, broad exemption for crowdfunding. Hazen, supra note 7, at 17–22. However, he does offer that “[i]n the event that an additional exemption is warranted, it should be conditioned on mandated disclosures that would give investors the opportunity to evaluate the merits of the investment.” Id. at 22. The type of disclosure Professor Hazen has in mind is disclosure akin to that provided in a Regulation A offering, a more weighty level of disclosure than we recommend here. Id. at 14–15, 22.

353. See LAWTON & MAROM, supra note 4, at 93–102 (describing actual and aspirational attributes of crowdfunding platforms, and noting that the characteristics of a potential future crowdfunding platform may make regulators “a lot more comfortable,” and better support necessary fraud prevention algorithms).

354. See generally Heminway, supra note 345 (discussing the SEC’s investor-protection mission and funding situation in the context of an evaluation of reform efforts at the SEC).

355. We note that neither investment companies nor public companies can use Rule 504 to avoid registration under the Securities Act and that Rule 505 is not available to investment companies. See 17 C.F.R. §§ 230.504(a), 505(a) (2011); see also Campbell, supra note 146,
Our focus on open Internet offerings means abandoning Regulation D's prohibition on general solicitation and general advertising. Commentators have long argued that the general solicitation and advertising ban is defective or unnecessary.\(^3\) The SEC did, in fact, remove this proscription in Rule 504 offerings for a seven-year period during the 1990s only to reinstate it because of renewed concerns about fraud.\(^3\)\(^5\) There are a number of potential benefits associated with open websites and the enhanced information they can provide.\(^3\)\(^8\) Moreover, the general solicitation and advertising restriction is out-of-step with current communication norms, business practices, and lifestyles.\(^3\)\(^9\) The SEC has thus far been reluctant to take an aggressive view on abandoning this dated proscription, despite its uncertain purpose and effect.\(^3\)\(^6\) We have determined that abandoning

\(^{356}\) See, e.g., Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 70 (1989) (contending that the general solicitation and advertising ban is "unconscionably vague" and "broader than it should be"); Sjostrom, *supra* note 269, at 4 ("[T]here is no strong ideological foundation for the ban"); Yadley, *supra* note 282, at 82. ("Permitting greater use of general solicitation is not likely to diminish consumer protection or open the floodgates to fraud.").

\(^{357}\) See Bradford, *supra* note 4, at 77–78, we offer it as part of the mix of attributes to be considered by rule-makers. We believe that regulatory costs are saved by varying the new exemption little from the existing Rule 504 exemption.

\(^{358}\) See Bradford, *supra* note 145, at 19 (summarizing the relevant history); Campbell, *supra* note 146, at 97 n.92 (same). Professor Hazen, however, is very wary of delinking general solicitation and advertising from significant, substantive mandatory disclosure obligations. See Hazen, *supra* note 7, at 2, 10, 14, 19, 20. We understand the need for this linkage in the context of a private offering exemption under Section 4(2) and the related safe harbor under Rule 506 of Regulation D. However, we are concerned with requiring this linkage for all Section 3(b) offerings, regardless of offering size and other characteristics and terms.

\(^{359}\) See Olufunmilayo B. Arewa, *Securities Regulation of Private Offerings in the Cyberspace Era: Legal Translation, Advertising and Business Context*, 37 U. TOL. L. REV. 331, 362 (2006) ("The SEC view of general solicitations and advertising is based on assumptions about the distribution of information that are inconsistent with post-Internet era standards of information dissemination and business practice.").

\(^{360}\) Professor Don Langevoort notes this puzzle in one of his articles:

[We] must ask why general solicitations are barred in the first place—something on which the Commission has never been particularly forthcoming. One possibility is simple concern for the statutory language, which speaks in terms of non-public *offerings* rather than sales. But there is no obvious reason why "offerings" must necessarily be given a meaning that precludes public advertising or mass mailings, and the statutory restraint concern is no longer applicable at all.
general solicitation and advertising prohibitions is appropriate. However, to the extent that the ban on general solicitation and advertising actually limits investor risk or fraud, we believe it is important to place a renewed focus on addressing those values through other, more direct, investor and market protections.

One way to constrain investment risk is to limit an investor's exposure to losses in a particular enterprise.\footnote{361} This approach is a form of substantive regulation and is more than a bit patronizing. A per-investor cap curtails investor freedom by cutting the investor off from unacceptable losses before they occur, much in the same way that one might cut off a partygoer from inebriation by limiting the number of drinks that she may have. We have very mixed feelings about this aspect of our proposal.

As a result, we recommend limiting any per-investor cap to those investors who are not accredited or sophisticated. The logistics of implementing this type of hybrid requirement in crowdfunded offerings will not be trivial, and the costs may well exceed the benefits. In that event, a per-investor cap would be an unwise regulatory element. But those costs and benefits should be weighed in light of an overall proposal for a crowdfunding exemption. The implementation of a per-investor cap represents a heavy-handed form of investor protection, and if it is adopted, offering processes will need to be redesigned or modified. On the other hand, the nature of the crowdfunding market is such that it may attract participants who are intent on abusing the privilege of open solicitation and advertising.\footnote{362} Just as Professor Margaret Sachs suggests reaching out to protect the "least sophisticated investor" from fraud in inefficient markets,\footnote{363} it may be appropriate in these early stages of crowdfunding development to extend extraordinary protection to the unsophisticated and

in light of the Commission's new exemptive authority under the Act, which allows it to eliminate any statutory restrictions it wishes. Another possibility is that the prohibition is designed to protect the unsophisticated investor who might be tempted by the promotion into misrepresenting his or her qualifications in order to take part in the deal. That paternalistic concern is strained on its face; elsewhere, the Commission has recognized that since no prequalification procedures are fail safe, all we should require is \textit{reasonable belief} by the issuer in the offeree's qualifications.

\begin{footnotesize}
Donald C. Langevoort, \textit{Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities}, 2 J. SMALL \\ 
& EMERGING BUS. L. 1, 24 (1998) (footnotes omitted); see also Cohn \\ & Yadley, supra note 144, at 36-42.

361. \textit{See} Bradford, \textit{supra} note 4, at 66-68 (discussing potential exemptions that limit investor losses to a "tolerable amount").

362. \textit{See supra} Part IV.A.2; Hazen, \textit{supra} note 7, at 20.

\end{footnotesize}
unaccredited investors in a crowdfunded offering by limiting their capacity to invest in crowdfunding interests ex ante.\(^{364}\)

In a similarly over-protective way, restricting the resale of crowdfunding interests may help constrain fraud, which may be more likely to occur in resale markets.\(^ {365}\) An investor who buys and sells securities in a resale market may find himself or herself attenuated from an accurate and complete source of information about the crowdfunded venture or the crowdfunding interest being offered. Typically, crowdfunding websites are designed to attract interest in primary offerings conducted over a short, defined period. Investors advance funds to a crowdfunded venture in order to achieve a specified funding target by a date certain.\(^ {366}\) Currently, most crowdfunding websites are not built to serve as markets for secondary offerings or even as hosts for ongoing disclosures that might support an appropriate secondary market. SEC endorsement of secondary trading in crowdfunding interests is unlikely in the absence of a reliable means for market participants to obtain current information about those interests and the crowdfunded venture.\(^ {367}\)

In practice and in theory, information is very important to investor protection and market integrity. Investors typically will not fund unknown risks.\(^ {368}\) Moreover, the regulation of securities offerings provided under the

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\(^{364}\) See Hazen, *supra* note 7, at 20 (raising investor protection concerns based on the possible nature of crowdfunding investors). An interesting question is whether the per-investor cap should be an aggregate cap for all of a single investor's crowdfunding investments (perhaps together with investments made by affiliates and associates) or whether the cap should only apply to investments in a particular crowdfunded venture. Professor Steve Bradford posits that the former is more reasonable. See Bradford, *supra* note 4, at 76. We suggest otherwise, see *supra* note 340 and accompanying text, but understand and appreciate Professor Bradford's concern and would reassess this aspect of a possible exemption in light of other attributes of a specific exemption proposal.

\(^{365}\) In reinstating the prohibition on general solicitation and advertising under Rule 504 in 1999, the SEC noted concern about fraud in the trading markets for securities offered and sold by issuers under Rule 504. See Bradford, *supra* note 145, at 19. The risk may have been overstated or given undue effect in the SEC's decision-making, however. *Id.*; Campbell, *supra* note 146, at 97 n.92.

\(^{366}\) See *supra* Part II.B.3 (describing this funding model in the context of the commonality element of the Howey test).

\(^{367}\) This apparently was a further concern of the SEC in its decision to reinstate the general solicitation and general advertising requirement to Rule 504. See Bradford, *supra* note 145, at 19 ("The SEC believed that . . . the lack of widely-distributed public information about companies making Rule 504 offerings, and the freely tradable nature of Rule 504 securities may have exacerbated the opportunities for microcap fraud."). We note that it is difficult for issuers in this context to constrain resale transactions. However, any regulatory solution should address the manner in which investor violations of any resale prohibition impact the issuer's exemption. See Cohn & Yadley, *supra* note 144, at 54–58 (raising this issue).

\(^{368}\) This principle can be illustrated simply in a basic discussion of business finance.
Securities Act reflects the semi-strong version of the efficient capital markets hypothesis.\textsuperscript{369} As a result, the Securities Act requires the disclosure of investor-significant information through mandatory disclosure rules (in the form of prospectuses, offering circulars, and otherwise in registration exemptions) and through fraud-protection rules that call for the disclosure of material information where there is a duty to disclose.\textsuperscript{370} Neither Congress nor the SEC has deemed mandatory disclosure or fraud protection to be a sufficient regulatory tool without more.\textsuperscript{371} Consistent with these

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\textbf{Professor Heminway has been known to begin her first Securities Regulation class of the semester with a simple statement and question that illustrate this basic point. She says something like: “I have started a business. Do you want to buy an interest in it?” Students hesitate, and when she asks why (to the extent they do not offer a reason), they respond with something akin to: “Well, before I put down my hard-earned money, I would like to know something about the business.” Further discussion illuminates that they want to know about the finances and operations of the business, as well as the nature of the interests being offered and where the offering proceeds will go. A well-guided discussion can touch on all of the areas of mandatory disclosure in a Securities Act registration statement. Of course, these students have been assigned (and may have read) the introductory chapter of our casebook as background to this discussion.}
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\textsuperscript{370} See supra Parts III.A.1, 2.
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\textsuperscript{371} In early presentations of this article to faculty audiences, we advocated mere reliance on antifraud rule protections, suggesting that (with a minimization of investor risk in other ways) mandatory disclosures in the form of SEC filings or investor information materials were not needed. After some push-back from those audiences, we rethought the issue and determined that minimal mandatory disclosures would best serve the policies underlying the Securities Act and support important related regulatory values. See Cohn, supra note 150, at 365 (“The impetus for disclosure in the nonregistered setting is compliance with exemption conditions and effective sanctions.”). The exemption could (and perhaps should) expressly designate the required mandatory disclosures as, individually and collectively, a prospectus for the purposes of Section 12(a)(2), affording the purchasers of crowdfunding interests a Securities Act cause of action for material misrepresentations and omissions. Current law may already afford investors that right. See infra note 374. Professor Hazen, among others, favors giving crowdfunding investors this right of action. See, e.g., Hazen, supra note 7, at 14, 22. Any plan to abandon mandatory disclosure must meet a high burden of proof, given its centrality to the federal securities regulation scheme.
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[A]t the same time that the Internet is increasing the impact of small business offerings, regulatory reform efforts . . . may be effectively transforming [Internet
regulatory objectives, and in furtherance of our foundational principles of enhancing informational transparency and fostering disclosure and enforcement standardization, we suggest that putative rule makers consider requiring issuers/offerors to (a) file with the SEC both an issuer registration form and an abbreviated brief notice of each offering and (b) include cautionary language and certain other limited disclosures on the crowdfunding website though which the offering is made.

The important issue in fashioning these filing and disclosure requirements is balancing the desired level of information against the costs of producing and disseminating that information. Indeed, “[t]oo much complexity at the entrepreneurial level will . . . destroy the exemption’s utility.” Accordingly, our suggested filing and other disclosure requirements are intended to be minimal but substantive. At the low dollar-value level of investment that issuers would be requesting and investors would be making under the exemption, most of the disclosure requirements for crowdfunding websites and crowdfunded ventures would be satisfied by complying with the anti-fraud protections afforded by Section 17 of the Securities Act and Section 10(b) of and Rule 10b-5 under the Exchange Act.

In that spirit, we envision SEC filing requirements that are simple notice submissions—one or more forms that would represent a tailored version of either the Form D required for offerings under Regulation D or [offering] regulation . . . from a prophylactic disclosure structure to one that merely reacts to and combats fraud. The original promulgation of the federal securities laws was based on congressional perception that such a structure was an ineffective means of regulating the national securities markets. Proponents of regulatory reform need to explain why technological developments since the 1930s have rendered that perception obsolete.

Fisch, supra note 274, at 89.

372. Constraining costs to issuers is a foundational principle for our proposed regulatory solution, as set forth supra Part IV.B.1.

373. Bradford, supra note 4, at 68.

374. See supra notes 140–42 and accompanying text. We also note the probable application of Section 12(a)(2) of the Securities Act to prospectuses used in offerings exempt under Section 3(b), even in the event there is no express provision in the exemption itself. See Elliott J. Weiss, Some Further Thoughts on Gustafson v. Alloyd Co., 65 U. CIN. L. REV. 137, 152 (1996) (“[M]ost important . . . are . . . small-scale offerings made pursuant to section 3(b). . . . [A]t least where securities are sold to the public, section 12(2) applied pre Gustafson, and section 12(2) would continue to apply.”); Natasha S. Guinan, Note, Nearly a Decade Later: Revisiting Gustafson and the Status of Section 12(a)(2) Liability in the Courts—Creative Judicial Developments and a Proposal for Reform, 72 FORDHAM L. REV. 1053, 1069 (2004) (“Section 12(a)(2) liability expressly attaches to Section 3 offerings by referring to: ‘Any person who . . . offers or sells a security (whether or not exempted by the provisions of [Section 3]).’”)

the Small Company Offering Registration form. For example, the issuer registration would include basic information about the crowdfunding website or crowdfunded venture, including information necessary for locating and notifying the filer and its relevant personnel in connection with monitoring and enforcement. Similarly, the level of information required for the notice of each offering would be comparable to that required to complete a Form 144 under the Securities Act. Logically, the amount of required disclosure in the company registration and offering notice would bear an inverse relationship to the aggregate size of the offering and the dollar value of the per-investor cap. However, a certain minimal amount of information necessary for monitoring and enforcement would be required as a threshold matter.

In addition, rule makers should consider requiring the inclusion of certain cautionary language and other disclosures on websites through which crowdfunded offerings of securities are made. Professor Steve Choi aptly summarizes the behavioral psychology basis for these types of requirements in securities regulation as a means of protecting investors:

One possible method of correcting for behavioral biases is to provide corrective or cautionary information to investors. If investors view sales materials too optimistically, then providing the investors more sober


376. The Small Company Offering Registration Form (Form U-7) is available at http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/.

377. Although registration requirements will not enable the SEC, the Department of Justice, or the Federal Bureau of Investigation to find every Internet fraudster, we offer it as a way to ameliorate the effects of the faceless, opaque, remote nature of the Internet. See Fisch, supra note 274, at 81 (“The power of the Internet to transcend jurisdictional boundaries suggests . . . that it may be more difficult for victims and regulators to trace the source of fraudulent offers and obtain legal recourse against wrongdoers.”) (footnote omitted)).


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

380. We acknowledge that standardized disclosures have a cost to the crowdfunded venture and crowdfunding website. We believe that these costs are not significant, but we may be wrong in this regard. See Bradford, supra note 4, at 84–85. A more detailed cost-benefit analysis can be made as proposals develop through engagement among the relevant constituencies. If disclosures necessary to appropriate risk reduction are not cost-effective for crowdfunding websites, crowdfunded ventures, and crowdfunding investors, then the exemption we envision here should be abandoned. The adoption of an exemption that will seldom, if ever, be used is a waste of regulatory time and effort.
materials on the issuer's business, properties, and financial health may, in theory, help overcome their overoptimism. Additional information may serve to educate investors about the potential pitfalls they face in investing... or, alternatively, caution the investors to take extra care in their investment decisions. If investors are capable of learning, then mandatory disclosure and legends may work to educate investors, reducing their behavioral biases.\(^3\)

In a crowdfunding context, these required disclosures could be made on the web page for each crowdfunded venture. The most critical information could also be displayed for would-be investors to acknowledge as a condition to the crowdfunding website accepting their investment funds (through, e.g., something akin to a click-wrap agreement,\(^3\)) implemented through a pop-up window with a check-the-box requirement). Warning and advisory legends are already used in disclosure rules and exemptions under the Securities Act.\(^3\) Although many may read over a standard cautionary legend without heeding or reacting rationally to its content,\(^3\) we believe that those investing in crowdfunding interests should at least have notice that their entire funded amount is at risk, that the probability of any return is remote, and that their interests are illiquid. Discussions among regulators and those in the industry will help decide whether and how additional cautions should be issued. This approach represents a minimal and inexpensive means of promoting investor protection and fosters transparency and standardization.\(^3\)

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382. See generally Francis M. Buono & Jonathan A. Friedman, Maximizing the Enforceability of Click-Wrap Agreements, 4 J. TECH. L. & POL’Y 13 (1999), available at http://jtlp.org/vol4/issue3/friedman.html (“A ‘click-wrap agreement’ is an agreement, formed entirely in an online environment such as the Internet, which sets forth the rights and obligations between parties.”).
383. See 17 C.F.R. § 230.134(b)–(d) (requiring certain statements in communications used after filing a registration statement that may otherwise be prospectuses within the meaning of the Securities Act); 17 C.F.R. § 230.135(a)(1) (requiring in a communication used before the filing of a registration statement “a statement to the effect that it does not constitute an offer of any securities for sale” so that the issuer will “not be deemed to offer its securities for sale through that notice”); 17 C.F.R. at § 230.163(b)(2) (requiring issuers to state that they may file a registration statement with the SEC and directing potential investors to read the prospectus included in that filing); 17 C.F.R. § 230.433(c)(2) (requiring issuers to state that they have filed a registration statement and directing potential investors to read the prospectus included in that filing).
384. For a pithy critique of legending requirements (focused on those in connection with the SEC’s 2005 offering reforms), see Choi, supra note 381, at 118–19.
385. Before implementing the legending requirement, however, we suggest that the SEC study its efficacy. See id. at 128 (suggesting four ways in which the SEC should clarify and make explicit the assumptions about investors on which its regulatory proposals rest). Consistent with our foundational principles of constraining regulatory costs and minimizing
Transparency and standardization, as well as (potentially) investor protection and fraud prevention, also may be promoted by mandating certain simple disclosures on the crowdfunding website relating to the crowdfunding website, the crowdfunded ventures, the interests being offered, the way in which the offering is being conducted, the ongoing role of the crowdfunding website after investments are made, and any follow-on ministerial services that will be rendered, such as delivery of investor funds to the crowdfunded venture, monitoring of the crowdfunded venture’s operations and financial data, and collection and distribution of profit-sharing or revenue-sharing amounts to investors. The major disadvantages of this type of disclosure requirement are its cost and potential to stifle efficient, desirable innovation.\footnote{386} Again, however, we posit that the required disclosures could be minimal given the relatively low amount at risk, if low caps on both the aggregate offering price and per-investor funding are instituted. More disclosure is not necessarily more protective to investors.\footnote{387} We suggest an assessment of investor needs, a review of industry best practices, and a touch of aspirational imagination to identify the nature and extent of appropriate, efficient, and efficacious mandatory disclosure requirements in the crowdfunding context. We would hope that the result would be a competition for investors based on, among other factors, the quality of the crowdfunding website’s disclosures.

Neither the suggested process for regulatory change nor the substantive recommendations we outline in this article addresses market regulation issues under the Exchange Act, investment advisory issues under the Investment Advisors Act of 1940, the interaction of crowdfunding with state securities (or “Blue Sky”) rules, or the inherent cross-border nature of costs to issuers and investors, disclosure burdens should not be added unless their benefits clearly exceed their costs. See id. at 119 (noting that the SEC likely bases its decisions to impose legends on an “\textit{ad hoc} basis”); id. at 122 (“\textit{[T]he SEC implicitly makes assumptions about how investors behave}”). We acknowledge the possibility that standardization, if taken too far, can dampen positive entrepreneurial innovation. Bradford, supra note 4, at 85.

\footnote{386} Professor Alan Palmiter expresses the disadvantages well and advocates that issuers be permitted to choose the level of disclosure they offer:

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

\footnote{387} See Choi, supra note 380 (“While more disclosure into the market may help some investors, the increased information may simply cause others to fall further into the traps of overconfidence and overoptimism.”).
Internet securities offerings (including crowdfunded offerings).\textsuperscript{388} We leave federal market regulation and investment advisory issues to another commentator or another article.\textsuperscript{389} As to state securities law interactions, we believe that the SEC is best positioned to administer and enforce crowdfunding regulation (given the interstate and international nature of crowdfunding), which would require federal preemption of state regulation.\textsuperscript{390} Finally, as to the globalization of securities markets and transactions, we join the growing chorus of voices that urge continued consideration of a more coherent approach to international regulation and enforcement in an increasingly global transactional world.\textsuperscript{391}

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\item\textsuperscript{388} See supra notes 7, 218, 237, 250, 341 (noting these exclusions as well as the exclusion of other regulatory schemes, such as gambling and charitable solicitation regulation, from treatment in this article). We also do not address the precise status of crowdfunding websites for purposes of the overall regulatory scheme under the Securities Act. See supra note 341. Any crowdfunding regulatory solution, regardless of whether it follows any or all of the elements of the proposal we set forth in this article, should address the issue of the regulatory status of crowdfunding websites under all applicable securities laws. Other authors already are approaching some of these issues. See Bradford, supra note 4, Hazen, supra note 7; Pope, supra note 215.

\item\textsuperscript{389} See Bradford, supra note 4, at 32–51. The need for improved regulation of market professionals extends beyond the crowdfunding context. See, e.g., Jennifer J. Johnson, Private Placements: A Regulatory Black Hole, 35 Del. J. Corp. L. 151, 191 (2010) (“[A]s the recent financial crisis has demonstrated, there is much room to improve the regulation of institutions that intermediate between individual investors and the securities markets. Many scholars believe that the SEC should increase its oversight of these intermediaries, such as investment advisors and broker-dealers.” (footnote omitted)).

\item\textsuperscript{390} Accord Bradford, Peer-to-Peer Lending, supra note 7 (“A federal exemption that does not preempt state law isn’t going to accomplish much.”). This is not a new suggestion. Scholars have argued for preemption in connection with existing registration exemptions. See, e.g., Bradford, supra note 145, at 33–34 (“Small businesses should receive the same consideration that the 1996 Act gave public companies: the states should be preempted from requiring the registration of Rule 504 offerings.”); Campbell, supra note 146, at 106–110, 119 (describing the high cost of state securities compliance for small businesses using Regulation A offerings and concluding that “[t]he best way to eliminate state interference is for Congress to expand the preemption of NSMIA to include securities issued under Section 3(b) of the 1933 Act.”); Rutheford B Campbell, Jr., The Insidious Remnants of State Rules Respecting Capital Formation, 78 Wash. U. L. Q. 407, 413–33 (2000) (arguing generally for federal preemption of state securities law regulation of capital formation). But see Johnson, supra note 389, at 192 (arguing for a return to state regulation “of Rule 506 private placements by private entities to largely retail investors.”). Unlike our proposal for handling the Securities Act registration exemption, this change would require congressional action. See Hazen, supra note 7, at 16–17.

\item\textsuperscript{391} See, e.g., Chris Brummer, Post-American Securities Regulation, 98 Calif. L. Rev. 327 (2010) (noting the need for, barriers to, and prospects for international securities regulation); Eric C. Chaffee, Contemplating the Endgame: An Evolutionary Model for the Harmonization and Centralization of International Securities Regulation, 79 U. Cin. L. Rev. 587 (2010) (arguing for reform, harmonization, and centralization of securities regulation); Stephan J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International
V. CONCLUSION

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

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

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

This tension drives the cost-benefit analysis of regulating securities markets. Regulatory systems that allow for flexible, dynamic financial markets inevitably come at the risk of investor loss, fraud, and corruption. Regulators have to exercise restraint and allow for misconduct and abuse of investors because, at some point, investor protection overburdens

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Reach of Securities Regulation, 71 S. CAL. L. REV. 903 (1998) (proposing “portable reciprocity” and recommending “a regulatory regime that focuses on regulatory competition and gives issuers and investors the ability to choose the law that governs their transactions.”).

392. See supra notes 133-35 and accompanying text.
financial markets. The question of when it becomes too costly for the government to protect investors is a fundamental challenge of securities regulation.

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

<table>
<thead>
<tr>
<th>Promoter: Nature of Project Funded</th>
<th>Funder Pseudonym; Attributes</th>
<th>Unit of Interest; Price per Unit; Max # of Units; Max Aggregate Value</th>
<th>Financial Return to Funder</th>
<th>Other Funder Benefits</th>
<th>Contributors to Profit Generation</th>
<th>Financial Return to Promoter</th>
<th>Financial Return to Project</th>
</tr>
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<tbody>
<tr>
<td>Appbackr</td>
<td>Backr</td>
<td>No units; Backr purchases copies of apps in bulk from promoter, which will then be held in a queue as they are sold on the App store at retail</td>
<td>As apps are purchased at retail, the profit is split between the funder and the developer of the app for the amount of apps that the funder purchased</td>
<td>None</td>
<td>Funder pays to have apps listed on App Store; promoter lists the apps on the App Store; developer responsible for the app's retail success</td>
<td>Promoter's profit share is roughly 13% of retail revenue</td>
<td>Developer retains all ownership rights in the app (only sells copies to the Backer); developer typically receives 45% of sales revenue for concept apps and 35% for apps already sold on the App Store</td>
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<tr>
<td>CinemaShares&lt;sup&gt;4&lt;/sup&gt;</td>
<td>Investor; must register as a member of the site</td>
<td>Stock: $20/share; minimum funding target of $10 million</td>
<td>Profit-sharing based on the number of shares owned</td>
<td>DVD, pass to observe filmmaking, access to directors and producers of the film</td>
<td>Producers and directors of the movie; promoter underwrites the direct public offering on NASDAQ</td>
<td>Not disclosed</td>
<td>Not disclosed</td>
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<sup>4</sup> The list of websites in this Appendix was compiled on August 23, 2011. This table was updated on December 28, 2011 to verify the accuracy of the listed websites.

<sup>5</sup> "Promoter" means the crowdfunding website.

<sup>6</sup> CinematicShares.com is a licensee of MediaShares.com, which utilizes the same business model.
<table>
<thead>
<tr>
<th>Promoter: Nature of Project Funded</th>
<th>Funder Pseudonym; Attributes</th>
<th>Unit of Interest; Price per Unit; Max # of Units; Max Aggregate Value</th>
<th>Financial Return to Funder</th>
<th>Other Funder Benefits</th>
<th>Contributors to Profit Generation</th>
<th>Financial Return to Promoter&lt;sup&gt;d&lt;/sup&gt;</th>
<th>Financial Return to Project</th>
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<tr>
<td>MicroVentures</td>
<td>Investor</td>
<td>Stock; investments are typically between $250 and $500; sold as a private offering</td>
<td>Equity ownership</td>
<td>None</td>
<td>Principal</td>
<td>Principal must pay a $100 application fee, $250 screening fee if selected, and 10% of offering price to promoter</td>
<td>Principal retains residual ownership</td>
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<td><a href="http://www.microventures.com">www.microventures.com</a></td>
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<tr>
<td>Small businesses (predominantly those that focus on technology, finance, and healthcare)</td>
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<tr>
<td>ProFounder</td>
<td>Investor; limited to individuals invited by the principal; maximum number of investors limited by state laws of the investors' residence (normally 35)</td>
<td>Pledges; minimum of $100 per pledge; utilizes Rule 504 and 506 of Regulation D</td>
<td>Share of quarterly revenues of the business (based on terms established by principal)</td>
<td>None</td>
<td>Principal; promoterควร the website to market the business and may perform administrative duties at the election of the principal</td>
<td>Promoter receives $100 at the beginning of fundraising and, if the business is successful, performs administrative work for a fee of $1,000</td>
<td>Principal retains all ownership in the business, but will only receive the revenue not distributed to funders</td>
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<td><a href="http://www.profounder.com">www.profounder.com</a></td>
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<tr>
<td>Entrepreneurial business ventures (must be a U.S. for-profit business)</td>
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<tr>
<td>Quirky</td>
<td>Community member</td>
<td>Influence; these entitle the supporter to share of revenue but are not sold at a specific price per share; no maximum # of people who influence; no</td>
<td>30% of revenue (and 10% of indirect retail revenue) generated by sale of the product is split among the Quirky community and distributed pro rata based on the</td>
<td>None</td>
<td>Principal; promoter (who actually engineers, manufactures, sells, and markets the product); often other members influence the project by</td>
<td>Principal pays a $10 submission fee; promoter retains 70% of revenue from online sales (90%) of revenue from retail sales are</td>
<td>About 35% of the 30% of revenues shared in the Quirky community goes to the principal</td>
</tr>
<tr>
<td><a href="http://www.quirky.com">www.quirky.com</a></td>
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<tr>
<td>Innovative product ideas which are manufactured by promoter and then sold via an online store or at</td>
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<sup>d</sup> "Promoter" means the crowdfunding website.
| CROWDFUNDING | 2011 |

<table>
<thead>
<tr>
<th>retail</th>
<th>maximum value</th>
<th>amount of &quot;influence&quot; each individual contributed to a project; &quot;influence&quot; includes submitting the idea, financially supporting the idea, voting on the idea, refining the idea, etc.</th>
<th>contributing suggestions or comments to the project</th>
<th>allocated between promoter and retailers</th>
</tr>
</thead>
<tbody>
<tr>
<td>SeedUps</td>
<td>Investor; must be &quot;qualified high net worth / sophisticated investor&quot;</td>
<td>Maximum aggregate amount of $250,000</td>
<td>Equity share in the business</td>
<td>None</td>
</tr>
<tr>
<td>33Needs[^]</td>
<td>Investor</td>
<td>Generally, there are no units for the investment; however, funders can earn Impact Points ($1 = 1 Impact Point)</td>
<td>Investment dollars are traded for &quot;financial and emotional goodies,&quot; dependent upon the project</td>
<td>Impact points and investments entitle the funder to various nonfinancial &quot;rewards,&quot; in addition to the altruistic emotional benefits</td>
</tr>
</tbody>
</table>

[^] Because 33Needs now requires membership to access the website, this information is current as of August 2011.
### U. S. Crowdfunding Companies without Profit-sharing or Revenue-sharing Arrangements

<table>
<thead>
<tr>
<th>Promoter; Nature of Project Funded</th>
<th>Funder Pseudonym; Attributes</th>
<th>Unit of Interest; Price per Unit; Max # of Units; Max Aggregate Value</th>
<th>Financial Return to Funder</th>
<th>Other Funder Benefits</th>
<th>Contributors to Profit Generation</th>
<th>Financial Return to Promoter</th>
<th>Financial Return to Project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chip In</td>
<td>Contributor</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>Promoter provides the interface to promote the project</td>
<td>None</td>
<td>Funds for the non-profit project are raised, but there are no returns to the project</td>
</tr>
<tr>
<td><a href="http://www.chipin.com">www.chipin.com</a></td>
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<tr>
<td>Citizen Effect</td>
<td>Citizen Philanthropist</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>Principal is responsible for carrying out the project</td>
<td>None</td>
<td>Project is funded, but there are no returns to the project</td>
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<tr>
<td><a href="http://www.citizeneffect.org">www.citizeneffect.org</a></td>
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<tr>
<td>GlobalGiving</td>
<td>None</td>
<td>No units; minimum individual donation of $10; minimum aggregate amount of $250</td>
<td>None</td>
<td>None</td>
<td>Promoter and &quot;project sponsors&quot; choose the projects for funding; &quot;project leaders&quot; and implementing organization responsible for the project’s success</td>
<td>15% of funds raised</td>
<td>Funds for the non-profit project are raised, but there are no returns to the project</td>
</tr>
<tr>
<td><a href="http://www.globalgiving.org">www.globalgiving.org</a></td>
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<tr>
<td>IndieGoGo</td>
<td>Fans</td>
<td>No units; individuals simply pledge money and there are no explicit limits on aggregate amount</td>
<td>None</td>
<td>&quot;VIP Perks&quot; chosen by the project creators (all appear to be non-financial)</td>
<td>Principal: promoter provides various social media and marketing tools</td>
<td>4% of funds raised, but if funding target is not reached, promoter may retain 9% of funds raised (if the &quot;flexible funding&quot; method is chosen)</td>
<td>Principal retains 100% ownership</td>
</tr>
<tr>
<td>Platform</td>
<td>No unit; individuals select favorite sites to “kachingle” each month; limited to $5 per month</td>
<td>None</td>
<td>None</td>
<td>None; Principal (the participating website) receives a payment each month as long as the funder continues to “kachingle” the site</td>
<td>15% of all funds raised are retained by promoter for use of PayPal and as commission</td>
<td>Participating site is paid 85% of the portion that is to be allocated to that based on the funder’s visits each month</td>
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</tr>
<tr>
<td>Kickstarter</td>
<td>None; individuals pledge money and there are no limits on the aggregate amount raised</td>
<td>None</td>
<td>Various rewards determined by the artist; these can range from $1 to $10,000 in value</td>
<td>Artist</td>
<td>5% of the total amount funded once target is met</td>
<td>Artist retains all ownership of the project and is entitled to all profits</td>
<td></td>
</tr>
<tr>
<td>Kiva</td>
<td>No unit; no explicit limits on aggregate amount and individual funders can fund from as much as the entire requested amount</td>
<td>None</td>
<td>None; lenders get their loan back with no interest</td>
<td>Entrepreneur; “field partner” (microfinance institutions); field partner keeps the interest on the loan to cover costs</td>
<td>None</td>
<td>Entrepreneur keeps profits after loans are repaid</td>
<td></td>
</tr>
<tr>
<td>Peerbackers</td>
<td>None; no limits on amount funded</td>
<td>None</td>
<td>Various rewards at the principal’s discretion, but cannot include financial returns</td>
<td>Principal responsible for success of the business</td>
<td>5% of amount funded</td>
<td>Principal retains all ownership and profits</td>
<td></td>
</tr>
</tbody>
</table>

Kachingle

www.kachingle.com

Donates a portion of $5 per month to any group of participating websites (selected by the funder) in proportion to the number of days that the funder visits each website during a month.

Kickstarter

www.kickstarter.com

Artists’ various projects are funded

Kiva

www.kiva.org

Small businesses in underdeveloped countries

Peerbackers

www.peerbackers.com

Entrepreneurial projects and businesses
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<th>Founder Pseudonym; Attributes</th>
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<td>RocketHub</td>
<td>Fueler</td>
<td>RocketFuel; $1/Liter of RocketFuel; no explicit limits on aggregate amount</td>
<td>None</td>
<td>Various items at the artists' discretion</td>
<td>Artist</td>
<td>8% of funded amount</td>
<td>Artist keeps 100% ownership and profits</td>
</tr>
<tr>
<td>40Billion</td>
<td>None; funders must be solicited privately (i.e., invited by principal or another funder that was invited by principal)</td>
<td>Three types of funding: (1) gift/contributions are limited to $25 - $10,000 per person; (2) direct loans are limited to $25 - $10,000 per person; (3) commercial paper is limited to $100 - $1,000,000 per person; maximum funding target: $99,000, unless commercial paper is used, in which case the limit is $1,000,000</td>
<td>Interest on direct loans or commercial paper</td>
<td>None beyond helping a friend or family member, since all funders must be invited</td>
<td>Promoter structures the debt financing, markets, and provides resources for connection to other businesses; principal responsible for success of business</td>
<td>There are currently no start-up fees; fees of $9.99 - $49.99 per month to extend funding period</td>
<td>Principal retains 100% ownership</td>
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<tr>
<td>Buzzbnk</td>
<td>Backer</td>
<td>BTIs (loan units); no explicit limits</td>
<td>Backers' loans may entitle them to either: (1) share of revenue for the term of the agreement; (2) interest for the term of the agreement; or (3) repayment of principal only</td>
<td>Additional benefits as determined by the principal</td>
<td>Principal</td>
<td>£25 registration fee and an administrative fee of 5% of funds raised</td>
<td>Principal retains 100% ownership</td>
</tr>
<tr>
<td>Crowdcube</td>
<td>None; limited to UK residents age 18 or over</td>
<td>None; minimum of £10 per person; maximum of £5,000 per person unless that person qualifies as a High Net Worth Individual or Sophisticated Investor; minimum aggregate amount of £5,000; no maximum aggregate amount</td>
<td>Funders receive a share of profits by virtue of equity ownership, as determined by the principal</td>
<td>Rewards (usually gifts or services of the business) at the principal's discretion</td>
<td>Success of business depends on principal</td>
<td>£250 listing fee (waived for a limited time), 5% of funds successfully raised, and legal fees of £1750 for each completed investment</td>
<td>Principal retains residual interest in equity not distributed to investors (determined before the project can seek funding)</td>
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<td>Investiere</td>
<td>Investor</td>
<td>Minimum investment is usually around $250 per investor; maximum is usually $10,000 per investor; two investment models are (1) equity, and (2) mandatory convertible debt</td>
<td>Funder receives an equity share in the company</td>
<td>None</td>
<td>Promoter performs due diligence and selects the funded ventures; promoter also helps manage financial aspects of the business after the financing round; principal is otherwise responsible for growth and success of the business</td>
<td>6.5% of funds raised</td>
<td>Residual equity interest</td>
</tr>
<tr>
<td>Sollaband</td>
<td>Believer</td>
<td>Part; price varies, but typically $10 Per Part; no maximum # of Parts; maximum amount of $250,000</td>
<td>Revenue sharing (at artist’s discretion)</td>
<td>Music downloads, CDs, t-shirts</td>
<td>Artist is responsible for success of album; promoter contributes to the artist’s fundraising by offering clips of songs on the website</td>
<td>Fee of 15% of amount funded for “providing the platform and expertise in the music industry”</td>
<td>Artist retains all ownership and is entitled to all profits (less any revenue-sharing agreement with funders)</td>
</tr>
<tr>
<td>SonicAngel</td>
<td>Angel</td>
<td>FansHares; $10/FanShare; maximum of 100 FansHares ($1,000) per individual</td>
<td>Revenue sharing, usually around 25-30% of net sales</td>
<td>Name published on website, album download, and various “Behind the Scenes” perks</td>
<td>Artist; promoter places the music on iTunes (and other online music platforms) and in retail stores, and has connections with various record companies</td>
<td>Promoter takes zero commission on funders’ contributions; however, promoter enters into agreement with artist giving promoter recording, managing, and publishing rights</td>
<td>Artist and promoter share the remaining 70-75% of net sales from the funded project per the terms of the agreement; artist must relinquish some control to the promoter under the “Full Rights Contract”</td>
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<tr>
<td>CROWDFUNDING</td>
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</table>

**Spa**nner Films *(Age of Surplus)*

spannerfilms.net

Raised over £850,000 for a film on global warming.

<table>
<thead>
<tr>
<th>None</th>
<th>Shares: varied between £500 and £35,000</th>
<th>Profit share for those who donated more than £5,000</th>
<th>Those who contributed less than £5,000 got their names in the credits</th>
<th>Promoters were entitled to profits remaining after pro-rata distributions are made to funders</th>
<th>Remaining profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facilitators, who provide peer reviews and advice and ratings on different startups listed on the site; Funders, who can invest along with promoter</td>
<td>Points, which are earned by participating in reviewing and backing (by voting) a particular startup: no explicit limits</td>
<td>Funders receive an equity interest; facilitators receive no equity interest (only points)</td>
<td>Points earned by facilitators can be redeemed for various non-financial goods and services</td>
<td>Funders and facilitators choose which startup should be funded; principal and promoters manage the company</td>
<td>Promoter receives equity in exchange for the investment</td>
</tr>
</tbody>
</table>

**VenCorps**

www.vencorps.com

Promoter provides $25,000 in venture capital to startups picked by the site’s members
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<tr>
<td>FanzNextdoor⁶</td>
<td>Fan</td>
<td>None; no explicit limits on maximum # or value of shares</td>
<td>None</td>
<td>Rewards are chosen by the principal and usually reflect the amount contributed</td>
<td>Principal; fans are encouraged to promote the product online and offline</td>
<td>Not disclosed</td>
<td>Principal retains 100% ownership; promoter retains a license</td>
</tr>
<tr>
<td><a href="http://www.fanznextdoor.com">www.fanznextdoor.com</a></td>
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<tr>
<td>Various creative projects</td>
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</tr>
<tr>
<td>Pledge Music</td>
<td>Fan</td>
<td>None</td>
<td>None</td>
<td>Incentives include a copy of the album, merchandise, special events, etc., at the discretion of the artist</td>
<td>Artist; promoter contacts the artist's mailing list to let them know about the project</td>
<td>15% of funded amount</td>
<td>Artist retains 100% ownerships</td>
</tr>
<tr>
<td><a href="http://www.pledgemusic.com">www.pledgemusic.com</a></td>
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<tr>
<td>Music albums</td>
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<tr>
<td>Possible</td>
<td>None</td>
<td>None; no explicit limits on maximum # or value of shares</td>
<td>None</td>
<td>Principal has the ability to choose different tiers of rewards (none appear to be monetary)</td>
<td>Principal is solely responsible for the project's success</td>
<td>5% of funded amount for those who were invited to post the project by promoter; 7.5% for everyone else</td>
<td>Principal retains 100% ownership</td>
</tr>
<tr>
<td><a href="http://pozible.com.au">http://pozible.com.au</a></td>
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<tr>
<td>Various creative projects; developed for artists, musicians, filmmakers, journalists, designers, entrepreneurs, inventors, etc.</td>
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<tr>
<td>Ulule</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>Rewards (nonfinancial) determined by the principal, typically related to the project</td>
<td>Principal</td>
<td>5-8% commission on the collected amount of successful projects</td>
<td>Principal retains 100% ownership of project</td>
</tr>
<tr>
<td><a href="http://www.ulule.com">www.ulule.com</a></td>
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<tr>
<td>Allows individuals to raise money for any personal cause or fundraising effort (most projects are those that enhance social welfare)</td>
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</table>

⁶ The site was recently restructured and no longer has information under the “How it Works” page. This information provided is current as of February 2011.