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The Legal Regulation of U.S. Crowdfunding: An Organically Evolving Patchwork

Joan MacLeod Heminway

Introduction

Crowdfunding may be defined in many different ways. The panhandler on the street corner is engaged in an age-old form of crowdfunding—sourcing financial backing for his basic needs from those who pass him by. Yet, in the current Web 2.0 environment, crowdfunding has taken on a more specific contemporary meaning. In this setting, crowdfunding more commonly refers to the solicitation of funding from, and the provision of funding by, an undifferentiated, unrestricted mass of individuals (the crowd), commonly over the Internet. Archetypally, there are many individual funders, each contributing a small amount. Funding may be sought to capitalize business entities or to finance business or personal projects, activities, or expenses.

The legal regulation of crowdfunding in the United States is neither well calibrated nor holistic. With the exception of specific securities regulation legislation, the regulation of crowdfunding under U.S. law exists as an extension of principles of pre-existing regulation to a specific new and continually changing Internet-based financing space. As a result, while some common consumer protection objectives can be identified, the legal regulatory approach to crowdfunding did not develop through deliberate, rational choice based on coherent public policy objectives. Instead, it arose and evolved by necessity in response to the spontaneous and natural origination and development of crowdfunding as a socio-economic phenomenon.

As a general matter, U.S. law regulates crowdfunding based on the deemed nature of the financial interest of the funder. Some funders expect nothing back in return for their contribution to a crowdfunding campaign; others expect a good, service, or possible financial return. Each of these funding interests is governed by distinct rules operating, most prominently, to protect the funder from certain elements of risk. Regulation of these various types of offering also may have the objective of fostering or encouraging that particular type of financial instrument or method of financing. Accordingly, it is important to identify various types of crowdfunding in the United States based on the nature of the applicable funding interest and the various manners in which crowdfunding is engaged to best understand how crowdfunding is regulated under U.S. law.

1 P. BELLEFLAMME/T. LAMBERT/A. SCHWIENBACHER, “Crowdfunding: Tapping the right crowd,” J. Bus. Venturing 10 (2014) 585, 588 (“Crowdfunding involves an open call, mostly through the Internet, for the provision of financial resources either in the form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes.”).
This report begins by identifying and defining types of crowdfunding that engage U.S. legal regulation. It continues by briefly describing the legal regulation applicable to each type. This represents the bulk of the report. Finally, before concluding, the report highlights a few additional legal regulatory risks and considerations in U.S. crowdfunding.

**A U.S. Legal Regulatory Taxonomy of Crowdfunding**

The crowdfunding universe has been divided into various subparts categorized in distinctive ways to serve different objectives. For U.S. legal regulatory purposes, it is useful to separate crowdfunding into four distinct types: donative crowdfunding, consumption interest crowdfunding, consumer lending crowdfunding, and securities crowdfunding (also known as investment crowdfunding). This taxonomy represents a functional system of classification based on the application of U.S. law to crowdfunding campaigns and is a variant of systems of classification commonly employed by U.S. legal academics focusing on securities regulation.²

*Donative Crowdfunding*

A funder may give money to an individual, eleemosynary cause, or a for-profit enterprise over the Internet. The objective is pure altruism; no goods or services are provided in return for the financial contribution of the funder. Moreover, no financial return to the investor (e.g., interest, dividends, profit-sharing or revenue-sharing) is offered, expected, or paid.

In the United States, GoFundMe (https://www.gofundme.com) is an example of a crowdfunding platform that specializes in donative crowdfunding. Common financing opportunities include medical, memorial, and charitable fundraising. For example, those seeking funding include individuals looking for financial support for emergency surgical procedures, cancer treatments, funerals, and burials, as well as non-profit firms desiring to purchase real property, equipment, or supplies.

*Consumption Interest Crowdfunding*

A funder in the United States may finance a business or project in return for a good or service. As with donative crowdfunding, no financial return to the investor is offered, expected, or paid. Two principal types of consumption interest crowdfunding are easily identified: pre-purchase crowdfunding and reward-based crowdfunding. Kickstarter

Pre-purchase crowdfunding involves providing advance funding to a business or entrepreneur to foster the research, development, production, marketing, distribution, or sale of a new product or service offering. When the product or service becomes available, the funder is entitled to receive it gratis or to occupies a privileged position in obtaining it (e.g., an early or exclusive right to purchase or discounted pricing). Funders therefore generate both seed business financing and later product or service demand. As a result, they tend to be enthusiasts of the product or service. As a result, those who finance businesses and projects (especially those in music and sports) through pre-purchase crowdfunding are sometimes classified as being among a group of financial backers known as “fan-funders.”

Those who provide financing to businesses or projects through reward-based crowdfunding also may be fan-funders. In rewards-based crowdfunding, those providing funding get a nonfinancial perquisite of some kind in return for their monetary contribution. The perk offered varies with the business or project seeking funding, but often is an item that also promotes the business or project (e.g., a logo t-shirt, sweatshirt, tote bag, or the like).

**Consumer Lending Crowdfunding**

U.S. funders may desire to make a refundable financial contribution to a business or project by collectively loaning the business or project promoters and principles the necessary money. This form of crowdfunded financing often is referred to as peer-to-peer or P2P lending. Loans may or may not carry interest.

There are several models of consumer lending crowdfunding. One key factor in distinguishing among the platforms in this area is whether loans are made directly through the platform to borrowers or indirectly through microfinance lenders or other loan facilitators. LendingClub (<https://www.lendingclub.com>) and Prosper (<https://www.prosper.com/plp/investor-registration-agreement/> ) are U.S. direct-investment consumer lending crowdfunding platforms and Kiva (<https://www.kiva.org>) is a world-renowned consumer lending platform in the United States that facilitates both direct 0% interest loans and indirect loans.

**Securities (Investment) Crowdfunding**

If a funder wants a traditional financial investment in a business or project, it is likely that the financing will be classified as securities or investment crowdfunding in the United States. This report will subsequently use the term “securities crowdfunding” for ease of reference. The financial interest acquired by an investor of this kind through securities crowdfunding may be equity, debt, or any other bundle of interests categorized as an investment contract—i.e., any financial instrument that is defined as a “security” under applicable law.
There are a number of different forms of Internet financing that commentators may describe as securities crowdfunding. These may include Internet securities offerings conducted using offering registration exemptions provided under:

- Rule 506 of Regulation D\(^3\) under the Securities Act of 1933, as amended (the “1933 Act”);\(^4\)
- Regulation A\(^5\) under the 1933 Act; and
- Section 3(a)(11) of,\(^6\) and Rule 147\(^7\) or Rule 147A\(^8\) under, the 1933 Act.

Each of these methods of Internet financing is regulated in a distinct way under U.S. securities law. Some of these regulatory frameworks have elements in common with the legal regulation of crowdfunding. At its core, however, each is narrowly tailored to the specific method of financing and the associated risks.

Accordingly, these three types of exempt Internet offering are not included in securities crowdfunding for purposes of this report. They do not or may not constitute the offer and sale of securities to an undifferentiated, unrestricted mass of individuals. In each case, the offering, by its nature, is or may be restricted to specific classifications of people based on, for instance, position (relative to the business or project seeking funding), financial wherewithal, or residency (or other geographic considerations). Crowdfunding, by contrast, typically constitutes what Belleflamme et al. have referred to as an “an open call . . . for the provision of financial resources.”\(^9\)

Securities crowdfunding is still relatively new and rare in the United States. Although some securities crowdfunding is conducted through direct public offerings, more securities crowdfunding campaigns now are conducted through platforms because of recent legal regulatory changes. Currently, the leading U.S. securities crowdfunding platform is Wefunder (https://wefunder.com). Wefunder permits fundraising using any security.

### The Legal Regulatory Framework for Crowdfunding in the United States

There is no specialized law governing crowdfunding in the United States other than specific provisions of federal and state securities regulation that may apply to securities crowdfunding and certain consumer lending crowdfunding. Each type of crowdfunding

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\(^3\) Exemption for limited offers and sales without regard to dollar amount of offering, 17 C.F.R. § 230.506 (2017).


\(^7\) Intrastate offers and sales, 17 C.F.R. § 230.147.

\(^8\) Intrastate sales exemption, 17 C.F.R. § 230.147A.

\(^9\) P. Belleflamme/T. Lambert/A. Schwienbacher (note 1).
invites its own specialized type of legal regulation. A summary of the most significant legal regulatory aspects of each type of crowdfunding is set forth below. Each subpart of this part of the report addresses, for the relevant type of crowdfunding, statutory and common law regulation of the manner of conducting the offering as well as prominent federal income tax effects.

However, it is important to note at the outset that there are generally applicable bodies of legal regulation that may relate to the conduct of a crowdfunding business. For example, in the absence of specialized laws that preempt agency law, principles of agency law may govern relationships in crowdfunding—in particular as to platforms and other intermediaries. Under general agency law principles, an intermediary that is an agent may have fiduciary duties of care and loyalty to its principal (the fundraisers or funders for whom the agent is acting). Also, intellectual property law regulates aspects of crowdfunding in the United States. The unauthorized representation or use of patented technology, trademarks, or copyrighted material has been a concern of crowdfunding platforms. As a result, platforms monitor and tend to strictly enforce compliance with U.S. federal law governing intellectual property rights. Fundraisers and platforms also act to protect their own intellectual property which, given crowdfunding’s open Internet business model, is at risk of infringement. These and other legal regulatory issues that may rise in a crowdfunding context but relate to general business operations (rather than business finance) are not addressed in this report.

**Donative Crowdfunding**

In the United States, the legal regulation of donative crowdfunding largely follows from the regulatory status of the fundraiser. In general, there is no statutory law governing crowdfunded donations made by one individual to another, as may occur in the crowdfunding of medical procedures or care or in the crowdfunding of memorial service or interment expenses. However, the crowdfunding of donations from public charities is general governed by state charitable donation laws and regulations.

If the fundraiser is an individual, although some states do have antifraud statutes that may be applicable, the primary U.S. regulatory tool is state common law—and more specifically, state-based common law governing fraud. A number of cases of fraud in donative crowdfunding have been documented.10

Anti-fraud enforcement requires filing a legal claim with a court. This may mean that fraud prohibitions may go unenforced by private parties because litigation is inefficient from a cost-benefit perspective—the cost of filing a legal claim may exceed the amount donated. The availability of a class action claim may or may not change the cost-benefit analysis for all involved. In egregious cases, however, federal or state public criminal enforcement may

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be available, although prosecutors may decline to exercise their discretion to take enforcement action.\textsuperscript{11}

Private regulation has arisen to reinforce and fill gaps in the common law in the absence of specifically applicable enforceable legal regulation. The donative crowdfunding market has undertaken significant steps to protect donees, donors, and platforms from the perceived risks of donative crowdfunding. Curation—a process through which the crowdfunding platform vets potential fundraisers—is becoming more common, and curation standards continue to be refined.\textsuperscript{12} Moreover, a crowdfunding platform typically establishes and publishes terms of use that, when properly constructed and integrated into it operations, are generally understood to constitute a click-wrap agreement that is legally enforceable as a contract among the donees, donors, and platform regarding their donative crowdfunding relationship. Some terms of use may instead comprise browse-wrap agreements, which are less likely to constitute legally valid, bind, enforceable contracts. Regardless, this private conduct regulation through platform terms of use is enforceable only through private legal process, which may be more expensive than it is worth.

If the fundraiser is a charity, U.S. state laws on charitable fundraising likely will apply in addition to—and not in substitution for—applicable statutory and common law fraud protections and private regulatory structures.\textsuperscript{13} In general, state attorneys general are charged with enforcement of state charitable fundraising laws. Charities typically are defined for this purpose to include legal entities and other organizations that solicit funds for charitable purposes. For example, under New York’s charitable solicitation law, “charitable organizations” comprise “[a]ny benevolent, philanthropic, patriotic, or eleemosynary person or one purporting to be such . . . .”\textsuperscript{14} These definitions typically include organizations qualified for a federal income tax exemption under Section 501(a) of the U.S. Internal Revenue Code of 1986, as amended (the “IRC”),\textsuperscript{15} because they are “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes” or for other listed purposes under IRC Section 501(c)(3).\textsuperscript{16} An organization of this kind is commonly referred to as a “501(c)(3) organization.”

Charitable fundraising regulation typically requires registration and recordkeeping and governs the accuracy and completeness of disclosures, use of solicited funds, and protection of donor privacy (among other things). Activities of volunteers, professional

\textsuperscript{12} M. BERGER/G. TAKAGI, “Understanding Crowdfunding after a Tragedy,” \textit{Nonprofit Q.} (June 28, 2016), \textit{available at https://nonprofitquarterly.org/2016/06/28/understanding-crowdfunding-tragedy/}.
\textsuperscript{13} M. BERGER/G. TAKAGI (note 12).
\textsuperscript{14} Solicitation and Collection of Funds for Charitable Purposes, Definitions, N.Y. Exec. Law § 171-a (McKinney).
\textsuperscript{15} Exemption from tax on corporations, certain trusts, etc., 26 U.S.C. § 501(a) (2012).
fundraisers, and fundraising counsel, in addition to conduct of the fundraising charity itself, typically are regulated under these laws. Platforms and other crowdfunding intermediaries are wise to avoid disclaim responsibility as charities or charitable fundraisers. GoFundMe’s terms of use, for example, provide that:

GoFundMe facilitates the Donation transaction . . . , but is not a party to any agreement . . . between any user and a Charity. GoFundMe is not a broker, agent, financial institution, creditor or insurer for any user. GoFundMe has no control over the conduct of, or any information provided by . . . a Charity, and GoFundMe hereby disclaims all liability in this regard to the fullest extent permitted by applicable law.17

California’s Attorney General cautions that certain services that may be provided by a crowdfunding platform (specifically, “[c]oaching or giving specific charities advice on how to tailor their pages in order to raise the most money” and “[d]esigning the content of a charity’s page relating to solicitations”) may likely qualify the platform for regulation as fundraising counsel under its charitable fundraising laws.18 The National Association of State Charity Officials adopted advisory guidelines for charitable solicitations over the Internet in 2001.19 Although they are not legally binding, these guidelines include important information for charities using crowdfunding.

Legal enforcement actions for wrongful conduct by charitable donees outside charitable donation solicitation law also may exist. The U.S. Federal Trade Commission, an independent federal agency charged with protecting consumers (“FTC”), also may have jurisdiction over charitable organizations engaging in fraudulent activity in donative crowdfunding. Its jurisdiction is based on “unfair or deceptive acts or practices in or affecting commerce.”20 The FTC has used its regulatory enforcement power against charitable fundraisers at least twice.21 Charitable fundraisers engaging in fraudulent or otherwise unlawful activities also may be subject to legal actions brought by other federal or state agencies or enforcement authorities.

The federal income taxation of crowdfunding donations held by platforms and received by donees is an unsettled area. A March 2016 letter from the Office of the Associate Chief Counsel of the U.S. Internal Revenue Service (“IRS”) states that “crowdfunding revenues generally are includible in income if they are not . . . gifts made out of detached generosity and without any ‘quid pro quo.’”22 This restatement of the general rule regarding the federal income taxation of gifts23 leaves many questions to be answered, however. In fact, the letter eschews taking a firm position on the matter, expressly noting that “the income tax consequences to a taxpayer of a crowdfunding effort depend on all the facts and circumstances surrounding that effort.”24 In other words, the IRS likely will look at the specifics relative to each type and instance of donative crowdfunding independently to determine whether the donation represents taxable income to the donee. It should be noted that individual donors making significant gifts (currently $14,000 per donor to an individual donee) and certain other donors in any tax year are required to file a gift tax return, even if no gift tax is then due.25 State income tax laws may or may not follow federal guidelines for determining income and related filing requirements.

If a 501(c)(3) organization is crowdfunding donations, the donations to the 501(c)(3) organization typically are not taxed as income to the organization, and those donations may deductible for U.S. federal income tax purposes (net of any benefit received).26 Otherwise, donors are not entitled to a federal income tax benefit for their contribution to a donative crowdfunding campaign. Individual state laws may or may not offer the same or similar income tax benefits to charitable donors; some state income tax laws do not provide for any itemized deductions.

There also may be income-based regulatory effects of crowdfunding outside the income tax area. For example, a crowdfunding done who qualifies for public assistance may lose that public assistance of the crowdfunding proceeds exceed certain amounts because crowdfunding donations may be included in means testing related to public benefits of various kinds.27 These types of risk are neither widely publicized nor known.

*Consumption Interest Crowdfunding*

24 M.J. Montemurro (note 22).
Consumption interest crowdfunding in the United States is most specifically regulated through general federal and state consumer protection and unfair trade practices laws. Although it may be harder to argue that a specific reward-based crowdfunder is a consumer (given that a reward may be deemed to constitute a mere token incentive to donate), a pre-purchase crowdfunder is generally acknowledged to be a consumer. The FTC and the Washington State Attorney General have each brought enforcement actions against fundraisers in consumption interest crowdfunding in relation to their failure to meet commitments to funders. The FTC action related to a pre-purchase and reward-based campaign conducted on Kickstarter by Erik Chevalier, also doing business as The Forking Path Co., to fund production of a board game, “The Doom That Came to Atlantic City.” The action brought by the Washington State Attorney General addressed a Kickstarter campaign conducted by Edward J. Polchlopek III (Ed Nash) and his firm (Altius Management) for the financing of “Asylum Playing Cards.” Both cases have been highly publicized, but there have been reports of others, including a settlement with one pre-purchase crowdfunding principal following a failure to deliver innovative coolers to funders.

As with donative crowdfunding, individual state fraud law actions also regulate consumption interest crowdfunding. Private litigation of this kind has been rare, but cases have begun to be brought. In 2012, Neil Singh, a Kickstarter project funder, sued Seth Quest and his business partner (although the claim against the business partner was later dropped) for a failure to deliver on promises relating to the promotion of the “Hanfree,” an iPad stand. In addition, a group of individuals reportedly filed a class action in March 2017 against a number of defendants, including Sam Tsu (D/B/A ONAGOFLY), asserting fraud in connection with an Indiegogo campaign promoting a novel drone device.

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In addition, contract law plays a strong role in regulating consumption interest crowdfunding. Breach of contract claims may be argued as an alternative or in addition to fraud claims. And private regulation plays a complimentary and supplementary role in consumption interest crowdfunding, as it does in regulating donative crowdfunding. In addition to curation, platforms supporting consumption interest crowdfunding may offer targeted support services. Published reports indicate that both Indiegogo and Kickstarter, for example, offer fundraisers access to gap-filling expertise (in, e.g., design and manufacturing).

Moreover, specialized regulators of consumer products, notably the federal Food and Drug Administration ("FDA"), may have a legal regulatory role in regulating consumption interest crowdfunding. If the FDA regulates a good or service provided to funders through pre-purchase or reward-based crowdfunding, fundraisers must take care to comply with applicable FDA regulations in connection with the promotion and delivery of the relevant product or service promised to funders. Scanadu’s Indiegogo campaign for its Scout product—a medical device that collects an individual’s vital signs—provides an example. This pre-purchase crowdfunding campaign may have been governed by (and may have run afoul of) FDA regulations in its promotional processes.

U.S. laws governing federal income taxation typically treat consumption interest crowdfunding as either a charitable donation or a sale of goods or services. If the fundraiser is a 501(c)(3) organization or another type of tax-exempt entity, the contributions would not result in taxable income to the entity as long as the income is received in the entity’s tax-exempt endeavors and would be deductible (net of the fair market value of any product or service received) by the funders. If the fundraiser is an individual or entity subject to income taxation, then any contribution received is likely to be treated as income to the fundraiser. However, it also may be that the funding transaction could, on specific facts, be determined to be a gift. State sales taxes may apply to consumption interest crowdfunding—especially pre-purchase crowdfunding that involves a deemed sale of the fundraiser’s product.

**Consumer Lending Crowdfunding**

Consumer lending crowdfunding is considered a type of consumer credit and is relatively highly regulated as a lending practice. Many aspects of financial regulation applicable to commercial bank lending also may apply to consumer lending crowdfunding. Accordingly,

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35 P. BATTISTA (note 22).


37 Comm'r v. Duberstein, 363 U.S. 278 (1960); P. BATTISTA (note 22).
“[r]esponsibility for regulating such lending potentially falls within the purview of a wide variety of federal and state regulators, including the new CFPB, the Federal Trade Commission, the United States Department of Justice, the United States Securities and Exchange Commission, various federal bank regulators, and the state counterparts of all these entities.”

The legal regulatory scheme is therefore relatively complex. Because a variety of evolving models for consumer lending crowdfunding exist and legal compliance remains relatively untested, it is difficult to identify the precise combination of U.S. laws and regulations applicable to a consumer lending crowdfunding operation without knowing the details of its operations, even at the federal level alone. Having said that, it is possible to identify certain common elements of legal regulation. Consumer lending crowdfunding involving banks is the most highly regulated. One pair of scholars describes the applicable laws as including “the Bank Secrecy Act, the Electronic Fund Transfer Act, the Electronic Signatures in Global and National Commerce Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Federal Trade Commission Act, the Gramm-Leach-Bliley Financial Modernization Act, the Servicemembers Civil Relief Act, and the Truth in Lending Act.”

However, all consumer credit, whether commercial or private, is subject to some element of financial regulation. In a public practice advisory, a prominent U.S. law firm lists the following laws as being potentially applicable to consumer lending crowdfunding: the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Gramm-Leach-Bliley Act, the Electronic Fund Transfer Act, the Bank Secrecy Act, and the Fair Debt Collection Practices Act, as well as the Consumer Financial Protection Bureau.

Advising participants in consumer lending crowdfunding of their rights and responsibilities under consumer credit laws is a non-trivial matter.

Yet, the picture is even more complex. Federal and state securities laws also may regulate some consumer lending crowdfunding. In general, an interest-bearing debt instrument offered directly by fundraisers to funders through crowdfunding is likely to be viewed as a security under applicable U.S. statutory and decisional law. The regulation of these debt offerings is addressed, together with the regulation of other securities offerings, in the discussion below of the legal regulation of securities crowdfunding. Direct 0% interest loans and indirect loans (i.e., those made through financial services firms) are typically not securities for federal regulatory purposes.


The intricate and fractured system of regulation governing consumption interest crowdfunding has not gone unnoticed. In the Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), Congress directed the Government Accountability Office (“GAO”) to evaluate the P2P lending environment and prescribe an ideal legal regulatory scheme. The GAO issued that report in 2011 and continues to report on the industry as requested. In April 2017, the GAO released a report on the financial technology sector that summarizes, among other things, the then current legal regulatory environment.

Like consumption interest crowdfunding, general U.S. consumer protection law plays a role in regulating consumer lending crowdfunding. And as with all forms of crowdfunding, applicable fraud and contract law principles and causes of action, as well as private regulation, provide additional sources of legal regulation over consumer lending crowdfunding. Virtually all commentators note the potential for fraud in consumer lending crowdfunding. One legal scholar identifies affinity fraud as an especial risk in the P2P lending environment. Although risks of nonpayment loom large, consumer lending crowdfunding platforms tend to offer a limited number of contract options and engage in due diligence, curating, and enforcement activities to help ensure that borrowers comply with their obligations under those contracts.

From a basic U.S. federal income tax perspective, funds received by a fundraiser through crowdfunding in the form of a bona fide loan are not income to the fundraiser, and interest paid by the fundraiser to a funder is income to the funder. Other questions relating to debt financing are also clearly addressed in the IRC. A crowdfunded loan secured through consumer lending crowdfunding is essentially treated like any other loan.

**Securities (Investment) Crowdfunding**

Certain financial instruments that may be offered and sold through crowdfunding constitute securities as defined under applicable statutes and decisional law. These definitions typically include equity interests, debt interests, and other profit-sharing (or income-sharing) interests in firms or projects commonly referred to as “investment contracts.” These may include, for example, SAFEs (Simple Agreements for Future Equity).
Equity) and what the author of this report has term "unequity." U.S. federal and state securities law regulates crowdfunded offers and sales of securities and other aspects of securities crowdfunding (including the existence and role of securities crowdfunding platforms).

To avoid unnecessary length and complexity, the overall securities law summaries and analysis in this report reference and cite to federal law only. Specific state law principles can and do vary, but the overall system of state securities regulation is analogous to the system of federal securities regulation. State securities regulation and the effect of federal regulation on it is referenced in key places.

Securities crowdfunding, as a method of financing, involves offering and selling securities. Under U.S. law, the offer or sale of securities—securities offerings—is required to be registered with the U.S. Securities and Exchange Commission ("SEC") unless an exemption is applicable. Initial highly publicized efforts in securities crowdfunding frequently ran afoul of this core principal.

Many crowdfunded offerings of securities are conducted using internet-based platforms that serve as transactional intermediaries. U.S. law regulates individuals and entities acting as intermediaries in securities transactions. For example, those who facilitate the purchase or sale of securities may be regulated as brokers. And those who establish, sustain, or operate trading markets for securities may be regulated as securities exchanges. In each case, regulation requires registration with the SEC as well as compliance with other prescriptions and proscriptions. Securities crowdfunding platforms may perform a brokering or market-originating role. Early securities crowdfunding efforts also raised concerns that platforms might be unregistered brokers or securities exchanges.

Accordingly, before specialized regulation of securities crowdfunding became applicable, U.S. federal legal rules regulating securities offerings, brokers, and securities exchanges—and also possibly others (e.g., rules governing investment advisors)—had potential applicability to securities crowdfunding. The weight of this regulation, together with its application to certain early crowdfunding, discouraged market entrants. In crowdfunding’s early years, the market’s enthusiasm for securities crowdfunding was therefore tempered

55 C.S. Bradford (note 2).
by the federal system of legal regulation, which introduced significant cost and adverse timing considerations into financing decisions.

In the spring of 2012, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act ("CROWDFUND Act")\textsuperscript{56} became law as part of the Jumpstart Our Business Startups Act ("JOBS Act").\textsuperscript{57} The CROWDFUND Act preempted state registration requirements for offerings\textsuperscript{58} and was designed to facilitate securities crowdfunding by providing for three important things:

- An exemption from offering registration;
- A requirement that platforms be used and be registered with both the SEC and an applicable self-regulatory organization, either as brokers or as funding portals (a new type of securities transactional intermediary introduced in the CROWDFUND Act); and
- An exemption for holders of crowdfunded equity securities from the shareholder calculation that may trigger the registration and reporting obligations applicable to public companies.

The first two features of the legislation address the two primary legal regulatory barriers identified above as salient impediments before implementation of the CROWDFUND Act. Details are offered about each below. The third feature also was acknowledged soon after the advent of securities crowdfunding to be a source of concern for issuers of crowdfunded securities.\textsuperscript{59} The CROWDFUND Act includes a statutory amendment directing the SEC to engage in rulemaking to effectuate this adjustment.\textsuperscript{60} The rule became effective in November 2015.\textsuperscript{61}

Implementation of the CROWDFUND Act was not self-actuating. The U.S. Congress required the SEC to approve enabling regulations before the CROWDFUND Act’s terms and provisions could become operative. Those SEC regulations (known as Regulation Crowdfunding\textsuperscript{62}) were finalized in October 2015 and published in the Federal Register in November 2015. The CROWDFUND Act’s regulatory scheme became fully operative on May 16, 2016.

\textsuperscript{61} Exemption for securities issued pursuant to section 4(a)(6) of the Securities Act of 1933, § 240.12g-6 (2017).
The offering exemption provided for under the CROWDFUND Act is multifaceted. Apart from requiring the use of a specific type of registered intermediary,\textsuperscript{63} the CROWDFUND Act and implementing rules under Regulation Crowdfunding mandate certain offering and periodic disclosures, provide for a new type of securities liability for certain offering participants, and substantively regulate certain offering terms and provisions as well as how categories of participants—issuers (as fundraisers), investors (as funders), and intermediaries (including the brokers or funding portals managing platforms)—must conduct their activities or operations. More specifically, the CROWDFUND Act and Regulation Crowdfunding:

- Limit offerings by any individual issuer to $1,000,000 (currently $1,070,000, as that adjusted to reflect inflation) in a 12-month period;\textsuperscript{64}
- Limit the amount that an individual investor may devote to crowdfunding under the exemption based on the investor's annual income or net worth, with an absolute maximum of $100,000 (currently $107,000);\textsuperscript{65}
- Require disclosures and filing of information about the issuer, the securities, and the offering at the time of the offering and annually after the offering (including for various offerings corroboration of financial statement disclosures with tax returns accountant reviews, and audits, depending on the aggregate offering amount and other offering attributes);\textsuperscript{66}
- Prohibit issuers from advertising the terms of the offering and compensating or committing to compensate promoters of the offering (in each case, subject to exceptions);\textsuperscript{67}
- Compel intermediary brokers and funding portals to make certain disclosures, carry out investor education and understanding mandates, implement fraud risk reduction and investor privacy mechanisms, supply information to the SEC, ensure compliance with the release of proceeds to issuers and the individual investment

limits, and comply with other operating mandates (including constraints on their advisory activities);\(^{68}\)

- Prohibit intermediary brokers and funding portals from compensating promoters for investor identifying information and the principals of these intermediaries from having a financial interest in the issuer;\(^{69}\)
- Restrict investor resales in the one-year period following the offering.\(^{70}\)

Three additional aspects of the CROWDFUND Act and Regulation Crowdfunding bear mention. First, only certain issuers of securities are eligible to use the exemption. Notably, entities organized outside the United States, public companies—companies with reporting responsibilities under the Securities Exchange Act of 1934, as amended (the “1934 Act”)—and investment companies may not avail themselves of the offering registration exemption under the CROWDFUND Act and Regulation Crowdfunding.\(^{71}\) Second, issuers and their directors or partners, principal executive officers, principal financial officers, and controllers or principal accounting officers (and others with an analogous position or function) may be held liable for misstatements of or misleading omissions to state material fact.\(^{72}\) General federal securities fraud claims also may lie under, e.g., Section 10(b) of and Rule 10b-5 under the 1934 Act.\(^{73}\) Finally, minor noncompliance may not result in a loss of the registration exemption.\(^{74}\)


\(^{71}\) Requirements with respect to certain small transactions, 15 U.S.C. § 77d-1(f) (2012); Crowdfunding exemption and requirements, 17 C.F.R. § 227.100(b) (2017); Disqualification provisions, 17 C.F.R. § 227.503 (2017).

\(^{72}\) Requirements with respect to certain small transactions, 15 U.S.C. § 77d-1(c) (2012).


\(^{74}\) Insignificant deviations from a term, condition or requirement of this part (Regulation Crowdfunding), 17 C.F.R. § 227.502 (2017).
Funding portals must register the Financial Industry Regulatory Authority ("FINRA") as well as with the SEC.\footnote{Requirements with respect to certain small transactions, 15 U.S.C. §§ 77d-1(a)(1) & (2) (2012); Intermediaries, 17 C.F.R. § 227.300(a)(1) & (2) (2017); Registration of funding portals, 17 C.F.R. § 227.400 (2017).} The SEC provides regulatory oversight to FINRA, which has adopted a series of rules relating to funding portal registration, as well as rules regarding funding portal conduct, compliance, investigations, sanctions, procedures, and alternative dispute resolution.\footnote{Funding Portals, Financial Industry Regulatory Authority, \url{http://www.finra.org/industry/funding-portals} (last visited Oct. 20, 2017).} One registered funding portal (UFP, LLC, d/b/a uFundingPortal) withdrew its registration and terminated its operations in response to alleged rule violations; FINRA subsequently settled the matter with the firm.\footnote{Letter of Acceptance, Waiver, and Consent (No. 2016051563901), Fin. Reg. Auth., \url{http://www.finra.org/sites/default/files/fda_documents/2016051563901_FDA_JG411996.pdf} (last visited Oct. 20, 2017).} 

Although, as noted above, the CROWDFUND Act preempts the substantive regulation of CROWDFUND Act offerings (registration and related prescriptions) under state law,\footnote{Exemption from State regulation of securities offerings, 15 U.S.C. § 77r (2012).} state fraud (including securities fraud) and contract law claims are not preempted by the CROWDFUND Act. State law interactions with federal securities law matters also are contentious matters in U.S. securities regulation in a number of respects, including with regard to whether jurisdiction resides for actions under federal or state law. The U.S. Supreme Court currently is set to decide a case relating to whether state court actions lie for federal claims arising only out of the 1933 Act.\footnote{Cyan, Inc. v. Beaver County Employees Retirement Fund, 136 S. Ct. 1865 (2016).}

Before leaving the topic of securities law in the securities crowdfunding context, it is significant to note that the extraterritorial application of the U.S. securities laws has been a contentious issue over the past seven years. No clear unitary rules have been established to define the territorial boundary of The CROWDFUND Act or, for that matter, U.S. securities offering regulation more generally. There is a clear way to avoid U.S. offering registration requirements through a Regulation S offering, but crowdfunded securities offerings are not constructed to comply with Regulation S (which requires that the offers and sales of securities occur outside the United States).\footnote{Under Morrison, transactions in securities are subject to private enforcement under the antifraud provisions of the federal securities laws only if they are listed on a U.S. exchange or were purchased or sold in the United States. The propriety of public enforcement under these antifraud provisions is, under current dominant interpretations, subject to a different test, based on where the wrongful conduct and the effects of that conduct occurred.} 

Moreover, in 2010, the U.S. Supreme Court decided \textit{Morrison v. National Australia Bank Ltd.} Under \textit{Morrison}, transactions in securities are subject to private enforcement under the antifraud provisions of the federal securities laws only if they are listed on a U.S. exchange or were purchased or sold in the United States. The propriety of public enforcement under these antifraud provisions is, under current dominant interpretations, subject to a different test, based on where the wrongful conduct and the effects of that conduct occurred.\footnote{Morrison v. Nat’l Australia Bank Ltd., 561 U.S. 247 (2010).}
This conduct-and-effects test formerly was the rule used in both private and public enforcement actions in most federal courts.

In response to this uncertainty, some have suggested that national regulators should be working on international regulation.

The regulatory approaches to date are national in scope, whereas the Internet is a global source of information offering investment opportunities across borders. It is premature to develop cross-border and international approaches to the promotion and regulation of equity crowdfunding. But such work should begin now among governments if ECBI is to achieve its full potential.

Yet, the U.S. legal regulation of securities crowdfunding remains national and somewhat ambiguous in scope, limited at the margins by notions of comity and regulatory and judicial economy.

The U.S. federal income tax ramifications of securities crowdfunding vary with the type of security offered. No gain or loss is recognized for U.S. federal income tax purposes for corporate or partnership equity/ownership interests purchased through securities crowdfunding. Funders who receive rewards or other benefits in addition to equity interests generally recognize gain (but not loss) to the extent of the fair market value of the reward or benefit received. Although distributions of rewards or other benefits to partners may not be taxable under generally applicable U.S. federal tax rules, the receipt of a reward or benefit also may be classified as a taxable sale or exchange based on relevant facts and circumstances. Debt acquired through securities crowdfunding is treated for federal income tax purposes in the same manner as debt acquired through consumer lending crowdfunding. The federal income taxation of various forms of investment contract that are captured within the definition of a security for U.S. federal law purposes is somewhat uncertain but likely to be determined by reference to analogous securities. Resales of securities acquired through securities crowdfunding should receive the same federal income tax treatment that any resale of those same types of securities would receive, including the recognition of capital gain or ordinary income to the reseller.

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84 Transfer to corporation controlled by transferor, 26 U.S.C. § 351(a); Nonrecognition of gain or loss on contribution, 26 U.S.C. § 721 (2012); P. BATTISTA (note 22).
85 P. BATTISTA (note 22).
Additional Legal Regulatory Risks and Considerations in U.S. Crowdfunding

The extent to which crowdfunding intermediaries of various kinds may be held liable in statutory and common law actions is, as yet, unclear. Platforms and others (e.g., doctors whose diagnoses are misused or misrepresented in medical crowdfunding campaigns\(^\text{87}\)) may be exposed to risks posed by statutory and common law fraud litigation.\(^\text{88}\) However, many—if not most—platforms directly disclaim liability in their terms of use.

Fundraisers and funders who disclose personal information on the Internet may open themselves up to privacy risks, including identity theft. Donative crowdfunding for medical expenses involves considerations under U.S. medical privacy laws.\(^\text{89}\) The CROWDFUND Act addresses privacy concerns to some extent through its regulation of platform activities.\(^\text{90}\)

Regulators and others also have been apprehensive about the use of crowdfunding as a vehicle for money laundering.\(^\text{91}\) This concern prompted the Financial Crimes Enforcement Network in the U.S. Department of the Treasury to propose clarifying regulation in 2016 applicable to securities crowdfunding.\(^\text{92}\)

Conclusion

Crowdfunding has grown rapidly over a short period of time. Legal regulation in the United States has been valiantly attempting to keep pace. Some standards and principles in existing legal doctrine fit the crowdfunding better than others, and most commentators in and outside the law recognize that.

Yet, little has been done to customize rules to fit the various models of crowdfunding or to regulate crowdfunding as a whole in a more comprehensive way. The law applicable to crowdfunding in the United States provides a remarkable example of the resulting complexity in the legal regulation of crowdfunding. The applicable system of legal regulation includes federal and state legal rules derived from statutory law, agency pronouncements, judicial opinions, and private regulation (including through platform terms of use).


\(^{89}\) J. CONA/D.W. SIVAK (note 10).


This report does not take a position on this organically grown matrix of legal regulation. Rather, it summarizes the current playing field in context. As crowdfunding markets mature, it will be important for policy makers and others to evaluate the extant legal regulatory systems and tools and make appropriate proposals for change. It is hoped that the legal regulatory observations described in this report may provide a basis for reflection in this and other contexts.
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