CROWDFUNDING: THE REAL AND THE ILLUSORY EXEMPTION

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Crowdfunding is commonly defined as raising small amounts of capital from a large number of people over the Internet. To avoid the expense of securities regulation, companies often crowdfund by giving away rewards (such as a free t-shirt) instead of selling stock or other securities. In April 2012, Title III of the JOBS Act sought to change this status quo by directing the Securities and Exchange Commission (SEC) to facilitate securities-based crowdfunding through websites like Kickstarter. Congress and the President believed this would broaden access to sidelined capital and help companies grow and hire. But this "retail crowdfunding" exemption, open to all investors, was not the only means of crowdfunding in the bill. A last minute compromise, which has been largely overlooked, expanded the ability of issuers to use the private placement exemption, as revised in new Rule 506(c), to crowdfund from accredited investors. This "accredited crowdfunding" exemption provides a less regulated capital-raising alternative to retail crowdfunding that is available to the same companies and more.

This article is the first to examine the impact that accredited crowdfunding will have on retail crowdfunding. It claims that accredited crowdfunding is likely to dominate and, depending on SEC action, could render retail crowdfunding superfluous or a market for lemons. But it also claims that accredited crowdfunding—when compared to traditional private placements—may face a similar lemons problem over the longer term on account of rules that discourage investors from fending for themselves. These potential problems threaten to undermine the social welfare goals of the JOBS Act: increasing access to capital, spurring business growth, and creating jobs. But the SEC can minimize these problems and promote social welfare by strengthening the bargaining incentives of accredited investors and encouraging retail investors to piggyback off of accredited investors' work. The normative section of this Article provides targeted recommendations that balance the need for capital formation against a novel incentives-based theory of investor protection.

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INTRODUCTION

In April 2012, Title III of the Jumpstart Our Business Startups Act ("JOBS Act")[1] directed the Securities and Exchange Commission ("SEC") to facilitate a new way for companies to raise capital from the general public through the sale of securities, a method known as "crowdfunding." In Octo-

[1] *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) [hereinafter the JOBS Act] (codified as amended in scattered sections of the U.S. Code).

ber 2013, the SEC published its long-awaited proposal to implement the crowdfunding mandate.[2] But what is crowdfunding?

Crowdfunding is a financing method used primarily by startups and small businesses to raise small amounts of capital from a large number of people over the Internet. It was originally popularized by websites such as Kickstarter that were seeking to help companies raise capital without implicating the securities laws. Rather than allow companies to crowdfund by selling stock or other securities, these websites only allowed (and continue to allow) companies to give away rewards, like a free t-shirt. This inspired a movement advocating a new securities law exemption to enable the model to expand to securities. Supporters argued that viable startups and small businesses were being denied funding by traditional private means, such as banks, venture capitalists, and angel investors, and could not afford traditional public means, such as initial public offerings ("IPOs"). To solve this perceived funding shortfall, they sought a new low-cost exemption to help companies access sidelined capital from the "crowd," meaning the more than 300 million Americans ("retail investors") who are normally shut out of this market because they do not qualify as accredited investors.[3]

In the lead-up to the JOBS Act, the Republican-controlled House of Representatives passed a bill to legalize such an exemption. But the Democrat-controlled Senate demanded customary investor protections, which would inevitably raise costs. What began as a nearly "regulation-free zone" quickly evolved into a "heavy and costly set of responsibilities."[4]

This "retail crowdfunding" exemption,[5] however, was not the only means of crowdfunding in the bill. A last minute compromise in Section 201(c) of the JOBS Act, which has been largely overlooked,[6] creates a broker-dealer exemption for crowdfunding websites that facilitate private placements to accredited investors only.[7] In the past, these placements were truly private since companies were prohibited from advertising their offerings or soliciting potential purchasers, except where there was a prior relationship. But this ban was lifted on September 23, 2013 with the adoption of Rule

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[2] Crowdfunding, 78 Fed. Reg. 66,428 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) [hereinafter SEC Proposal on Crowdfunding]. The proposal was originally disseminated to the public through the SEC's website on October 23, 2013.

[3] Accredited investors are generally institutions as well as individuals who regularly earn over $200,000 a year in income (or $300,000 with a spouse) or have a net worth, not including their primary residence, of over $1 million. *See* 17 C.F.R. § 230.501(a) (2014).

[4] Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 Cornell L. Rev. 1573, 1605 (2013) [hereinafter Thompson & Langevoort, *Redrawing*].

[5] "Retail crowdfunding," as used herein, means crowdfunding under Sections 4(a)(6) and 4A of the Securities Act (put in place by Title III of the JOBS Act) and the SEC's related rules. This method will not be legal until the SEC's related rules are finalized. *See supra* note 2.

[6] *See infra* Part I.D (describing "the quiet compromise" resulting in JOBS Act Section 201(c)).

[7] *See infra* note 89 and accompanying text for more detail on Section 201(c).

506(c).[8] Eliminating the ban on general solicitation and advertising coupled with the facilitation of direct access through the Internet has the potential to significantly increase accredited investor participation in crowdfunding. In 2012, while the ban was in place, about 1% of the accredited investor population (fewer than 91,000 persons) participated in startup and small business offerings.[9] Yet, there are at least 8.7 million U.S. households that qualify as accredited (7.4% of all households in the country).[10] Moreover, this accredited pool controls over 70% of available capital in the country.[11] So, "accredited crowdfunding,"[12] which is less regulated but open to the same companies and more, creates a serious competitor to retail crowdfunding.

This Article is the first to examine the impact that accredited crowdfunding will have on retail crowdfunding. It makes two claims.

First, accredited crowdfunding is likely to dominate and, depending on SEC action, could render retail crowdfunding superfluous (i.e., not viable) or a market for lemons.[13] The viability problem, which may impede the use of retail crowdfunding before a market for lemons can arise, is illustrated by an analysis of the legal differences between the two crowdfunding exemptions.[14] The analysis shows that, from the perspective of companies seeking to raise capital ("issuers"), accredited crowdfunding will generally be more attractive than retail crowdfunding. The main reason is that it is less costly and has the same general benefits so long as each deal is limited to the accredited investor pool. Retail crowdfunding, by comparison, has more required disclosures (including audited financial statements for capital raises exceeding $500,000), a requirement to use specific regulated crowdfunding

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[8] *See* 17 C.F.R. § 230.506(c) (2014). Rule 506(c) was mandated by Section 201(a) of the JOBS Act. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239, and 242) [hereinafter General Solicitation Adopting Release].

[9] *See* Vladimir Ivanov & Scott Baugess, Div. of Econ. and Risk Analysis, U.S. Sec. & Exch. Comm'n, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012 15 (2013) [hereinafter Ivanov & Bauguess July 2013 Study].

[10] *See* General Solicitation Adopting Release, *supra* note 8, at 44,793.

[11] *See* Edward N. Wolff, *The Asset Price Meltdown and The Wealth of the Middle Class* 58 (Nat'l Bureau of Econ. Research, Working Paper No. 18559, 2012). Table 2 therein shows that in 2010 42.1% of non-home wealth was concentrated in the top 1.0% of households and 29.6% was concentrated in the next 4.0% of households. This suggests that the top 5% of households control 71.7% of non-home wealth. Upon taking into account the top 10% of households, this figure jumps up to 84.9%.

[12] "Accredited crowdfunding," as used herein, means Rule 506(c) offerings that are sold through crowdfunding websites with the aid of JOBS Act Section 201(c) and/or recent SEC no-action letters that extend the non-broker exemption for crowdfunding websites to certain private funds (*see* AngelList and FundersClub No-Action Letters, *infra* note 93). The term does not include Rule 506(c) offerings outside of crowdfunding websites or other types of securities offerings.

[13] For an explanation of the market for lemons problem, see *infra* note 222 and accompanying text.

[14] *See infra* Part II and Appendix I (comparing retail and accredited crowdfunding from an issuer's perspective).

websites that must perform a variety of duties, and a higher level of liability, which extends to directors, many executive officers, and the crowdfunding websites. This will translate into higher legal and accounting fees, higher premiums on directors and officers liability insurance ("D&O insurance"), and higher intermediation fees. For a capital raise of $1 million (which is the maximum in retail crowdfunding), the SEC roughly estimates a cost of up to $152,260, which may be an underestimation.[15] This could be prohibitively expensive for many small issuers.

Even if retail crowdfunding is affordable enough to be viable, however, it could degrade into a market for lemons if investors lack sufficient incentives to perform due diligence. Annual investment limits, which are intended to protect investors by limiting their exposure to risky investments, could disincentivize due diligence because they prevent any one investor from having significant "skin in the game." There are also limits on pooled investing. Together, these "protections" prevent possible cures to the collective action problem that may arise on account of many individual investors having insignificant stakes.[16] An intractable information asymmetry between the companies and investors would tend to give rise to a market for lemons. While retail crowdfunding offers some advantages over accredited crowdfunding—principally a larger pool of potential investors—issuers will likely resort to this method only if they cannot succeed among accredited investors first.

Second, and more importantly, the Article claims that accredited crowdfunding—when compared to traditional private placements[17]—may face a similar lemons problem over the longer term on account of rules that similarly discourage investors from due diligence and monitoring. Unlike traditional private placements, which, in 2012, had an average of eight and a median of four investors per deal,[18] the new ability to broadly advertise in accredited crowdfunding encourages a much larger investor base (potentially thousands per deal). In the short term, issuers may prefer this new method to the traditional method because selling small stakes to more investors could mean giving away fewer control rights to investors.[19] Less sophisticated investors with less "skin in the game" will not have the same incentives to influence the issuer as a more concentrated group of sophisticated investors

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[15] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,521 (taking into account costs to compensate the crowdfunding website ($112,500), EDGAR filing fees ($60), an outside law firm's non-financial disclosure preparation and updates ($11,000), and audited financial disclosure ($28,700). These figures do not appear to take into account D&O insurance or in-house labor costs).

[16] For an explanation of the collective action problem, see *infra* note 227 and the accompanying paragraph.

[17] *See* 17 C.F.R. § 230.506(b) (2014). Traditional private placements, which are now governed by Rule 506(b) (the equivalent of old Rule 506), continue to ban general solicitation and advertising.

[18] *See* Ivanov & Bauguess July 2013 Study, *supra* note 9, at 15.

[19] *See infra* notes 228 and 229 and accompanying text.

would. But, over the longer term, this may also encourage a collective action problem in accredited crowdfunding that could lead to the funding of more deals with a lesser likelihood of success (i.e., less allocation efficiency).[20] By eroding the incentives of investors to actively protect their investments through due diligence, monitoring, and advice to companies, critical feedback loops between inexperienced management and knowledgeable investors may be lost.[21] If this leads to more failed deals than the failure rates of traditional private placements, this could hurt investor confidence and cause many of these investors to avoid accredited crowdfunding over time.[22]

If for these reasons both methods of crowdfunding fail, society, and not just the individual companies and investors, will bear the costs.[23] This is because Congress and the President intended this method of financing as a general measure to increase access to capital, spur business growth, and create jobs in an economy long plagued by slow growth and sustained high levels of unemployment and underemployment in the aftermath of the 2007–2009 financial crisis.[24] The importance of designing rules to promote, and not undermine, these social welfare goals is thus manifest.

The question, then, is how the SEC should act to make both retail and accredited crowdfunding viable and to prevent each from degrading into a market for lemons. This question can only be answered if the SEC understands both the factual and theoretical relationship between accredited and retail crowdfunding. To date, this relationship has been largely ignored.[25]

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[20] Allocation efficiency in economics measures how effective a market or economy is in allocating capital to the most productive opportunities.

[21] *See* Thompson & Langevoort, *Redrawing, supra* note 4, at 1610. They explain that the ability to fend for oneself, which substitutes for the protections of the securities laws, comes from "bargaining among a limited number of sophisticated parties." In other words, having a more dispersed group of investors, rather than a limited number, can aggravate a party's ability to bargain and thereby fend for oneself. This suggests that where the law has fewer investor protections, it should instead provide sufficient incentives to motivate such investors to fend for themselves. This insight is the basis for the incentives-based theory of investor protection developed in Part III and deployed in Part IV herein.

[22] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,514–15 (citing various studies that already show high failure rates among startups, including venture-backed startups, and opining that retail crowdfunding may have even higher failure rates).

[23] Such social costs, however, depend upon an important assumption made by Congress and the President: that the regulatory structure in place before the JOBS Act was hampering capital-raising by smaller companies and thus stifling business growth and hiring. *See, e.g.*, Remarks on Signing the Jumpstart Our Business Startups Act, 2012 Daily Comp. Pres. Doc. (Apr. 5, 2012) [hereinafter Obama's Signing Statement]. Yet, Congress did not conduct any study prior to the JOBS Act to rigorously identify impediments to capital raising. Recently, two economists at the SEC stated that "the evidence from Form D filings suggests an active and vibrant market for private offerings compared to registered offerings, and is inconsistent with the view that there are significant frictions in the capital raising process that prevent issuers from funding investment through private offering channels." *See* Ivanov & Bauguess July 2013 Study, *supra* note 9, at 10.

[24] *See, e.g.*, Obama's Signing Statement, *supra* note 23 ("Our job is to help our companies grow and hire. That's why I pushed for this bill.").

[25] *But see The JOBS Act in Action: Overseeing Effective Implementation That Can Grow American Jobs*: *Before the Subcomm. on TARP, Fin. Serv. and Bailouts of Pub. and Private Co. of the H. Comm. on Oversight and Gov't Reform,* 112th Congress 2 (2012) (statement of

While some leading scholars have recognized that issuers will generally prefer offerings that utilize Rule 506(c) rather than retail crowdfunding,[26] this Article is the first to comprehensively show why. This is an important contribution to the literature because issuers will view the two crowdfunding exemptions as alternate options. Furthermore, the viability of accredited crowdfunding must also be considered because issuers will view other financing methods (specifically, traditional private placements) as alternatives.[27] Through a holistic examination of the two exemptions, this Article provides the SEC with a new framework to assess the implementation of both.

The thesis is that the SEC can minimize the potential viability and lemons problems and promote social welfare by strengthening the bargaining incentives of accredited investors and encouraging retail investors to piggyback off their work. It is derived from an incentives-based theory of investor protection that this Article develops.[28] The theory holds that investors need stronger incentives to fend for themselves where the protections of the securities laws are sparse (e.g., private offerings) than where they are abundant (e.g., public offerings). This novel restatement of the regulatory line between "public" and "private" securities offerings recognizes that lines that were once hard have blurred into a spectrum. This is because private offerings are increasingly taking on public characteristics and vice versa. Since an empirical cost-benefit analysis is not yet possible,[29] this theory substitutes to assess the balance struck between capital formation and investor protection.[30]

Applying this theory, the Article makes a number of recommendations to minimize the potential problems. Chief among them is the recommendation to strengthen accredited investor bargaining power by encouraging pooled investments managed by a sophisticated and financially aligned lead

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John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) [hereinafter Coffee June 2012 Testimony] (contrasting representative differences between private placements and crowdfunding).

[26] *See* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 Sec. Reg. L.J. 3, 221–22 (2012) (noting in conclusion the irony that changes to Rule 506 are more important for internet offerings than the CROWDFUND Act); Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1604 (claiming that the changes to Rule 506 will have a more substantial impact than the new retail crowdfunding exemption); Coffee June 2012 Testimony, *supra* note 25, at 9–14 (claiming that issuers may be persuaded to use private placements instead of retail crowdfunding because of harsher requirements in the latter).

[27] For example, issuers will view non-securities-based methods such as Kickstarter, other securities-based exemptions (e.g., Regulation A and Rules 504 and 147), and registered offerings, as alternate options. The reasons to use these other options instead of either accredited or retail crowdfunding are beyond the scope of this Article.

[28] *See infra* Part III.

[29] Empirical evidence regarding the impact of accredited and retail crowdfunding is not yet available because accredited crowdfunding was only legalized on September 23, 2013, and retail crowdfunding has yet to be implemented. After both are permitted, generating a data set will take time. Allowing an experiment to gather empirical evidence is the only way to measure the impact that these crowdfunding methods will have on social welfare.

[30] *See infra* Part IV (assessing how the SEC can resolve certain open items to change the calculus).

investor in accredited crowdfunding and to encourage retail investors to piggyback off of this work through rules that facilitate back-to-back offerings where retail investors and passive accredited investors (but not the lead investor) participate on the same terms.[31]

The Article proceeds in five parts. Part I provides background on crowdfunding and how the two exemptions emerged. Part II contrasts the retail exemption against the accredited exemption and shows why issuers will generally prefer the accredited form. Part III describes a novel incentives-based theory of investor protection that can be used to assess the balance between capital formation and investor protection. Part IV assesses some potential action that the SEC could take in light of this theory to minimize the potential problems and to promote social welfare. Part V puts theory to practice by providing targeted recommendations.

I. Background

This Part introduces crowdfunding and the rationale behind the adoption of a new retail crowdfunding exemption. It then briefly describes the legislative history of the exemption, including the mysterious addition, at the eleventh hour, of a second crowdfunding exemption for accredited investors.

A. An introduction to crowdfunding

There are many forms of crowdfunding classified by the return each provides to its backers: donation-based, rewards-based, no-interest lending, interest-based debt, and equity-based.[32] Some crowdfunding sites combine one or more of these different types.[33] Since only interest-based debt and equity-based (together, "securities-based") sites provide investors with an expectation of profit, they are the only forms that implicate the securities laws.[34] Accordingly, these forms are the only two in which the accredited/retail distinction is relevant.

In 2012, the largest of these crowdfunding forms—measured by capital raised—was no-interest lending together with interest-based debt (together, "peer-to-peer lending").[35] Crowdfunding sites such as Kiva, Lending Club,

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[31] *See infra* Part V. *See also* letters of Jason W. Parsont to Elizabeth Murphy, Secretary, Securities and Exchange Commission dated Feb. 18, 2014 and November 4, 2013, *available at* https://www.sec.gov/comments/s7-09-13/s70913-282.pdf and http://www.sec.gov/comments/s7-06-13/s70613-463.pdf.

[32] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 Colum. Bus. L. Rev. 1, 14–27 (2012) (describing each type of crowdfunding in depth).

[33] *See, e.g.*, Fundable, http://www.fundable.com (a platform that combines equity-based and rewards-based crowdfunding).

[34] S*ee* Bradford, *supra* note 32, at 29–42 (analyzing which types of crowdfunding investments are subject to the securities laws under the Howey, Landreth, Forman, and Reves tests).

[35] *See* Patrick Clark, *Crowdfunders Are Quietly Donating and Lending Billions*, Businessweek.com (Apr. 8, 2013), http://www.businessweek.com/articles/2013-04-08/crowdfunders-

and Prosper that use this form raised $1.17 billion, up from $555 million in 2011. Donation-based crowdfunding, through platforms such as GlobalGiving, followed. This form raised $979 million in 2012, up from $675 million in 2011. Rewards-based crowdfunding, through sites such as Kickstarter, came next, raising $383 million in 2012, up from $62 million in 2011. The smallest form was equity-based crowdfunding, which accounted for $116 million in 2012, up from $89 million in 2011.[36]

While equity-based crowdfunding was the smallest form, it was also the most restricted in 2012. The SEC did not implement accredited crowdfunding until September 23, 2013, and, as of July 3, 2014, retail crowdfunding remains a mere proposal.[37] This means that issuers using equity-based crowdfunding have been limited to forms of crowdfunding that many consider either too costly or lacking in sufficient access to potential investors.[38] Leading sites, such as AngelList, CircleUp, FundersClub, MicroVentures, and Fundrise, have used exemptions such as Rule 506(b) and Regulation A.[39] In addition, the two leading sites facilitating resales of private securities—SecondMarket and SharesPost—are expanding into accredited crowdfunding.[40] While the status quo with respect to these restrictions has long endured, Rule 506(c) is now operative and retail crowdfunding will likely be implemented by the end of 2014 or in 2015.[41] In the meantime, the growth of these equity-based sites as well as the other types of legal

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are-quietly-donating-and-lending-billions (citing statistics compiled by research firm Masssolution surveying 362 platforms).

[36] *See id.*

[37] *See* General Solicitation Adopting Release, *supra* note 8. *See also* SEC Proposal on Crowdfunding, *supra* note 2.

[38] *See, e.g.,* Bradford, *supra* note 32, at 44–48 (detailing possible crowdfunding exemptions under current law and the problems posed by each).While equity-based crowdfunding involving accredited investors and, in some cases, retail investors, is currently taking place through existing exemptions, these alternatives fall outside of this Article's definitions of "accredited crowdfunding" and "retail crowdfunding" in notes 5 and 12.

[39] AngelList, CircleUp, FundersClub, and MicroVentures all rely on Rule 506(b) for offerings to accredited investors only. Fundrise has utilized Rules 506(b) and Regulation A. *See Innovation and Micro Financing: Hearing Before the Subcomm. on Investigations, Oversights, and Regulations of the H. Comm. on Small Business*, 113th Cong. (2013) (testimony of Ben Miller, Founder, Fundrise) (noting Fundrise's use of Regulation A for equity-based crowdfunding).

[40] SecondMarket recently partnered with CircleUp and AngelList. *See SecondMarket+*, SECONDMARKET, https://www.secondmarket.com/education/secondmarket-plus, last visited May 27, 2014. In addition, SecondMarket has also announced a new general solicitation solution. *See General Solicitation Solution*, SECONDMARKET, https://www.secondmarket.com/education/landing/general-solicitation-solution. SharesPost has also begun claiming it facilitates raising primary capital. *See* SHARESPOST, http://welcome.sharespost.com/resources/faqs/company-faqs, last visited May 27, 2014.

[41] *Testimony on "JOBS Act Implementation Update" Before the Subcomm. on Investigations, Oversight and Regulations of the H. Comm. on Small Business*, 113th Cong. (2013) (statement of Lona Nallengara, Acting Director, Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n. & John Ramsay, Acting Director, Div. of Trading and Mkts., U.S. Sec. & Exch. Comm'n) (indicating that the remaining provisions of the JOBS Act will be implemented "as soon as practicable").

crowdfunding will likely continue.[42] Crowdfunding proceeds are projected to nearly double in 2013 to approximately $5.1 billion.[43]

B. *The rationale for a new exemption*

The main rationale for a new securities law exemption is that a significant number of value-generating startups and small businesses are not getting funded because the current options are insufficient. The problem is often referred to as the "small business capital gap."[44] It is a theoretical funding shortfall to such businesses caused by informational inefficiency and the unavailability of traditional sources of capital: banks, venture capital firms, and angel investors.[45] In turn, an unknown number of jobs and innovations are presumed to be lost.[46]

To help close this perceived gap,[47] many commentators have recommended securities-based crowdfunding.[48] Professor C. Steven Bradford authored the most influential proposal prior to any Congressional action.[49] Drawing on the success of rewards-based models, such as Kickstarter,[50] he

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[42] At year-end 2012, there were already 9,001 websites containing the word "crowdfund." *See* Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WSJ.COM (Jan. 17, 2013), http://online.wsj.com/article/SB10001424127887323783704578247380848394600.html.

[43] *See* Clark, *supra* note 35. According to a 2013 World Bank Study, the global crowdfunding market could reach between $90 billion and $96 billion by 2025. *See* Katherine Noyes, *Why Investors are Pouring Millions into Crowdfunding*, FORTUNE (April 14, 2014), http://fortune.com/2014/04/17/why-investors-are-pouring-millions-into-crowdfunding.

[44] *The Jobs Act—Importance of Effective Implementation: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Public and Private Programs of the H. Comm. on Oversight and Gov't Reform*, 112th Congress 2 (2012) (statement of C. Steven Bradford, Earl Dunlap Distinguished Professor of Law, University of Nebraska College of Law) [hereinafter Bradford June 2012 Testimony].

[45] *See* Bradford, *supra* note 32, at 101.

[46] *See* Bradford, *supra* note 32, at 100. *But see* Obama's Signing Statement, *supra* note 23; Ivanov & Bauguess July 2013 Study, *supra* note 9, at 10.

[47] *See* Obama's Signing Statement, *supra* note 23; Ivanov & Bauguess July 2013 Study, *supra* note 9, at 10.

[48] *See, e.g.*, Bradford, *supra* note 32; Joan McLeod Hemingway & Sheldon Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879 (2011); Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973 (2010–2011); Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?* 29 LOY. L.A. ENT. L. REV. 375 (2008–2009).

[49] *See* Bradford, *supra* note 32, at 89 n.443 (explaining that a draft of his crowdfunding proposal was publicly available on the Social Science Research Network long before any of the crowdfunding bills were introduced and that he had an extensive conversation with Congressman Patrick McHenry's staff after the original bill was introduced). McHenry has been quoted as saying that Bradford had "written the bible of crowdfunding." Press Release, University of Nebraska-Lincoln, Nebraska Faculty Take Over Congress, http://newsroom.unl.edu/announce/law-faculty/1449/8255. *See also infra* Part II (showing that the CROWDFUND Act follows many of Bradford's principles).

[50] *See* KICKSTARTER, http://www.kickstarter.com.

suggested a new exemption to effectively legalize this model for securities, while also including some novel investor protections.[51]

The genius of the Kickstarter model is that, on account of being unregulated, it is affordable to issuers and yet has no limitation on potential investors. As an alternative to raising capital through the sale of equity or debt, Kickstarter allows companies to raise money in exchange for distinct rewards. These rewards, such as a free t-shirt, do not constitute an ongoing financial relationship with the company. For this reason, contributors have no expectation of profit. They are thus not investing in the company, but rather buying distinct products as consumers.[52] For example, consider the difference between a person who makes a one-off purchase of a book on Amazon.com (a consumer with no further financial relationship to the company) and one who buys stock in the company (an investor who will profit if Amazon.com becomes more valuable over time). This distinction between investment and consumption allows Kickstarter capital raises to avoid the application of the securities laws.[53] This means, most importantly, that companies need not face the high cost of securities regulation (though Kickstarter takes a cut of the funds raised) and companies have no limits on who can contribute (i.e., anyone, not just accredited investors, can participate).

To give an example of how Kickstarter works, the creator and executive producer of the television show *Veronica Mars* put together a campaign to raise money for a film version.[54] The campaign raised nearly $6 million from over 90,000 backers by selling distinct rewards, which were not yet created, at a variety of price points. Those contributing $35, for instance, were promised a copy of the script, a limited edition t-shirt, and a free digital download. One fan contributing $10,000 was promised a speaking role.[55] This effectively allowed the movie's producer to begin taking in revenues before creating the rewards or beginning work on the film. These present revenues, minus the future cost to create the rewards, helped finance the film.[56]

This model combines low costs with broad access to retail investors. However, it is not effective for all types of capital raises. While it works well for projects such as *Veronica Mars* that already have large existing fan bases and can offer inexpensive or costless gimmicks, it would be unlikely

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[51] *See* Bradford, *infra* note 69 and accompanying text listing Bradford's five principles.

[52] *See* Bradford, *supra* note 32.

[53] *See* Bradford, *supra* note 32, at 32. In fact, using a credit card to contribute to the company's capital raise may entitle contributors to a full refund from the credit card company if the entrepreneur fails to later deliver the promised goods. *See* Felix Salmon, *Kickstarter funders aren't angel investors*, REUTERS.COM (Apr. 18, 2013), http://blogs.reuters.com/felix-salmon/2013/04/18/kickstarter-funders-arent-angel-investors.

[54] *The Veronica Mars Movie Project*, KICKSTARTER, http://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project (last visited Mar. 2, 2014).

[55] *See id.*

[56] *See* Salmon, *supra* note 53.

to work for a healthcare company such as Ekso Bionics ("Ekso").[57] This company creates a wearable robot or exoskeleton that enables people with lower-extremity paralysis or weakness to stand and walk.[58] Since the company is not widely known and the product is expensive to manufacture and only suitable for a small segment of the population, Ekso, during its initial startup phase, could not have offered the product itself as a reward. Only those suffering paralysis or weakness would be candidates to buy it. Moreover, unrelated gimmicks, such as a t-shirt, would not be in demand without any existing fan base and could stigmatize the product's noble aspirations. For a company such as Ekso to raise capital, a profit motive for investors seems necessary.[59]

Companies similar to Ekso may be denied funding from the traditional seed-stage sources as a result of the small business capital gap.[60] Seeking funding from the general public through an IPO or a private placement, moreover, has been thought by some to be either too expensive or too muzzled by rules that limit communication and potential participants.[61]

"Economies of scale," claims Bradford, "make registration inefficient for smaller offerings, even if registration creates a net benefit for larger offerings."[62] Registered offerings cost hundreds of thousands of dollars and mini-registrations under Regulation A can cost between $40,000 and $60,000.[63] The claim is that these fixed costs add a disproportionate level of expense. This may partly explain why small company IPOs are at record lows[64] and why only sixteen Regulation A offerings were conducted between 2009 and 2012, even though both methods provide full access to retail investors.[65]

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[57] *See FAQ*, Ekso Bionics, http://www.eksobionics.com/FAQ (last visited Mar. 2, 2014). Ekso is an established private company that recently sought to raise $15 million in a second round financing.

[58] *See id.*

[59] Companies in other industries might similarly need to sell securities, rather than rewards, to stimulate investment. For instance, this may be the case for clean energy companies seeking capital to profit from energy efficiency savings like building and selling a more efficient battery. Such companies depend upon long-term patient capital. They will not be able to finance their projects through short-term rewards.

[60] *See* Bradford, *supra* note 32, at 101 and accompanying text.

[61] *See* Bradford, *supra* note 32, at 42–49 (explaining why the menu of pre-JOBS Act options was insufficient).

[62] *See* Bradford, *supra* note 32, at 119.

[63] *See* Bradford, *supra* note 32, at 42, 48.

[64] *See* Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?* (Dec. 17, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1954788 (explaining that the regulatory overreach hypothesis has been the dominant explanation for the drought in IPOs and introducing a new explanation—the economies of size and scope hypothesis). *See also* John C. Coffee, Jr., *Gone With the Wind: Small IPOs, the JOBS Act, and Reality*, The CLS Blue Sky Blog (Feb. 1, 2013), http://clsbluesky.law.columbia.edu/2013/02/01/gone-with-the-wind-small-ipos-the-jobs-act-and-reality [hereinafter Coffee, *Gone With the Wind*] (listing both of the above hypotheses, as well as others, as possible explanations for the decline in small company IPOs).

[65] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,509–10.

Moreover, none of the less costly exemptions from registration otherwise fit the Kickstarter model. The main problem is that each limits access to potential investors by either prohibiting communication methods or limiting the pool of potential investors. Beginning with Section 4(a)(2) and its safe harbor in Rule 506, there are two reasons that private placements were thought to be insufficient: such offerings are generally limited to accredited investors only and therefore are not open to the full crowd (i.e., retail investors); and such offerings prohibit the use of general solicitation and advertising and thus could not be shown on an open access website.[66] For similar reasons, Section 4(a)(5), Rule 505, and Rule 504 also would not work.[67] Section 3(a)(11) and Rule 147—the intrastate offering exemption—also would not fit the model because of localized geographic limitations.[68]

To solve this tradeoff between high costs and the ability to access a broad number of potential investors in the securities context, Bradford suggests a new securities law exemption. His recommendations can be boiled down to the following five principles: (1) affordability in small offerings through no expensive federal or state regulatory requirements for issuers or crowdfunding sites; (2) no barriers to accessing potential investors, such as limits on general solicitation and advertising or investor eligibility requirements; (3) ensuring no catastrophic investor losses through individual investment limits and warnings about potential risks; (4) requiring crowdfunding sites to act as gatekeepers on behalf of investors through affirmative duties and limitations on conflicts of interest; and (5) harnessing the wisdom of the crowd by requiring crowdfunding sites to host open communication forums to detect fraud and to withhold funds from issuers until a sufficient segment of the crowd subscribes.[69] The first two are capital formation principles that would address the cost/access tradeoff; the latter three are novel investor protection principles. Together, I refer to these as "Bradford's five principles."[70]

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[66] *See* Bradford, *supra* note 32, at 45–46.

[67] *See* Bradford, *supra* note 32, at 46–48.

[68] *See* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. Rev. 1735, 1745 (2011–2012) (suggesting that crowdfunding is national in character).

[69] *See generally* Bradford, *supra* note 32, at 117–49.

[70] It is notable that Bradford also argues that crowdfunded securities should have no resale restrictions as a means of protecting unsophisticated investors from "a trap for the unwary," but he says that the presence of such restrictions would "not unduly chill use of the exemption." *See* Bradford, *supra* note 32, at 144–45.

C. The legislative history of the retail crowdfunding exemption

(i) The regulation-free zone

Bradford's rationale for a new crowdfunding exemption likely influenced[71] Republican Congressman Patrick McHenry's initial bill setting forth a proposed crowdfunding exemption.[72] While this initial bill was rather sparse and did not adopt Bradford's precise recommendations, a revised bill that the House eventually passed included some variation of each of Bradford's five principles.[73] This bill has been aptly described as putting in place a "regulation-free zone."[74]

First, the bill put in place an offering cap to ensure small offerings and placed no restrictions on eligible issuers. Then, to keep down costs, it did not require mandatory disclosure or heightened liability exposure. In addition, the bill exempted participating crowdfunding sites from broker-dealer regulation, which would lower the platform's regulatory costs, and preempted the potential for the states to impose similar requirements in place of federal law. The bill included an explicit exemption from the 500 record holder rule that normally forces companies with too many shareholders into the expensive continuous disclosure system required by the Securities and Exchange Act of 1934 (the "Exchange Act").[75] This would have addressed the *Veronica Mars* situation where individual contributors quickly exceeded 500 on account of tiny contributions from thousands. Last, the bill allowed issuers to rely on self-certification by investors with respect to individual investment limits. This would have alleviated potential costs associated with an issuer having to verify that investors are complying with their limits. The bill also included certain custom-built resale restrictions. Together, this package meant that issuers and crowdfunding sites, compared to other small offering alternatives, would have been subject to a relatively affordable regulatory regime.

Second, the bill sought to ensure full access to potential investors. It achieved this by placing no limits on general solicitation and advertising nor on eligible investors. This meant that issuers could freely and aggressively market their product, subject only to the antifraud rules, and any investor could participate.

Third, the bill sought to prevent catastrophic investor losses by including individual investment limits and risk warnings. It capped individual in-

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[71] *See supra* note 49.

[72] *See* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011) (as introduced by Congressman Patrick McHenry on Sept. 14, 2011).

[73] *See* H.R. Res. 2930, 112th Cong. (2011) (enacted).

[74] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4.

[75] The JOBS Act raised the threshold to 2,000 holders of record or 500 non-accredited holders of record. *See* JOBS Act § 501 (requiring the SEC to amend Section 12(g) of the Securities and Exchange Act as codified in 15 U.S.C. § 781(g) (2012)).

vestments at a maximum of $10,000 per year. For investors making less than $100,000, the limit was capped at 10% of annual income. This sought to address the concern that investors may not be able to afford a complete loss of their investment, though the levels were substantially higher than those Bradford specifically recommended. It also required the issuer or crowdfunding site to warn investors about the speculative nature of investments in startups, emerging businesses, and small issuers, including risks in the secondary market related to illiquidity.

Fourth, the bill required crowdfunding sites to perform gatekeeping duties for the benefit of investors and it limited conflicts of interest. In other words, it put the websites to work on behalf of investors to root out fraud and provide other investor protection functions. Alternatively, the bill allowed issuers to perform these duties and comply with conflict of interest rules (including disclosing its inherent conflict) if it chose not to hire an intermediary. The duties included, for example, a requirement that the crowdfunding site or issuer take measures to reduce fraud. The conflicts rules, meant to mitigate sales pressure, prohibited the site or issuer from providing investment advice and required them to outsource cash management functions.

Fifth, the bill sought to protect investors by harnessing the wisdom of the crowd. It required open communication forums to presumably facilitate self-help in exposing fraud and it ensured a critical mass of crowd interest by preventing any funding to the issuer until at least 60% of the target amount was subscribed by non-affiliates.

(ii) How the bill evolved

After the House bill passed, the Senate took its turn, which began the evolution of the bill into what has fittingly been called a "heavy and costly set of responsibilities."[76] Initially, the Senate's bill closely paralleled the House's and similarly included some variation of each of Bradford's five principles.[77] While none of the initial Senate changes would cause much friction with Bradford's original vision, four changes were significant in that they would add back some issuer costs by strengthening investor protection. First, it lowered the individual investment limits from a maximum of $10,000 per year to $1,000 per year, a figure more in line with Bradford's specific recommendations. This change reduced the chance of catastrophic loss. Second, the bill omitted any provision enabling the issuer to rely on self-certification, which could potentially be interpreted as requiring costly verification of investor compliance. Third, it required the use of a crowdfunding intermediary. This would deny issuers the choice of potentially saving money by cutting out the middleman. Fourth, it added one more

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[76] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1605.

[77] *See* Democratizing Access Capital Act of 2011, S. 1971, 112th Cong. (2011).

conflict of interest requirement, also suggested by Bradford, to strengthen the alignment of crowdfunding sites and investors.[78]

On December 1, 2011, a Senate Committee held hearings to get feedback on the bills. Many of the commentators expressed concern that the bills would not provide investors with sufficient protection. The first concern was a lack of meaningful disclosure.[79] There was also concern that the bills did not include adequate regulatory oversight[80] and would subject vulnerable investors to high-pressure sales tactics.[81] Two other commentators pointed out the importance of considering the need for more robust investor protections in light of the experience with fraud in the 1990s under the prior iteration of Rule 504.[82]

These investor protection critiques set up a battle between two competing camps: the capital formation camp, led by Republican Congressman McHenry, and the investor protection camp, helmed by Democratic Senator Jeff Merkley. Within a week of the Senate Committee testimony, Merkley introduced a new bill, called the CROWDFUND Act, to increase investor protections.[83] In particular, the new bill sought to augment mandatory disclosure requirements, impose regulatory oversight of crowdfunding sites, and curb opportunities for high-pressure sales tactics by subjecting active solicitors to broker-dealer regulation. The final version included even tougher requirements, including heightened liability exposure.[84] For present purposes, it is enough to note that most of the criticism of the Act has focused on concerns that the additional investor protections make retail crowdfunding too expensive to use.[85] For this reason, some suggest that the SEC take a light touch in

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[78] *See id.* Furthermore, it prohibited a site's employees from investing in offerings made through the site or from having any financial interest in companies posting offerings through the site.

[79] *See Spurring Job Growth Through Capital Formation While Protecting Investors*: *Hearings Before the Senate Comm. on Banking, Hous. and Urban Affairs*, 112th Cong. 8 (2011) (statement of Professor John C. Coffee, Jr.) (citing no "meaningful disclosure" as one of the premises of the bill) [hereinafter Spurring Job Growth]; *id.* at 5 (statement of Scott Cutler, Executive Vice President and Co-Head of U.S. Listings and Cash Execution at NYSE Euronext) ("Any crowdfunding exemption should . . . require that issuers disclose sufficient information to ensure that investors understand what they are purchasing.").

[80] *See* Spurring Job Growth, *supra* note 79, at 8 (statement of Professor John C. Coffee, Jr.) (observing that the bill allows issuer solicitation "without prior SEC oversight"); *id.* at 4 (statement of Jack Herstein, President of the North American Securities Administrators Association ("NASAA")) (expressing concern that the bill would prohibit state enforcement).

[81] *See* Spurring Job Growth, *supra* note 79, at 1 (statement of Professor John C. Coffee, Jr.) (suggesting the bill could aptly be titled the "The Boiler Room Legalization Act of 2011").

[82] *See* Spurring Job Growth, *supra* note 79, at 14–15 (statement of Meredith Cross, Director, and Loni Nallengara, Deputy Director, Div. of Corp. Fin., U.S. SEC).

[83] *See* CROWDFUND Act, S. 1970, 112th Cong. (2011).

[84] *See generally* JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315–23 (2012).

[85] *See* Thompson & Langevoort, *Redrawing, supra* note 4, at 1605 ("it is difficult for us to see why a rational start-up entrepreneur would find it appealing to use the new 4[(a)](6) exemption at all."); Bradford June 2012 Testimony, *supra* note 44, at 17 ("small businesses, especially very small startups, may find the crowdfunding exemption too expensive to use."); *cf.* Coffee June 2012 Testimony, *supra* note 25, at 15 ("[T]hese factors seem likely to chill most issuers from *relying* on this exemption.").

the implementation process to make retail crowdfunding as inexpensive as possible.[86] Some have also leveled investor protection critiques at the removal of the requirement that crowdfunding sites operate open communication forums to help expose fraud.[87] Accordingly, on account of significant changes to Bradford's first and fifth principles, the CROWDFUND Act, which became law as part of the JOBS Act, departed in important ways from his original vision.

D. The quiet compromise

Given the strong partisan divisions in Congress, a crowdfunding bill would not have passed without significant compromise on both sides of the aisle. For the capital formation camp, the Merkley bill was probably a tough pill to swallow. It seems that a quiet compromise behind closed doors may have helped. The result was the accredited crowdfunding exemption.

From the point of view of the public, all that is known is that, on March 8, 2012, Congressman McHenry proposed what he described as a "simple," "narrow," and "specifically crafted" amendment to a different exemption within the JOBS Act.[88] This amendment, which introduced Section 201(c), expanded the ability of issuers to use Rule 506 over the Internet.[89] Not only

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[86] *See, e.g.*, Bradford June 2012 Testimony, *supra* note 44, at 1 (arguing that "SEC regulations should be as light-handed and unobtrusive as possible"); *see also* Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 43, 62 (2013) ("This Essay's core message to the SEC, and incoming Chairman White, is this: keep the rules and regulations governing securities crowdfunding as light and simple as possible."); Andrew Fink, *Protecting the Crowd and Raising Capital Through the JOBS Act* 35 (2012), *available at* http://ssrn.com/abstract=2046051.

[87] *See* Bradford June 2012 Testimony, *supra* note 44, at 6.

[88] 158 CONG. REC. H1277-03 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) (introducing amendment to the JOBS Act to add Section 201(c)) [hereinafter the McHenry Amendment].

[89] JOBS Act § 201(c) (2012) as codified in Section 4(b) of the Securities Act, 15 U.S.C. 77d (b)(1) (2012), states the following:

> (1) With respect to securities offered and sold in compliance with Rule 506 of Regulation D under this Act, no person who meets the conditions set forth in paragraph (2) shall be subject to registration as a broker or dealer pursuant to section 15(a)(1) of this title, solely because—(A) that person maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means; (B) that person or any person associated with that person co-invests in such securities; or (C) that person or any person associated with that person provides ancillary services with respect to such securities.
>
> (2) The exemption provided in paragraph (1) shall apply to any person described in such paragraph if—(A) such person and each person associated with that person receives no compensation in connection with the purchase or sale of such security; (B) such person and each person associated with that person does not have possession of customer funds or securities in connection with the purchase or sale of such security; and (C) such person is not subject to a statutory disqualification as defined in section 3(a)(39) of this title and does not have any person associated with that person subject to such a statutory disqualification.

did it explicitly extend a different provision of the JOBS Act—the long-debated elimination of the ban on general solicitation and advertising—to Internet-based offerings, but it clarified that companies can use any website (even those not regulated as a broker-dealer) to openly advertise and solicit interest in their offerings, subject to a few conditions.[90] It also introduced other rights that prior guidance[91] on Internet offerings did not allow, such as undisclosed co-investments by non-brokers in hosted offerings, the hosting of issuers of any size (not just startups and small businesses), and the provision of due diligence services, uncompensated investment advice, and standardized documentation.[92] While Section 201(c) is directed at Internet crowdfunding websites seeking an exemption from broker-dealer regulation, its guidance is also relevant to registered broker-dealers because permissible activity for non-brokers is also presumably permissible for those registered.[93]

> (3) For the purposes of this subsection, the term 'ancillary services' means—(A) the provision of due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors; and (B) the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.

[90] *See id.*

[91] For the prior guidance, see the following no-action letters: IPONET, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 642 (July 26, 1996) (carving out an exception to the ban on general solicitation and advertising for private placements offered to pre-screened accredited investors on password-protected sites); Lamp Technologies, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638 (May 29, 1997) (extending IPONET's guidance to investment advisers for private funds); Angel Capital Electronic Network, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 812 (Oct. 25, 1996) (extending IPONET's guidance to non-broker websites facilitating private placements if, among other things, the site did not give investment advice, provide standardized documentation, or co-invest (unless disclosed), and only small companies could offer securities) [hereinafter ACE-Net]; Internet Capital Corporation, 1997 SEC No-Act. LEXIS 1096 (Dec. 24, 1997) (extending ACE-Net's guidance to sites earning profits).

[92] *See* JOBS Act § 201(c) (2012) as codified in Section 4(b)(1) of the Securities Act, 15 U.S.C. 77d (b)(1) (2012).

[93] To this author's knowledge, AngelList is currently the only non-broker crowdfunding site relying on Section 201(c) to avoid broker-dealer regulation, though it plans to register as an investment adviser for some purposes. *See* AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter, 2013 SEC No-ACT LEXIS 294 (Mar. 28, 2013) [hereinafter AngelList No-Action Letter], *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf (permitting broker-dealer exemption for registered investment advisers). Many other sites, such as CircleUp and Microventures, are choosing to be regulated as broker-dealers. *See* J.J. Colao, *In The Crowdfunding Gold Rush, This Company Has A Rare Edge*, FORBES (June 5, 2013), *available at* http://www.forbes.com/sites/jjcolao/2013/06/05/in-the-crowdfunding-gold-rush-this-company-has-a-rare-edge. Others, such as FundersClub, will be regulated as venture capital fund advisers. *See* FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter, 2013 SEC No-Act. LEXIS 271, (Mar. 26, 2013) [hereinafter FundersClub No-Action Letter], *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf (permitting broker-dealer exemption for venture capital fund advisers). Significant limitations on how non-brokers may earn money likely explains why many of these sites prefer the regulated route. *See* SEC Division of Trading and Markets, *Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, U.S. SEC. & EXCH. COMM'N. (Feb. 5, 2013), *available at* http://

The exemption also codifies much of the prior no-action guidance.[94] In doing so, it paves the way for Internet crowdfunding sites to use Rule 506(c). Congressman McHenry explained the purpose behind the amendment as follows:

> This amendment is very simple. We know, and policymakers in Washington here know, that entrepreneurship is at a 17-year low in the United States. We also know that small businesses are the drivers of our economy. So what this amendment does is it enables investors to connect with start-ups. It takes away some red tape that is within securities regulations, and it allows incubators, forums, and online platforms which only connect accredited investors to start-ups to be exempt from SEC registration as a broker dealer if they, number one, do not charge a commission or fee for their service; number two, do not handle the moneys of investors; and, number three, only permit accredited investors to use their platforms . . . active seed in angel investors and their meeting venues should not be subject to the regulations that were designed to protect inexperienced investors.[95]

This set the stage for a game of regulatory arbitrage.[96] Minutes later, without substantive explanation, Congressman Barney Frank, representing the other side of the aisle, gave his stamp of approval. He said "there will be some subsequent amendments that I think will be controversial. This one is not."[97] McHenry gave thanks for the "more conciliatory tone in today's debate. It's fantastic."[98] He emphasized that he appreciated "the support across the aisle for this important issue."[99] And so, without debate, expert testimony, or additional discussion, the McHenry Amendment authorizing a second

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www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm (describing limitations on how sites can earn money).

[94] *See, e.g.*, ACE-Net, *supra* note 91 (limiting permissible compensation and prohibiting a non-broker from the handling of funds or securities).

[95] *See* the McHenry Amendment, *supra* note 88.

[96] *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010) ("Regulatory arbitrage exploits the gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision.").

[97] The McHenry Amendment, *supra* note 88. It is notable that Congressman Frank's view may be justified by the long-held notion that accredited investors do not need the protection of the securities laws because they can fend for themselves. *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1583 (noting that the accredited investor concept "purports to be an interpretation of the Ralston Purina standard but in fact marks a fairly radical departure in terms of practice"). This article shows in Part III, however, that certain changes over time to the incentives of accredited investors may undermine this notion.

[98] The McHenry Amendment, *supra* note 88.

[99] The McHenry Amendment, *supra* note 88.

crowdfunding exemption quickly and quietly passed the House.[100] It became law less than one month later.

II. Two Crowdfunding Exemptions Compared

Whereas the retail crowdfunding exemption, by some accounts, received "disproportionate attention"[101] in the lead up to the JOBS Act, the McHenry Amendment received almost none; at least, none in the public eye. This suggests a quiet compromise between Republicans and Democrats on crowdfunding. In exchange for the Republicans accepting Merkley's bulked-up regulatory vision of retail crowdfunding, it appears the Democrats accepted McHenry's vision for a regulation-light experiment limited to accredited investors only. This part illustrates the differences by contrasting the retail crowdfunding exemption against the accredited crowdfunding exemption. As a touchstone, each element is reviewed through the lens of Bradford's five principles below.[102] This analysis shows that, absent SEC action, accredited crowdfunding, on account of having fewer investor protections and other regulatory restrictions, will generally be more flexible and affordable for issuers, even though the pool of potential investors is smaller.

A. *Affordability in small offerings*

Bradford's first capital formation principle is affordability in small offerings. The theory behind this principle is that the "cost to register a relatively small offering exceeds any benefit that registration could provide."[103] This sub-part first compares the rules in retail and accredited crowdfunding that keep offerings small. Then it compares the eligible issuer rules to narrow the comparison to only those companies that can use both exemptions. The remainder compares the affordability of each exemption along eight different factors to show why accredited crowdfunding will generally be more cost-effective.

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[100] *See* The McHenry Amendment, *supra* note 88*; see also* Final Vote Results for H.R. 3606 in the House of Representatives (Mar. 8, 2012), *available at* http://clerk.house.gov/evs/2012/roll110.xml.

[101] Coffee June 2012 Testimony, *supra* note 25, at 9.

[102] For a discussion of Bradford's five principles, see *supra* Part I.B. While some of Bradford's principles were tailored specifically to sales to the general public and may not apply to accredited investors, a comparison that uses these principles as a touchstone is valuable in showing that accredited crowdfunding better achieves Bradford's capital formation principles (i.e., low cost/high access) than retail crowdfunding. Moreover, accredited crowdfunding does so without adopting any of Bradford's offsetting investor protection principles. The result reveals a stark compromise: an exemption going further than any other toward solving the cost/access tradeoff, so long as access is limited to wealthy (but not necessarily financially savvy) investors.

[103] Bradford, *supra* note 32, at 118–19.

(i) The small offering requirements

Offerings are kept small through two mechanisms: an offering cap and aggregation rules. The presence of an offering cap is a threshold concern for issuers because it limits the potential size of a given sale of securities. In retail crowdfunding, there is a $1 million annual offering cap.[104] In accredited crowdfunding, there is none.[105] So, an unlimited amount can be raised. This shows that retail crowdfunding, at the outset, is less flexible because it will not be an option if a company needs over $1 million in one year.

Aggregation means counting the amounts raised in two different capital raises toward one offering cap. Like the related integration rules (discussed herein),[106] aggregation can place a burdensome external constraint on raising subsequent rounds of capital. For example, if an issuer wishes to use retail crowdfunding to raise $1 million two months after an initial capital raise for $900,000 under Rule 506, the aggregation principle might count the initial amount against the $1 million offering cap, reducing it to only $100,000. Exceeding this limit in the second offering could violate the conditions of the exemption, which could have draconian consequences.[107]

In retail crowdfunding, the aggregation rule is ambiguous. It states that "the aggregate amount sold to all investors by the issuer, *including any amount sold in reliance on the [retail crowdfunding] exemption* . . . during the 12-month period preceding the date of such transaction, is not more than $1,000,000."[108] The ambiguity is whether all amounts sold during the twelve months before a capital raise, whether in reliance on the retail crowdfunding exemption or a different exemption, would be aggregated, or only amounts sold in reliance on the retail crowdfunding exemption. If the italicized language were deleted, the first interpretation would govern as a matter of plain meaning. This would severely limit the ability of retail crowdfunding to be used as a follow-on offering to a Rule 506 deal. But the italicized sentence creates ambiguity. Proponents of the second interpretation, which would preserve the $1 million cap for follow-on capital raises that use other exemptions, argue that it is supported by a rule of construction[109] that clarifies that the retail crowdfunding exemption is not exclusive and is meant to be used with other exemptions. The SEC, in its proposed regulation, has adopted this

[104] *See* JOBS Act § 302(a) as codified in 15 U.S.C. § 77(d) (2012).

[105] *See* 17 C.F.R. § 230.506 (2014).

[106] *See infra* Part II.A.iii.h.

[107] For a description of the potential draconian consequences, see *infra* Part II.A.iii.h.

[108] JOBS Act § 302(a) as codified in 15 U.S.C. § 77(d) (2012) (emphasis added).

[109] *See* JOBS Act § 302(b) as codified in 15 U.S.C. 77(d–1)(g) (2012) ("Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).").

view, which would encourage retail crowdfunding to follow offerings that use other exemptions.[110]

In accredited crowdfunding, by contrast, there is only aggregation risk if the deal is combined with a different exemption that has an offering cap. If an issuer uses Rule 506 for an initial and a follow-on capital raise, this avoids all aggregation risk. Accordingly, the absence of an offering cap and the lack of aggregation risk in back-to-back Rule 506 offerings show that this option is more flexible for issuers with uncertain capital needs.

(ii) The Eligible issuer rules

The eligible issuer rules function as a second threshold matter for companies. Retail crowdfunding specifically prohibits many issuers from using the exemption, such as public companies, foreign companies, mutual funds, private investment funds, bad actors, and others whom the SEC adds.[111] This leaves only U.S.-based private companies—generally startups and small businesses—as potentially eligible. By contrast, in accredited crowdfunding, no issuers are excluded, except felons and other bad actors.[112] This means that all other types of issuers can utilize accredited crowdfunding.

In sum, only a narrow group of issuers—primarily U.S.-based startups and small businesses that need less than $1 million in capital in any given year—will be eligible to decide between retail and accredited crowdfunding based on the affordability factors discussed in the next sub-section. For the rest, retail crowdfunding will not even be an option.[113]

(iii) Elements bearing on affordability

a. Liability Exposure

Liability exposure is one of the biggest cost items in a securities offering. For example, in the public company context, heightened liability exposure translates into higher premiums under D&O insurance, higher auditing

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[110] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,432 ("Capital raised through other means should not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6).").

[111] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77(d–1)(f) (2012); JOBS Act § 302(d) as codified in 15 U.S.C. § 77(d) (2012). The SEC has proposed to add two new categories of ineligible issuers. *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,551 (Rule 100(b)).

[112] *See* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44, 730 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230, and 239).

[113] This suggests, at the outset, that crowdfunding sites that want to maximize their potential client base and their ability to generate fees will prefer accredited crowdfunding. Investors, moreover, may have more investment options if they browse through a site that caters to accredited crowdfunding. For example, only accredited crowdfunding sites will give access to foreign startups. These threshold differences may contribute to the predicted dominance of accredited crowdfunding.

costs, and higher underwriting fees.[114] In the private company context, where only antifraud liability typically applies, such fixed costs will be lower because there is less litigation risk to protect against. Retail crowdfunding will have higher fixed costs than accredited crowdfunding because it is exposed to a public-like form of liability—akin to 12(a)(2) liability[115]—whereas accredited crowdfunding is only exposed to antifraud liability.[116]

Antifraud liability poses a relatively low liability risk for issuers and other participants, such as management, accountants, and brokers. There are two main reasons.[117] First, just to survive a motion to dismiss, a plaintiff must plead facts in the complaint giving rise to a strong inference of scienter.[118] In a suit against a private company, it is very difficult to meet this standard without discovery because there will be no public filings to cite.[119] Furthermore, even if material misstatements or omissions are identified, mere negligence is not enough to prove scienter. The plaintiff will need to prove that the misstatement or omission was intentional or reckless.[120]

Second, the plaintiff must prove reliance.[121] For private companies whose stock does not trade in an efficient market, this is very hard to do. The plaintiff must prove that each investor actually relied on the misstatement or omission. This will effectively preclude the plaintiffs from being able to certify a class action.[122] Courts solve this problem in the case of stock trading in

[114] *See* Coffee, *Gone with the Wind*, *supra* note 64 (discussing the high fixed costs of IPOs and citing underwriting fees as probably the largest, followed by the cost of D&O insurance and auditor costs).

[115] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77(d–1)(c)(1)(B) (2012) ("An action brought under this paragraph shall be subject to the provisions of section 12(b) and section 13 [of the Securities Act of 1933], as if the liability were created under section 12(a)(2).").

[116] *See, e.g.*, Rule 10b-5 of the Exchange Act as codified in 17 C.F.R. § 240.10b-5 (2014). *See also* Section 18(c) of the Securities Act as codified in 15 U.S.C. § 77r(c) (2012) (preserving the authority of state securities commissions to investigate and bring enforcement actions with respect to fraud or deceit).

[117] There are also other reasons that antifraud liability poses a relatively low risk to issuers. *E.g.,* William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143, 1155–57 (2013) [hereinafter Sjostrom, *Rebalancing*] (describing why Rule 10b-5 is not a great source of protection to private placement investors).

[118] *See id.* at 1156 (explaining that scienter is the applicable mental state, that lower courts have uniformly held it to be satisfied by recklessness, and that "the Private Securities Litigation Reform Act of 1995 . . . heightened the pleading standard for a Rule 10b-5 claim by requiring a plaintiff to plead 'with particularity facts giving rise to a strong inference [of scienter].' ").

[119] *Id.* at 1157 ("Meeting this standard will often be impossible in a suit against a private company because there will be no company or insider SEC filings from which the plaintiff can pull facts for its pleading.").

[120] *See id.* at 1156.

[121] *See, e.g., Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011) (citations omitted) ("Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action.").

[122] *See id. at* 2185 (2011) (citations omitted) ("We recognized in *Basic*, however, that limiting proof of reliance in such a way 'would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.' We also observed that '[r]equiring proof of individualized reliance from each member of the proposed plaintiff

an efficient market through use of the fraud-on-the-market doctrine.[123] This, however, does not help plaintiffs in the crowdfunding context because efficient secondary markets (those characterized by accurate pricing and high liquidity) are unlikely to form.[124] While a liability regime based only on these rules creates a difficult challenge for plaintiffs, it makes accredited crowdfunding comparatively more attractive for issuers.

By contrast, the heightened form of liability that applies in retail crowdfunding is less friendly to issuers. The regime does not require plaintiffs to prove either scienter or reliance.[125] As long as the plaintiff did not know of the untruth or omission, the issuer and other defendants have to sustain a negligence-based due diligence defense to avoid liability.[126] Moreover, retail crowdfunding spells out which defendants are eligible to be sued. This list includes the issuer's directors and many executives as well as "any person who offers or sells the security in such offering."[127] This latter catch-all provision encompasses crowdfunding sites that engage in solicitation as registered broker-dealers,[128] but does not necessarily capture funding portals since they are prohibited from engaging in solicitation.[129] Nonetheless, the SEC has taken the view that funding portals are captured too.[130] If this provision becomes law, the use of funding portals will become comparatively more expensive for issuers.

While an over-taxed SEC may be unlikely to pursue small issuers and crowdfunding websites for disclosure defects and civil litigants may be deterred because of high legal costs, relatively low damages, and potentially judgment-proof issuers, this list makes a feasible recovery more likely. In any event, it suggests that issuer costs will rise with respect to D&O insur-

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class effectively would' prevent such plaintiffs 'from proceeding with a class action, since individual issues' would 'overwhelm[ ] the common ones.' ").

[123] *See id.* (citations omitted) ("According to that theory, 'the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.' Because the market 'transmits information to the investor in the processed form of a market price,' we can assume, the Court explained, that an investor relies on public misstatements whenever he 'buys or sells stock at the price set by the market.' "); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988) (establishing the fraud-on-the-market theory).

[124] *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711, 720–32 (2006) (describing the mechanisms necessary for market efficiency); *see also* Sjostrom, *Rebalancing, supra* note 117, at 1157; JOBS Act § 302(b) as codified in 15 U.S.C. § 77d–1(e) (2012) (describing resale restrictions that may impede efficient markets).

[125] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d–1(c)(2)(A) (2012).

[126] *See id. See also* Securities Act § 4A(c)(2)(B), 15 U.S.C. § 77d–1(c)(2)(B) (2012) (that the defendants "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission").

[127] *See* Securities Act § 4A(c)(3) as codified in 15 U.S.C. § 77d–1(c)(3) (2012).

[128] *See Pinter v. Dahl*, 486 U.S. 622, 646 (1988) ("The applicability of § 12 liability to brokers and others who solicit securities purchases has been recognized frequently since the passage of the Securities Act.").

[129] *See* JOBS Act § 304(b) as codified in 15 U.S.C. § 78c(a)(80) (2012) (prohibiting funding portals from soliciting purchases, sales or offers to buy).

[130] SEC Proposal on Crowdfunding, *supra* note 2, at 66,498–99.

ance and intermediation fees. This shows that Congress layered onto retail crowdfunding a level of liability exposure that simply does not apply to accredited crowdfunding. This will make accredited crowdfunding, on this dimension, more affordable for issuers.

b. Mandatory Disclosure

Mandatory disclosure is another means of raising regulatory costs, especially when the disclosure requires outside parties to be hired. Retail crowdfunding has mandatory disclosure requirements that are both non-financial and financial. The non-financial requirements include disclosing a description of the business, the use of proceeds, risk factors, and other items.[131] This kind of disclosure will likely require the work of counsel as well as compliance officers. The financial requirements become more onerous depending upon the size of the offering. For example, offerings between $100,000 and $500,000 require independent public accountants, and offerings between $500,000 and $1 million require audited financial statements.[132] Moreover, due to 12(a)(2)-like liability, issuers may disclose even more than the required minimum.

In accredited crowdfunding, by contrast, there are no such requirements as long as no sales are made to non-accredited investors.[133] This means that costly items, such as hiring an auditor, can be avoided. This does not mean, however, that the use of accredited crowdfunding will allow issuers to avoid disclosure altogether. Issuers must still disclose some limited information on Form D and must comply with the antifraud provisions that require the issuer to make sure that any disclosure made on a voluntary basis is not misleading on account of any omission of a material fact.[134] Accredited investors may demand a level of disclosure that approximates the disclosure in retail crowdfunding if they have the right incentives to do so; however, these incentives may be diluted by new Rule 506(c).[135] In any event, issuers will have more flexibility in fulfilling their disclosure obligations in accredited crowdfunding, and litigants will face higher hurdles in seeking to enforce disclosure defects. This will ease pressure on issuers in accredited crowdfunding and allow them to better economize on costs.

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[131] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d–1(b) (2012).

[132] *See id.* While the SEC may lower or raise the $500,000 threshold for audited financial statements by rule, it is not currently proposing to do so. *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,446–47.

[133] *See* 17 C.F.R. § 230.506(b)(1) (2014).

[134] *See, e.g.*, Letter from Goodwin Procter LLP to Annemarie Tierney, General Counsel SecondMarket Holdings, Inc. regarding *Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock* (Mar. 16, 2012), *available at* https://www.secondmarket.com/education/wp-content/uploads/2013/02/Memo-on-Secondary-Sale-Disclosure-Requirements-Goodwin-Proctor.pdf (describing disclosures made to comply with Rule 10b-5).

[135] *See infra* Part III.B.

c. Intermediation

Issuers will also incur costs in retail crowdfunding on account of the requirement to use a broker or funding portal as an intermediary in the conduct of each transaction.[136] Since the crowdfunding sites will need to make money, there will inevitably be some costs associated with their use. These costs will differ if the site is organized as a broker, which may take transaction-based fees,[137] or a funding portal, which may not.[138] The costs will also differ between accredited and retail crowdfunding because only retail crowdfunding imposes mandatory affirmatives duties on all crowdfunding sites.[139] Sites have no duties in accredited crowdfunding. Therefore, fewer costs will be passed on to the issuer.

In accredited crowdfunding, there is no intermediation requirement. In fact, issuers can choose to use a crowdfunding site or instead sell securities over their own platform without being subject to broker-dealer regulation.[140] This option gives issuers the flexibility to choose whether using an intermediary is cost-effective. Prior to the JOBS Act, issuers in a large majority of Regulation D offerings were already cutting costs by eliminating the middleman.[141] But it also may be the case that using an intermediary could, on balance, save costs.[142] In any event, issuers will only be able to choose the more cost-effective method for their firm if they take the accredited route.

Accredited crowdfunding also permits issuers to utilize a wider range of intermediaries. Instead of only two options—brokers or funding portals[143]—there are at least two more available forms: a private equity fund advised by a registered investment adviser[144] and a venture capital fund ad-

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[136] *See* JOBS Act § 302(a) as codified in 15 U.S.C. 77d(a)(6)(C) (2012).

[137] *See Study on Investment Advisors and Broker-Dealers*, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (describing the receipt of transaction-based compensation as generally requiring registration as a broker-dealer).

[138] *See* JOBS Act § 304(b) as codified in 15 U.S.C. 78c(a)(80) (2012) (prohibiting funding portals from compensating any person "based on the sale of securities").

[139] *See* JOBS Act § 302(b) as codified in 15 U.S.C. 77d–1(a) (2012) (describing mandatory affirmative duties of both brokers and funding portals).

[140] *See* JOBS Act § 201(c) as codified in 15 U.S.C. 77d (b)(1) (2012).

[141] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A, 77 Fed. Reg. 54,464, 54,476 (proposed Sept. 5, 2012) (to be codified at 17 C.F.R. pts. 230 and 239) [hereinafter SEC Proposed Rule on Lifting GS&A Ban] ("An analysis of all Form D filings on EDGAR made during the period from 2009 to 2011 shows that approximately 11% of all new offerings reported sales commissions of greater than zero because the issuers used intermediaries."); *see also* Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919, 926 (2011) (showing only 5.8% of Reg D offerings under $1 million used financial intermediation).

[142] *See* SEC Proposed Rule on Lifting GS&A Ban, *supra* note 141, at 54,477 n.118.

[143] In accredited crowdfunding, Section 201(c) of the JOBS Act provides a non-broker alternative that this article calls "201(c) platforms." They are similar to funding portals, but are much less regulated. As a legal matter, "funding portals" are only allowed in retail crowdfunding offerings.

[144] *See* AngelList No-Action Letter, *supra* note 93.

vised by a venture capital fund adviser.[145] In each case, the fund would be exempt from registration under the Investment Company Act of 1940 pursuant to Section 3(c)(1) or 3(c)(7) and the advisers and crowdfunding sites would be exempt from broker-dealer registration. Unlike brokers, who can take transaction-based fees, these advisers are only permitted to take carried interest: "compensation equal to a portion of the increase in value, if any, of the investment as calculated at the termination of the investment."[146] These adviser platforms have significant fiduciary obligations that do not apply to broker platforms and which raise the cost of managing the funds/sites.[147] But the ability to take carried interest may outweigh the costs. While it is not clear whether broker or adviser platforms will generally be more cost-effective for issuers in accredited crowdfunding, the issuer again has more freedom to choose.

d. State Law Preemption

State law registration requirements are another way that issuers could face additional costs. This is because, absent preemption, states can layer additional requirements on top of the federal rules. Here, however, both accredited and retail crowdfunding benefit equally from state law preemption. Section 18 of the Securities Act provides that "no law, rules, regulation, or order, or other administrative action of any State or any political subdivision thereof . . . requiring, or with respect to, registration or qualification of securities transactions, shall directly or indirectly apply to a security that . . . is a covered security."[148] Covered securities include securities sold under both the retail and accredited crowdfunding exemptions.[149] Nonetheless, such preemption does not extend to state enforcement authority under either exemption.[150] Accordingly, state law does not tip the balance in favor of either method.

e. Public Company Regulation

The continuous disclosure regime under the Exchange Act ("public company regulation") can also be very costly. It entails yearly, quarterly, and current disclosure obligations and compliance with items such as the proxy rules, the short-swing profit provisions, and the Williams Act.[151]

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[145] *See* FundersClub No-Action Letter, *supra* note 93.

[146] *See* AngelList No-Action Letter, *supra* note 93.

[147] *See* U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers (2011).

[148] Securities Act §18(a)(1) (1933), 15 U.S.C. § 77r(a)(1) (2012).

[149] *See* Securities Act §18(b)(4) (1933), 15 U.S.C. § 77r(b)(4) (2012) (including securities sold pursuant to Section 4(a)(6) (retail crowdfunding) and Section 4(a)(2) (accredited crowdfunding)).

[150] *See supra* note 116.

[151] *See* U.S. Sec. & Exch. Comm'n, Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3), 4 (Oct. 15, 2012) [hereinafter the Rule 12g5-1 Re-

While there are three gateways through which a private company can be forced to register as a public company, there is only one that is potentially outside the control of the issuer: the asset and shareholder thresholds in Section 12(g).[152] This section was originally introduced in 1964 to close a loophole that allowed large companies with dispersed shareholders to evade public disclosure by not listing on a national securities exchange or conducting an IPO, even though their securities were trading in the over-the-counter markets.[153] As amended by the JOBS Act, this section forces private companies into public company regulation only if the company has assets in excess of $10 million and a class of equity securities held of record by either 2,000 persons or 500 unaccredited investors.[154] Triggering public company regulation typically requires an issuer to disclose most of the information required in an IPO.[155] This poses an acute threat of increased regulatory costs to a company that grows too big and has too many shareholders of record—a concern that strikes at the core of crowdfunding.

Retail crowdfunding, unlike accredited crowdfunding, has a specific exclusion from public company regulation to avoid these costs.[156] Investors in such offerings are not counted towards the 2,000 and 500 record holder thresholds.[157] This suggests an advantage for issuers seeking to use retail crowdfunding: the ability to sell small stakes to an unlimited number of investors without ever entering the continuous disclosure regime. Retail crowdfunding will have substitute disclosure requirements that will put back some of these costs, but they will be less onerous than the Exchange Act requirements.[158]

But issuers using accredited crowdfunding may have a different way to avoid the Section 12(g) threshold that could paradoxically give accredited crowdfunding the advantage on this element. By counting entities with multiple beneficial owners as single record holders, issuers can potentially stay below the 2,000 record holder threshold while their actual beneficial owners far exceed it. In this sense, such issuers may have a choice to reach the same

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PORT], *available at* http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf.

[152] *See* 15 U.S.C. § 78l(g) (2012). The other gateways are in Sections 12(b) and 15(d) of the Exchange Act.

[153] *See* THE RULE 12g5-1 REPORT, *supra* note 151, at 4–7.

[154] *See* JOBS Act § 501 (amending Section 12(g) of the Exchange Act). Employees of the issuers are excluded from the record holder count under both exemptions. *See* JOBS Act § 502.

[155] *See* THE RULE 12g5-1 REPORT, *supra* note 151, at 3.

[156] *See* JOBS Act § 303.

[157] There is a question, however, whether the exclusion applies only to original investors or also to resale investors who purchase in the secondary market.

[158] *See* JOBS Act § 302(b) as codified in 15 U.S.C. 77d-1(b)(4) (2012) (An issuer who utilizes retail crowdfunding shall "not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule.").

number of shareholders[159] as those using retail crowdfunding without the burden of *any* further disclosure.[160]

Although the SEC has an anti-evasion rule to guard against such circumvention, it only counts beneficial holders as record holders when the "issuer *knows or has reason to know* that the form of holding securities of record is used *primarily* to circumvent the provisions of Section 12(g)."[161] The SEC admits that demonstrating a violation under this standard is difficult.[162] Moreover, the SEC is mainly equipped to learn about potential violations through tips, complaints, and referrals.[163] This might explain why the SEC has failed to force any violators into public company regulation to date.[164] In light of the SEC's recent report on this rule, which suggests no change to its current enforcement strategy,[165] issuers and investors may now have a blueprint to avoid public company regulation and the anti-evasion rule in accredited crowdfunding.[166]

Perplexingly, this analysis may mean that issuers using accredited crowdfunding might actually have a less expensive means of reaching the same number of investors than issuers using retail crowdfunding. Thus, it is not yet clear that the explicit exclusion in retail crowdfunding gives it the advantage on this element.

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[159] It is notable that private investment funds relying on Investment Company Act of 1940 § 3(c)(1) must limit their beneficial owners in each case to 100 persons. Most funds seeking individual investors will likely rely on this provision instead of Section 3(c)(7) because the latter is limited to a far smaller pool of investors, known as qualified purchasers. Individual qualified purchasers must generally own not less than $5 million in investments. So, in practice, there may often be outer limit on individual beneficial holders in accredited crowdfunding set at approximately 200,000 individuals (2,000 * 100).

[160] *See* Donald C. Langevoort and Robert B. Thompson, *'Publicness' in Contemporary Securities Regulation after the JOBS Act,* 101 GEORGETOWN L. J. 337, 355 (2013) (explaining the "dysfunction" surrounding the record holder concept) [hereinafter Langevoort & Thompson*, Publicness*]; *see also* John C. Coffee, Jr., *The Challenge of the Semi-Public Company*, THE CLS BLUE SKY BLOG (Apr. 1, 2013), *available at* http://clsbluesky.law.columbia.edu/2013/04/01/the-challenge-of-the-semi-public-company/#_edn3 ("By amending §12(g)(1) of the Securities Exchange Act to raise the mandatory threshold for 'reporting company' status to 2,000 shareholders of record, the JOBS Act has also ensured that all companies that are not yet a 'reporting company' will have considerable discretion and a debatable choice about whether to become one.").

[161] *See* 17 C.F.R. § 240.12g5–1(b)(3) (2013) (emphasis added).

[162] *Cf.* THE RULE 12g5-1 REPORT, *supra* note 151, at 21–23 (concluding that "Rule 12g5-1(b)(3) may be applicable only in limited circumstances").

[163] THE RULE 12g5-1 REPORT, *supra* note 151, at 33 (stating "it may be difficult for the Enforcement staff to know that such circumvention is occurring other than through a tip, complaint or referral").

[164] *Cf.* THE RULE 12g5-1 REPORT, *supra* note 151 (citing no such instances).

[165] *See* THE RULE 12g5-1 REPORT, *supra* note 151.

[166] In any event, there might be few instances where circumvention would even be needed in light of the recently heightened shareholder thresholds. The SEC points out that only 13% of current Section 12(g) registrants would be required to initially register with the Commission pursuant to the new thresholds of Section 12(g) today. *See* THE RULE 12g5-1 REPORT, *supra* note 151, at 26.

f. Verification of Investor Eligibility

Verification of investor eligibility is another important cost to issuers. If verification is required, the issuer must invest resources into reasonably confirming the eligibility status of each investor. This could amount to significant costs because crowdfunding, by definition, contemplates a large number of investors.

Verification is required in accredited crowdfunding. Issuers must "take reasonable steps to verify that purchasers of securities are accredited investors."[167] The purpose is to prevent sales to non-accredited investors. The rule provides a non-exclusive list of methods for its satisfaction. For example, the verification of income test will be deemed satisfied if an issuer reviews a potential investor's Form W-2 for the two most recent years and obtains a written representation from the potential investor that he or she has a reasonable expectation of reaching the required income level during the current year.[168]

Verification in retail crowdfunding, by contrast, is an open issue. The decision has been squarely delegated to the SEC. This approach marked a change from an earlier bill that explicitly allowed issuers to rely on an investor's self-certification of eligibility.[169] While verification in this context, which is limited to compliance with such investor's individual investment limits,[170] will be the responsibility of the crowdfunding sites and not the issuer, the sites will presumably pass on such costs to the issuers. For this reason, some commentators have argued that issuers in retail crowdfunding should be allowed to reasonably rely on self-certification by investors.[171] This would make retail crowdfunding less costly than accredited crowdfunding on this element. But the SEC could also equalize the burden, which might disproportionately impact retail crowdfunding since such fixed costs would represent a larger proportion of a smaller offering. The SEC is currently proposing to take the former path to allow issuers and intermediaries to rely on investor self-certification in retail crowdfunding.[172]

g. Liquidity Risk

Liquidity risk can raise an issuer's cost of capital at the time of a security's sale. Investors may demand a discount on the price of an equity security or a premium on the interest rate of a debt security to compensate them for the risk that they will not be able to resell the security at a fair price for cash.

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[167] *See* General Solicitation Adopting Release, *supra* note 8, at 44,803.

[168] *See* General Solicitation Adopting Release, *supra* note 8, at 44,804–05 (describing methods relating to the income test, net worth test, third-party certification, and a grandfather clause).

[169] *See* H.R. 2930, 112th Cong. § 4A(c) (2011), *supra* note 73 and accompanying text.

[170] *See* H.R. 2930, 112th Cong. § 4A(c) (2011), *supra* note 73 and accompanying text

[171] *See* Bradford June 2012 Testimony, *supra* note 44, at 10.

[172] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,470.

In both retail and accredited crowdfunding, there are restrictions on transfer that potentially make resales for investors complicated and risky.[173] The biggest deterrent for a reseller is the potential of being deemed a statutory underwriter.[174] Such status would cause the resale to violate Section 5 of the Securities Act because the Section 4(a)(1) exemption would not be available.[175] This could subject the reseller to remedies such as disgorgement of ill-gotten gains.[176] Resellers, therefore, will seek confidence that their actions will not cause such difficulties.

In retail crowdfunding, there is a potential statutory underwriter problem for resellers. Congress put in place transfer restrictions[177] and ostensible exceptions without specifying that a reseller's compliance with one of the exceptions would alone avoid statutory underwriter treatment under Section 4(a)(1). This omission creates ambiguity. On the one hand, the plain language of the statute suggests that initial investors can freely resell their retail crowdfunding securities to any subsequent purchaser after a one-year holding period or to an enumerated list of subsequent purchasers immediately after the original sale.[178] On the other hand, there is nothing to prevent such resellers from being deemed underwriters[179] short of satisfying the notoriously nebulous "Section 4(1½)" standard.[180] This test, which is so named because it borrows guidance from both Sections 4(a)(1) and 4(a)(2), has been developing over time through judicial interpretations and SEC positions.[181] But its application is still uncertain, which thereby increases investors' liquidity risk. Since Congress did not include retail crowdfunding

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[173] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(e) (2012) (preventing transfers in retail crowdfunding during the first year, "unless such securities are transferred—(A) to the issuer of the securities; (B) to an accredited investor; (C) as part of an offering registered with the Commission; or (D) to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the Commission"). *Cf.* Rule 144(b)(1)(i) of Securities Act of 1933 as codified in 17 C.F.R. 230.144(b)(1)(ii) (2014) (requiring, in the case of Rule 506 securities and others, non-affiliated investors in private companies to comply with a one-year holding period in order to be "deemed not to be an underwriter" when reselling such securities).

[174] *See, e.g.*, *SEC v. Chinese Consol. Benev. Ass'n, Inc.*, 120 F.2d 738, 741 (2d Cir. 1941); *Gilligan, Will, & Co. v. SEC*, 267 F.2d 461, 463 (2d Cir. 1959); *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412, 431 (S.D.N.Y. 2007).

[175] *See, e.g.*, *Chinese Consol. Benev. Ass'n, Inc.*, 120 F.2d at 741; *Gilligan, Will, & Co.*, 267 F.2d at 463; *Universal Express, Inc.*, 475 F. Supp. 2d at 431.

[176] *See, e.g. Universal Express*, 475 F. Supp. 2d at 428.

[177] For the applicable transfer restrictions in retail crowdfunding, see *supra* note 173.

[178] *See supra* note 173.

[179] *See* Section 2(a)(11) of the Securities Act as codified in 15 U.S.C. § 77b(a)(11) (2012) ("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 . . .").

[180] *See The Section "4(1½)" Phenomenon: Private Resales of "Restricted" Securities*, A Report to the Committee on Federal Regulation of Securities from the Study Group on Section "4(1½)" of the Subcommittee on 1933 Act, 34 Bus. Law. 1961 (1979), *available at* https://www.secondmarket.com/discover/wp-content/uploads/2012/01/The-Business-Lawyer-The-Section-4-1-1-2-Phenomenon-Private-Resales-of-Restricted-Securities.pdf [hereinafter "The Section "4(1½)" Phenomenon"].

[181] *Id.*

securities within the list of restricted securities in Rule 144,[182] the Section 4(1½) exemption may be applicable both during and after the one-year holding period.[183]

By contrast, in accredited crowdfunding, there is more certainty that resellers will not be deemed statutory underwriters after a one-year holding period. Rule 144 provides an objective safe harbor to this effect.[184] But prior to the expiration of one year, resellers in accredited crowdfunding must similarly rely upon the Section 4(1½) exemption.[185] Accredited crowdfunding, unlike retail crowdfunding, has no statutory language implying that such securities may be freely transferable without compliance with Section 4(1½) or Rule 144. So, this difference provides the SEC with an opportunity to distinguish the two exemptions with respect to resales.

The SEC's proposed rules and accompanying commentary do not consider whether a purchaser of retail crowdfunding securities would be deemed a statutory underwriter if such a purchaser were to immediately resell them to an accredited investor without compliance with Section 4(1½). But they do suggest that immediate resales would be allowed, without further restriction, as long as "the seller shall reasonably believe that the person receiving such securities is an accredited investor."[186] If this position is adopted, it would lower costs associated with liquidity risk in retail crowdfunding. But the SEC's silence on the application of Section 4(1½) leaves open the possibility that it may still be applicable. Accordingly, subject to SEC clarification, liquidity risk may be equal under the two exemptions during the first year after sale and greater in retail crowdfunding after the first year. This difference in risk, if maintained, could add to the expense of retail crowdfunding. The opposite result, which the SEC seems to favor, would lower the comparative expense of retail crowdfunding on this element.

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[182] One draft bill took this approach, but the final JOBS Act did not. *See* Democratizing Access Capital Act of 2011, *supra* note 77. Had Congress taken this approach, it would have clarified that non-affiliates of the issuer could freely resell after a one-year holding period.

[183] While free transferability in retail crowdfunding is uncertain after the one-year holding period expires, precedent suggests that the explicit inclusion of this holding period language may be enough to deem such securities to be freely transferable after the holding period. For example, under the intrastate exemption (Rule 147), the SEC and some courts have found that the SEC's nine-month holding period provides a requisite safe harbor. This is relevant because securities sold under Rule 147, such as retail crowdfunding securities, are also excluded from the definition of restricted securities in Rule 144. *See* Definitions and Clarification of Certain Conditions Regarding Intrastate Offering Exemption, 39 Fed. Reg. 2353 (Jan. 21, 1974) (to be codified at 17 C.F.R. pt. 230). *See, e.g.*, *Busch v. Carpenter*, 598 F. Supp. 519 (D. Utah 1984) (holding resale of intrastate offering within seven months did not void exemption). Nonetheless, without clarification by the SEC, practitioners can only speculate as to how the transfer restrictions will operate in retail crowdfunding.

[184] *See supra* note 173.

[185] *See* The Section "4(1½)" Phenomenon, *supra* note 180.

[186] *See, e.g.*, SEC Proposal on Crowdfunding, *supra* note 2, at 66,562.

h. Substantial Compliance and Integration

The final cost items differentiating accredited and retail crowdfunding are substantial compliance and integration. Accredited crowdfunding has a substantial compliance rule[187] and a six month integration safe-harbor to prevent two different capital raises from being treated as one (i.e., integrated).[188] The purpose of the substantial compliance rule is to prevent penalization of the issuer for an insignificant failure to comply with a term, condition, or requirement where attempted compliance was made in good faith. The purpose of the integration safe harbor is to provide certainty to practitioners that two individually compliant capital raises will not be treated together, which could cause a violation of a condition of one or both exemptions.

Both rules provide important safeguards for issuers because an insignificant failure to comply or a finding of integration could otherwise have a draconian impact. Namely, an issuer would not be able to rely on a given transaction exemption and may therefore be in violation of Section 5 of the Securities Act. This might result in rescission or recessionary damages under Section 12(a)(1)[189] and a five-year injunction against raising future rounds of capital under the "bad actor" rules.[190]

In retail crowdfunding, which has no substantial compliance rule, even the most minor failure by the issuer or the crowdfunding site to comply with one of the many requirements imposed might lead to such draconian results.[191] For this reason, some have argued that retail crowdfunding would benefit from a similar rule.[192] The SEC has accepted this logic and is currently proposing a rule that is substantially similar to the one applicable in Rule 506(c) offerings.[193]

In addition, the statute is silent on integration. Its silence means that the use of retail crowdfunding and a second exemption would be analyzed through a five-factor common law test that is famously difficult to apply.[194] Since this could lead to the same draconian results, this might deter practitioners from combining retail crowdfunding with other methods of financing. This would run contrary to a different provision of the JOBS Act that appears to encourage the combination of retail crowdfunding with other

[187] *See* Rule 508 under the Securities Act as codified in 17 C.F.R. § 230.508 (2014) (deemed the "substantial compliance" rule for its language permitting "insignificant" failures to comply with Rules 504, 505, and 506 without resulting "in the loss of the exemption from the requirements of Section 5" of the Securities Act).

[188] *See* Rule 502(a) under the Securities Act as codified in 17 C.F.R. § 230.502(a) (2014).

[189] *See* Section 12(a)(1) of the Securities Act as codified in 15 U.S.C. § 77l(a)(1) (2012).

[190] *See* 17 C.F.R. § 230.506(d) (2014).

[191] *See* JOBS Act § 302(a) as codified in 15 U.S.C. § 77d(a)(6) (2012).

[192] *See* Bradford June 2012 Testimony, *supra* note 44, at 4–5.

[193] *See, e.g.,* SEC Proposal on Crowdfunding, *supra* note 2, at 66,500. It is substantially similar to Rule 508 under Regulation D. 17 C.F.R. § 230.508 (2014).

[194] *See* Bradford June 2012 Testimony, *supra* note 44 at 7–9 (describing the test as a "confusing mess").

methods.[195] Accordingly, some have argued that an integration safe harbor in retail crowdfunding is also appropriate.[196] The SEC is currently taking the position that retail crowdfunding could be accomplished before, after, or concurrently with another exempt offering.[197] But this is subject to an important proviso: "that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering."[198] This proposal, which does not provide a safe harbor from the common law integration test, will make it very difficult for a retail crowdfunding offering to immediately follow an offering with different conditions, such as a Rule 506(c) offering. But it would likely allow a follow-on offering six months after the first.

The SEC has the opportunity to act with respect to both substantial compliance and integration. Adopting a substantial compliance rule and an integration safe harbor would significantly enhance the viability of retail crowdfunding.

B. Access to potential investors

Bradford's second capital formation principle is broad access to potential investors. Prior to the JOBS Act, Bradford's main critique of Rule 506 as a crowdfunding method was that it banned general solicitation and advertising, effectively prohibiting access to retail investors. The accredited investor limitation narrowed the pool of potential investors to those qualifying, while the ban on general solicitation and advertising narrowed it further to friends, family, and others having a pre-existing substantive relationship with the issuer. If implemented, Bradford's recommendations would place few restrictions on marketing and no restrictions on eligible investors. The following discussion shows that the JOBS Act took a mixed approach to these two elements. From the perspective of issuers, it gave accredited crowdfunding a superior general solicitation and advertising rule and retail crowdfunding a superior investor eligibility rule. The SEC proposals, to date, do not change this calculus.

(i) General Solicitation and Advertising

Some level of general solicitation and advertising was permitted under both exemptions[199] to allow securities offerings to be publicly posted on the Internet. But retail crowdfunding was given one significant marketing re-

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[195] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(g) (2012).

[196] *See* Bradford June 2012 Testimony, *supra* note 44, at 9.

[197] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,432.

[198] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,432.

[199] *See* JOBS Act § 201(c) (allowing "general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means."); JOBS Act § 201(a); Rule 506(c) under the Securities Act as codified in 17 C.F.R. § 230.506(c) (2014); JOBS Act § 304(b) as codified in 15 U.S.C. § 78c(a)(80) (2012)

straint that does not apply to accredited crowdfunding: issuers are prohibited from advertising "the terms of the offering, except for notices which direct investors to the funding portal or broker."[200] This means that the issuer will only be allowed to generally distribute a short teaser. The SEC has proposed that the information in the teaser be limited to the following items: the amount of the securities offered; the nature of the securities; the price and closing date of the offering period; explanation that the issuer is relying on Section 4(a)(6) of the Securities Act; the name and contact information of the issuer; a brief description of the issuer's business; and a link to the crowdfunding website (which may be named).[201] Moreover, as proposed, no advertising may occur until the issuer has filed its initial Form C disclosure.[202]

In accredited crowdfunding, by contrast, issuers can generally solicit and advertise without any such content restrictions.[203] But new SEC proposals, if adopted, would similarly impose an advanced form filing before the commencement of any general solicitation and advertising efforts.[204] In addition, the SEC is proposing to require a few other small procedural hurdles in accredited crowdfunding that have not been proposed in retail crowdfunding. These include requirements that written advertisements be temporarily submitted to the SEC and that they contain certain legends.[205] Even if these requirements are adopted, however, issuers will likely find the content restrictions in retail crowdfunding to be more distasteful than the additional procedural hurdles in accredited crowdfunding. More freedom to advertise and solicit in the latter is likely to lead to increased sales. This benefit seems to give accredited crowdfunding yet another edge.

(allowing funding portals, and hence brokers, to offer or display securities on their websites or portals).

[200] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(b)(2) (2012).

[201] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,555.

[202] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,552–55.

[203] *See* JOBS Act § 201(c) (permitting issuers to generally solicit and advertise, but only providing a broker-dealer exemption for the person maintaining the platform). *Cf.* Rule 3a4-1 of the Exchange Act as codified in 17 C.F.R. § 240.3a4-1 (2014) (setting forth conditions that an issuer's employees must meet to not be deemed a broker by reason of his or her participation in the sale of securities); William K. Sjostrom, Jr., *Going Public Through An Internet Direct Public Offerings: A Sensible Alternative For Small Companies*, 53 FLA. L. REV. 529, 564–66 (2001) (discussing Rule 3a4-1 and similar state rules). It appears that the broker exemption rules with respect to an issuer's employees would apply equally in retail and accredited crowdfunding. The content, however, will nonetheless continue to be subject to the antifraud rules.

[204] *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 and 239) (proposing, *inter alia*, a Form D filing before the use of general solicitation and advertising and, after an offering terminates, legends and disclosure on written materials, temporary submission of written materials to the SEC, year-long disqualification for failure to comply with the Form D requirements within the past five years, and more Form D disclosure).

[205] *See id.*

(ii) Eligible Investors

Retail crowdfunding, nonetheless, has a superior investor eligibility rule. It is open to all investors, meaning more than 300 million Americans.[206] By contrast, accredited crowdfunding is limited to only accredited investors. The SEC recently estimated that at least 8.7 million U.S. households (7.4% of all households in the country) qualified as accredited in 2010.[207] But there are annual individual investment limits in retail crowdfunding that do not exist in accredited crowdfunding.[208] These limits, which cap investable capital for most members of the retail pool at 5% or 10% of income or net worth, significantly reduce the total amount of capital that could be invested. In addition, most capital in the retail pool is also available in the accredited pool. A recent study showed that, in 2010, 71.7% of household wealth (not including the value of an investor's primary residence) was concentrated in only 5% of U.S. households.[209] This figure jumps up to 84.9% when taking into account the top 10% of households.[210] So, accredited investors, while a small minority, control somewhere between 70% and 85% of all sidelined capital in the United States. This suggests that issuers will generally not need to rely on non-accredited retail investors to fund their ideas.

However, the relative size of the two pools could change in the near future. Beginning in July 2014, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the SEC to review the net worth and income tests in the accredited investor definition to see whether revisions are appropriate.[211] The SEC could revise the income test even earlier,[212] but there is no evidence that this is currently planned. Whether or not the SEC further shrinks the size of the accredited pool, issuers will only be concerned about capital, not people. While a larger population in the retail pool will make the retail exemption marginally more attractive, it will not alone draw issuers to retail crowdfunding. Issuers will need to decide, in each case, whether access to the full crowd is necessary for a successful capital raise.

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[206] *See* 2011 U.S. Census Bureau data, *available at* http://quickfacts.census.gov/qfd/states/00000.html (showing a U.S. population of approximately 311.6 million).

[207] *See* General Solicitation Adopting Release, *supra* note 8, at 44,793.

[208] *See* JOBS Act § 302(a) as codified in 15 U.S.C. § 77(d) (2012) (limiting the amount each investor can invest annually in retail crowdfunding to the greater of $2,000 or 5% of annual income or net worth for those with an income or net worth below $100,000, and the lesser of $100,000 or 10% of annual income or net worth for those with an income or net worth above $100,000).

[209] *See* Wolff, *supra* note 11.

[210] *See* Wolff, *supra* note 11.

[211] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(b), 124 Stat. 1376, 1889 (2010).

[212] *See id.*

C. Investor protection

Bradford's final three principles deal with investor protection. Except for the notion of harnessing the wisdom of the crowd through open communication forums, which the SEC has now proposed,[213] each was incorporated in some form under Title III of the JOBS Act: imposing individual investor limits and risk warnings to prevent catastrophic investor loss;[214] imposing significant mandatory duties on crowdfunding websites, such as fraud detection, risk disclosure, investor education, enforcing individual investment limits,[215] and preventing certain conflicts of interest;[216] and requiring funding goals to ensure that a sufficient segment of the crowd is subscribed prior to releasing funds.[217] Accredited crowdfunding, by contrast, has no such requirements. Again, this means fewer issuer costs in accredited crowdfunding.

D. Summary and implications

Appendix I to this Article provides a simplified summary of each subsection in this part to show, in comprehensive fashion, why issuers will generally prefer accredited crowdfunding, even if the SEC's proposal becomes law in its current form. The appendix reveals that accredited crowdfunding will be less expensive, more flexible, and have fewer marketing restrictions than retail crowdfunding. Of these, cost is likely to weigh the heaviest in the transaction planning decisions of issuers. For a capital raise of $1 million, the SEC roughly estimates a cost of $152,260, which may be an underestimation.[218] Many of the same costs (such as auditing, intermediation, and legal fees) will not apply, or will apply to a lesser extent, in accredited crowdfunding. While the SEC's retail crowdfunding proposal suggests certain new cost-saving measures, like more lenient verification and resale rules, these are unlikely to carry much weight in the analysis. Similarly, the principal advantage of retail crowdfunding, which is its larger population of potential investors, may also be only a pyrrhic victory. The accredited pool, while smaller, controls more than 70% of available capital in both pools.[219] This suggests that accredited crowdfunding will generally be the logical choice for issuers seeking to crowdfund. The implication is that retail

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[213] *See, e.g.*, SEC Proposal on Crowdfunding, *supra* note 2, at 66,557.

[214] *See* JOBS Act § 302(a)(6)(B) as codified in 15 U.S.C. § 77d-1(a) (2012) (describing individual investment limits); JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(a) (2012) (describing risk warnings).

[215] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(a) (2012) (describing mandatory affirmative duties and certain prohibited conflicts of interest).

[216] *See id.*

[217] *See id.*

[218] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,521.

[219] *See* Wolff, *supra* note 11 and accompanying text.

crowdfunding, much like other costly exemptions,[220] may become largely superfluous. Such a result would not only deprive society of the intended benefits of the exemption—increasing access to capital, spurring business growth, and creating jobs—but would also waste scarce resources: the time and attention of both Congress and the SEC.[221]

If, however, the SEC's final regulation makes retail crowdfunding affordable enough, there is a high likelihood that at least some segment of the market will try it. In this case, the danger is that it could become a market for lemons.[222] This problem occurs when investors cannot tell the good companies from the bad. Mandatory disclosure and other signaling devices are often a way to overcome this. But, as structured, the extensive disclosure that is required in retail crowdfunding may not work for this market. Annual investment limits, in particular, will discourage retail investors from using disclosed information to make informed investment decisions. Why take the time to read disclosure and kick the tires when doing so would be more costly than the payment to invest? Limits on pooled investing also prevent a sophisticated investor, such as a venture capital fund adviser, from doing this work on behalf of the crowd. Private funds are encouraged to limit their offerings to only accredited investors because less disclosure is required.[223] Accordingly, only 0.6% of venture capital fund offerings include non-accredited investors.[224] Mutual funds are also not ideal in this context because they have incentives to be diversified[225] (which would mean less focused diligence on particular opportunities) and mutual funds usually must limit illiquid assets to 15% of their portfolio.[226] Moreover, a mutual fund capital-

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[220] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,509 (showing the dominance of Rule 506 over other existing exemptions such as Rule 504, Rule 505, and Regulation A).

[221] The SEC in particular has recently suffered from severe resource constraints. *See, e.g.*, John C. Coffee, Jr., *SEC enforcement: What has gone wrong?*, The CLS Blue Sky Blog (Jan. 2, 2013), http://clsbluesky.law.columbia.edu/2013/01/02/sec-enforcement-what-has-gone-wrong.

[222] *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q. J. Econ. 488, 488–95 (1970). The classic analogy used to describe the market for lemons problem is the used car market. Since owners of used cars have more information about their cars than proposed second buyers ("asymmetric information"), buyers cannot easily distinguish the good cars from the bad ("lemons"). So, buyers apply a discount to all cars on the market to compensate themselves *ex ante* for the possibility of buying a lemon. The effect, however, will be that lemons will sell for more than they are worth, while good cars will sell for less. Knowing this *ex ante*, owners of lemons will have an incentive to put their cars on the market, while owners of good cars will be discouraged from doing so. The bad will thus drive out the good, resulting in a market dominated by lemons. Unless signaling problems are cured, buyers will eventually learn to avoid this market and it will cease to exist.

[223] *See* 17 C.F.R. § 230.502(b) (2014).

[224] *See* Ivanov & Bauguess July 2013 Study, *supra* note 9, at 15.

[225] *See* Clifford E. Kirsch and Bibb L. Strench, *An Introduction to Mutual Funds*, *in* Financial Product Fundamentals 23 (Clifford E. Kirsch ed., 2011), *available at* http://www.pli.edu/product_files/booksamples/610_sample6.pdf ("To obtain favorable tax treatment, a mutual fund must also meet IRS diversification requirements.").

[226] *See id.* at 6–22.

ized at over $1 million would only be allowed to invest a maximum of $100,000 a year in retail crowdfunding securities.

Since retail crowdfunding encourages little skin-in-the-game and discourages methods to reintroduce the right incentives, the status quo suggests a collective action problem.[227] That is, a situation where no one in a dispersed group has sufficient incentive to act on behalf of the group (i.e., through collective action) because such an actor would have to foot all the costs while only receiving a small share of the benefits. In spite of the significant disclosure required, the disincentives for such investors to use this disclosure would exacerbate information asymmetries between companies and investors. This condition tends to give rise to a market for lemons. If such a market materializes, it would produce the same costs associated with the viability problem plus two others: tangible investor losses and a loss in investor confidence.

But accredited crowdfunding—when compared to traditional private placements—may also face a lemons problem over the longer term on account of rules that discourage investors from due diligence and monitoring. While accredited crowdfunding will focus on individuals meeting certain financial thresholds, the ability to broadly advertise will encourage the sale of small stakes to a large number of unsophisticated individuals. In the short term, issuers may prefer this new method to the traditional method because selling small stakes to more investors could mean giving away fewer control rights to investors[228] and getting more "evangelists" for a new product.[229] But less sophisticated investors with less skin-in-the-game will not have the same incentives to help an issuer succeed over the long run as a more concentrated group of sophisticated investors might. Indeed, 99% of eligible accredited investors will be strangers to startup and small business investing.[230] Whereas traditional private placements averaged eight investors per deal with a median of four in 2012,[231] accredited crowdfunding encourages thousands. Unlike retail crowdfunding, moreover, no disclosure is affirma-

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[227] For further background on the origin of collective action problems and how they differ from agency cost problems, see John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1276, 1285 n.23 (1991) [hereinafter Coffee, *Liquidity Versus Control*].

[228] Some entrepreneurs might view tapping a crowd of largely unsophisticated and rationally apathetic investors as a strategy to raise capital without diluting the entrepreneur's idiosyncratic value in the business. Idiosyncratic value means the value that a person attaches to the execution of his or her business idea without the interference of outsiders. *See generally* Zohar Goshen & Assaf Hamdani, *Concentrated Ownership Revisited: The Idiosyncratic Value of Corporate Control* (ECGI – Law, Working Paper No. 206, 2013), *available at* http://ssrn.com/abstract=2228194.

[229] A large number of investors could increase the likelihood of "evangelists" who might help sell their product through word-of-mouth. *See* Michael Pinchera, *Crowdfunding Meetings and Events*, MEETING PROFESSIONALS INTERNATIONAL (Aug. 23, 2013), *available at* http://www.mpiweb.org/Portal/Content/20130823/Crowdfunding_Meetings_and_Events.

[230] *See* Ivanov & Bauguess July 2013 Study, *supra* note 9.

[231] *See* Ivanov & Bauguess July 2013 Study, *supra* note 9, at 15.

tively required. If such investors are not given the proper incentives to bargain for the information they need to be informed, many deals may be funded in spite of information asymmetries that are not rectified. This again sets the stage for a market for lemons to develop.

Nonetheless, there may be potential remedies in accredited crowdfunding that cannot be directly worked into retail crowdfunding. Specifically, accredited crowdfunding has no annual individual investment limits. So some deals could have investors with significant skin-in-the-game. Such large stakes could help overcome a collective action problem and thus prevent a lemons problem by incentivizing some investors to do the necessary due diligence, pricing, and other work on behalf of the rest of the crowd. In particular, emerging models—only available to those who use the accredited method—contemplate private funds managed by an experienced lead investor with significant financial stakes and the opportunity for carried interest (i.e., a percentage of an investment's increase in value) as an incentive to do this specific work.[232] Crowd investors who co-invest alongside such lead investors might thus reap the direct benefit of the lead investor's efforts since they are financially aligned. Measures that limit the number of investors in each deal and consequently raise their stakes may also contribute to alleviating the incentive problems that result from having many investors who each take small stakes. While retail investors generally cannot benefit from direct participation under current law, the SEC can design rules that would allow such investors to piggyback off the work of these accredited investors. To the extent this happens, there is an opportunity to create social value in both markets.

The next part develops an incentives-based theory of investor protection to address these implied problems. Part IV later deploys it to help guide the assessment.

III. An Incentives-Based Theory of Investor Protection

Historically, the guiding theories behind investor protection in securities regulation have divided along a binary public/private line.[233] This was largely the product of the famed 1953 Supreme Court decision, *SEC v. Ral-*

[232] *See* AngelList No-Action Letter, *supra* note 93 (describing two models whereby passive accredited investors can co-invest alongside more sophisticated investors: one where the lead investor takes "an active role in identifying the investment opportunity, leading negotiations with the Portfolio Company, and providing (or offering to provide) significant managerial assistance and financial guidance to the Portfolio Company," and another where the lead investor "will not be required to take an active role . . . and may not even be aware that it is being 'followed' by the other Investors." Both lead investors would be allowed to take carried interest.).

[233] *See* Milton H. Cohen, *"Truth In Securities" Revisited,* 79 Harv. L. Rev. 1340, 1351–52 (1966) ("Thousands of pages, official and unofficial, expository and argumentative, have been written about the meaning of 'public offering,' . . . [T]here is a kind of continuous tug of war between Commission and bar as to whether new, borderline situations belong on one side or the other of the all-important boundary . . . [T]his 1933 Act borderline is essen-

ston Purina Co., which divided investors into a public group (those in "need [of] the protection of the [Securities] Act") and a private group (those "able to fend for themselves").[234] Today, however, private offerings are increasingly taking on public characteristics and vice versa.[235] The new accredited and retail crowdfunding exemptions each provide a case in point. The following explains the traditional public and private theories of investor protection and how they relate to retail and accredited crowdfunding. In light of the hybrid public-private characteristics of the two crowdfunding exemptions, a reformulated theory to describe the spectrum between private and public regulation is developed.

A. *The public theory and retail crowdfunding*

In the public context, the theory grounding investor protection has been disclosure-based.[236] Accurate and complete disclosure, which is incentivized through a liability scheme,[237] is the primary means through which the securities laws seek to protect investors.[238] But this assumes that investors, armed with the necessary information, have the capacity to process such information to make informed investment decisions.[239] Yet, commentators have recognized for nearly fifty years that retail investors—precisely those who

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tially a line between all or nothing—all the benefits and burdens of registration if an offering falls on one side, none of them if it fall on the other.").

[234] *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) ("Since exempt transactions are those as to which 'there is no practical need for . . . (the bill's) application,' the applicability of [Section 4(a)(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[235] *See* Anna T. Pinedo, *Public Deals Become More Private*, THE CLS BLUE SKY BLOG (Mar. 8, 2013), http://clsbluesky.law.columbia.edu/2013/03/08/public-deals-become-more-private ("[J]ust as private offerings have become more public, public offerings have become more private.").

[236] *See* H.R. REP. NO. 73-85; H.R. 5480, 73d Cong. (1933) ("There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.").

[237] *See, e.g.*, Securities Act of 1933 § 11 as codified in 15 U.S.C. § 77k (1998) (imposing strict liability on issuers and negligence-based liability on underwriters, accountants, and others, for untrue statements of material fact or omissions to state a material fact required to be stated or necessary to make the statements made not misleading).

[238] *See Ralston Purina Co.*, 346 U.S. at 124 ("The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

[239] *See* Troy A. Paredes, *Blinded By the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003) ("In short, if the users do not process information effectively, it is not clear what good mandating disclosure does.").

presumably need the protection of the securities laws most—do not generally have this capacity.[240]

This incongruity likely contributed to the considerable debate in the 1980s and 1990s regarding whether the mandatory disclosure system was still justified. Beyond consumer protection, alternative justifications included inadequate issuer incentives to disclose, the possibility that mandatory disclosure could solve certain agency problems, and allocation efficiency.[241] For many, allocation efficiency was the most critical, "even apart from the goal of investor protection," for the following reasons:

> [T]he capital markets allocate a scarce resource (capital) among competing users. By determining the cost of capital for corporate issuers, the securities markets serve in theory as the nerve center for a capitalist economy, encouraging the flow of capital to firms with superior prospects and penalizing less efficient firms by requiring them to pay more for capital. In this view, the capital markets, and in particular the stock market, promote efficiency and economic growth and thereby benefit all citizens, not simply investors.[242]

This thinking led Professors Goshen and Parchomovsky to claim in the mid-2000s that the "belief that securities regulation aims at protecting the common investor" is "misguided."[243] They claimed instead that "the role of securities regulation is to create and promote a competitive market for information traders" (i.e., sophisticated professional investors and analysts).[244] Such traders have long been theorized to be the best mechanism for ensuring relative market efficiency (i.e., share price accuracy and liquidity)[245] at any given time.[246] But the Goshen/Parchomovsky argument itself suggests that market efficiency redounds to the benefit of all investors.[247] In

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[240] *See* Cohen, *supra* note 233, at 1351–52 ("There are also the perennial questions of whether prospectuses, once delivered to the intended reader, are readable, and whether they are read. The cynic's answer to both questions is 'No'; the true believer's is 'Yes'; probably a more accurate answer than either would be: 'Yes—by a relatively small number of professionals or highly sophisticated nonprofessionals; No—by the great majority of those investors who are not sophisticated and, within the doctrine of *SEC v. Ralston Purina Co.,* are not 'able to fend for themselves' and most 'need the protection of the Act.'"). Some scholars also question whether professional investors lack this capacity too. *See* Paredes, *supra* note 239, at 452–60.

[241] For a summary of these justifications and others, see John C. Coffee, Jr. & Hillary A. Sale, Securities Regulation 2–9 (Thomson Reuters/Found. Press, 12th ed. 2012).

[242] *See id.* at 6.

[243] *See* Goshen & Parchomovsky, *supra* note 124, at 713.

[244] *See* Goshen & Parchomovsky, *supra* note 124, at 714.

[245] *See* Goshen & Parchomovsky, *supra* note 124, at 714.

[246] *See generally* Ronald J. Gilson & Reinier R. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984) (describing four mechanisms, all resulting from trading in the capital markets, that work to incorporate information in market prices at differing levels of relative efficiency).

[247] *See* Goshen & Parchomovsky *supra* note 122, at 715–16 ("By protecting information traders, securities regulation enhances efficiency and liquidity in financial markets. This protection, in turn, benefits other types of investors by reducing transaction costs and increasing

this sense, it is syllogistic that securities regulation aims to protect the common investor by protecting information traders. As earlier commentators implied, whether or not retail investors read disclosure, they are afforded a residual type of protection from those who do.[248] In other words, on account of the financial incentive of information traders to cause market prices to generally conform to their underlying value, such professionals provide the protection of the securities laws—contemplated by the *Ralston Purina* decision—to retail investors.

Retail crowdfunding is a hybrid between a public and a private offering. It employs many of the customary investor protections utilized in a public offering, including mandatory disclosure, heightened liability, and due diligence incentives for intermediaries. But it also limits each offering to a maximum of $1 million per year, imposes strict caps on how much any one investor, even a sophisticated investor, may invest each year, and has private-like resale restrictions. These three features will likely prevent a liquid secondary market comprised of knowledgeable professional investors from developing. Because this market will be small, no professional investor will have concentrated exposure, and scaled-back disclosure (compared to the public market) will lead to less transparency. This will create fewer opportunities and incentives for sophisticated investors to profit on price-value discrepancies. Accordingly, retail investors in this market, unlike the public market, will not benefit in the same way from professional investors' competitive pricing work. Moreover, the novel investor protection in retail crowdfunding, individual investment limits, will only protect investors from going bankrupt. It will not independently incentivize management or investors to promote business growth and hiring. This shows a gap in the current public theory of investor protection as it is applied to retail crowdfunding.

B. The private theory and accredited crowdfunding

In the private context, the protection of the securities laws has long been deemed unnecessary on account of a substitute: the ability of certain investors to "fend for themselves."[249] These investors are today grouped under the definition "accredited investor."[250] For example, a corporate executive may not need his own company's disclosure because he has access to

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liquidity. Furthermore, by protecting information traders, securities regulation represents the highest form of market integrity, which ensures accurate pricing and superior liquidity to all investors. In this way, securities regulation improves the allocation of resources in the economy."). *See also* Langevoort & Thompson, *Publicness, supra* note 160, at 363 ("[T]he presence of *some* prudent buyers will redound to the benefit of the less prudent.").

[248] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA. L. REV. 669, 694 (1984) (explaining that retail investors benefit from a "free ride" in the public market off of the work of professional investors without having to read disclosure because professional investors have a profit motive to correct prices through trading).

[249] *See Ralston Purina Co.*, 346 U.S. at 125.

[250] *See* 17 C.F.R. 230.501(a) (2014).

the same information that the law would otherwise compel.[251] Likewise, some investors (e.g., institutional investors) may not need the law to compel disclosure because they already have the bargaining power to compel it on their own.[252]

But there is a third kind of accredited investor who has been deemed capable of self-help even though he or she may lack access, bargaining power, and sophistication: the investor qualifying based on financial thresholds.[253] One potential justification for this choice is that it may be possible to motivate this kind of investor, more so than others, to gain the necessary sophistication to evaluate an investment or to hire a sophisticated agent to do the necessary work on the investor's behalf. After all, such investors, on account of their income or net worth, may have more time to devote to due diligence or better resources from which to enlist a surrogate.

In 1982, when the SEC adopted this standard as part of the accredited investor definition in Regulation D, the justification would have made more sense than it does today. Back then, the law put in place at least five structural constraints that might incentivize due diligence.[254] First, higher inflation-adjusted financial thresholds for those qualifying as accredited made the pool of potential investors very small.[255] Second, a prohibition on advertising to or soliciting investments from people with whom the issuer did not already have a prior relationship made the pool even smaller.[256] Third, a threshold limitation of 500 holders of record created a disincentive to having a widely dispersed capital structure because it might subject a company to public regulation.[257] Fourth, a prohibition on reselling private securities for three years from the date of purchase, subject to the 4(1½) exemption, meant that investors would have limited exit options.[258] Last, issuers faced a relatively high level of federal and state liability for inaccurate or incomplete disclosures.[259]

Together, these constraints created incentives to motivate issuers to work hard to profit and investors to perform due diligence and monitoring

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[251] *See Ralston Purina Co.*, 346 U.S. at 125.

[252] *See* Thompson & Langevoort, *Redrawing, supra* note 4, at 1610 ("When a concentrated group of sophisticated purchasers negotiate with the issuer, they are in a position to bargain for information and its credibility, through the use of representations and warranties.").

[253] *See supra* note 3.

[254] For an expanded discussion of these structural constraints and how they have been weakened over time, see Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1609–24; *see also* Sjostrom *Rebalancing*, *supra* note 117, at 1149–58.

[255] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1615 ("When adopted, the definition of accredited investor contained no provision for adjustment for inflation, and so over the ensuing decades—particularly quickly in the inflationary environment of the early part of that period—the wealth tests brought more and more retail investors into accredited investor status.").

[256] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1612.

[257] *See* Sjostrom *Rebalancing*, *supra* note 117, at 1153.

[258] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1613–14.

[259] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1613–14

functions. A small pool of investors meant that each had to take a proportionately larger stake. This skin-in-the-game encouraged due diligence. A pool comprised mostly of members of the same community, moreover, placed reputational pressure on the issuer and gave investors a head-start on due diligence, as they already knew the issuer. Limited exit opportunities encouraged ongoing monitoring during the life of the business because investors had no other way of cashing out profitably while their capital was tied up.[260] Last, heightened federal and state liability[261] promoted accurate and complete disclosure.

Accredited crowdfunding, however, does not benefit from these traditional incentives. Many have been eroded over time with respect to all types of private offerings. For example, the pool of accredited investors has grown significantly on account of inflation, the threshold limitation of 500 holders of record has been increased to 2,000, the three-year resale holding period is now a one-year holding period, new secondary markets have emerged to facilitate private security resales, and liability exposure has been significantly relaxed.[262]

But the most significant change, which is unique to accredited crowdfunding and other types of Rule 506(c) offerings, is that general solicitation and advertising is now permitted.[263] This goes further than any other change toward creating a privately regulated public offering method.

When viewed together, the incentives of accredited investors to fend for themselves in accredited crowdfunding offerings appear to be significantly undercut by these changes. This suggests the potential for collective action problems in these deals that could weaken investor protection and thwart critical feedback loops between inexperienced management and knowledgeable investors. It shows a gap in the private theory of investor protection as applied to accredited crowdfunding.

C. A theory to describe the spectrum

The emergence of hybrid public/private offering methods suggests a need to reformulate the traditional binary theory of investor protection. Based upon the insight that private offerings have traditionally created incentives for investors to fend for themselves as a substitute for the customary protections of the securities laws and the observation that retail investors in relatively inefficient markets are unlikely to benefit from the competitive pricing work of professional investors, a reformation of this theory to ac-

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[260] *See* Coffee*, Liquidity Versus Control, supra* note 227, at 1288.

[261] *See* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1614.

[262] *See generally* Thompson & Langevoort, *Redrawing*, *supra* note 4, at 1609–24; *see also* Sjostrom, *Rebalancing*, *supra* note 117, at 1149–58.

[263] *See supra* note 8.

count for the spectrum of hybrid offering methods is in order. It can be stated as follows:

> Investors need stronger incentives to fend for themselves where the protections of the securities laws are sparse (e.g., private offerings) than where they are abundant (e.g., public offerings).

Taking into account the two crowdfunding exemptions, traditional private placements, and public offerings, the spectrum from least protection to most is: accredited crowdfunding, traditional private placements, retail crowdfunding, and public offerings. Since accredited crowdfunding has the fewest protections, investors will need greater incentives to fend for themselves under the private theory to substitute for the new changes. Retail crowdfunding will likewise need substitute protection to make up for what is lost under the public theory. This kind of recalibration in accordance with this theory of the spectrum is deployed in the next Part to help guide the assessment of the open items in both retail and accredited crowdfunding.

IV. Assessing Potential SEC Action

This Part assesses some potential action that the SEC could take to minimize the potential problems in retail and accredited crowdfunding and to promote social welfare. It considers a pooled investment solution that the SEC has already informally approved as well as proposals for resolving each of the open items identified in Appendix I in the following order: public company regulation, verification, liquidity risk, integration and aggregation, substantial compliance, and the accredited investor definition. With respect to each proposal, it balances the incentives-based theory of investor protection against capital formation under both exemptions.[264]

A. Pooled investments managed by a lead investor

The first proposal is that the SEC should codify and refine some or all of the no-action relief it provided to AngelList and FundersClub, two existing accredited crowdfunding websites.[265] This relief informally confirmed that private funds managed by a registered investment adviser or venture capital fund adviser are permitted to intermediate deals between startups and accredited investors through the Internet without broker-dealer regulation.[266]

Under one AngelList model called "Angel Advised Deals," the crowdfunding website would designate a "well known, experienced venture

[264] Whenever the SEC promulgates rules, it must always consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." *See, e.g.*, JOBS Act § 302(a) as codified in 15 U.S.C. § 78c (2012).

[265] *See* the AngelList No-Action Letter and the FundersClub No-Action Letter, *supra* note 93.

[266] *See supra* notes 144–46 and accompanying text.

capital investor with demonstrated experience investing in and working with start-up companies" to actively identify and lead negotiations with startup companies.[267] This "Lead Angel" would register with the SEC or the applicable state as an investment adviser and would invest between 20% and 50% of his or her own capital into an identified startup company.[268] Then, through crowdfunding, other accredited investors would be given the opportunity to co-invest alongside the Lead Angel. Subject to twelve conditions, the SEC agreed to tolerate this model without bringing an enforcement action, although it reserves the right to modify or revoke this position at any time.[269]

This emerging model syncs very well with the incentives-based theory of investor protection because the Lead Angel's experience, large financial stake, and carried interest incentive (based on overall profitability) would align his or her interests closely with the co-investors. It would appear to be the best means of solving the collective action and lemons problems because it concentrates bargaining power and investment discretion in one person. By contrast, other models appear to do the opposite: encourage the dispersion of knowledge and power among many. For example, the broker-dealer model does not require any ongoing financial stake in the intermediary. While broker-dealers are permitted (though not encouraged) to take such a stake in accredited crowdfunding, the SEC is proposing to prohibit such stakes in retail crowdfunding.[270] Broker-dealers are encouraged to skim off the top by taking transaction-based fees (i.e., a percentage of the total amount of capital raised prior to its deployment). This allows broker-dealers to profit without regard to a company's future performance, meaning that the financial interests of the broker-dealer and individual investors are not necessarily aligned. Section 201(c) platforms and funding portals, which have more severe compensation restraints,[271] will have even less incentive to mitigate these collective action problems.

By comparison, the Lead Angel's incentives to monitor, negotiate, and perform due diligence are manifest. At the same time, by permitting passive co-investments, this model still promotes capital formation from the crowd through greater participation by accredited investors. This suggests that the SEC may want to take further measures to encourage this type of pooled investing. For instance, the SEC could collect empirical data about the vari-

[267] *See* the AngelList No-Action Letter, *supra* note 93.

[268] *See* the AngelList No-Action Letter, *supra* note 93.

[269] *See* the AngelList No-Action Letter, *supra* note 93.

[270] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,555–56.

[271] 201(c) platforms, which are allowed to operate in accredited crowdfunding only, are permitted to co-invest alongside other investors, but are not currently permitted to take transaction-based fees or carried interest. *See supra* note 93. The SEC is proposing to prohibit funding portals, which are allowed to operate in retail crowdfunding only, from co-investing. *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,555–56. Such platforms are also prohibited from taking transaction-based fees, but the SEC is proposing other limited ways through which funding portals can be compensated. *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,560–61.

ous compensation models to test this theory through a study that assesses the performance of each against the others. This data could later lead to a formal codification of a refined version of the SEC's current no-action positions. While retail investors will generally be shut out of these opportunities, changes to the integration and aggregation rules, as later discussed, provide possible ways for such investors to residually benefit.

B. Public company regulation

The second proposal to consider is that the SEC should tighten the public company regulation trigger in Section 12(g) of the Exchange Act with respect to Rule 506(c) offerings.[272] Alternatively, the SEC could consider whether to require minimum investment amounts in such deals. Both proposals would work toward increasing investor bargaining power by discouraging small stake investments from a large number of investors.

This trigger currently requires companies exceeding 2,000 holders of record to comply with public company regulation. However, issuers using accredited crowdfunding may be able to avoid it by counting entities with multiple beneficial holders as single record holders.[273] As a result, issuers can circumvent public company regulation by selling securities to fewer than 2,000 entities that have dozens of beneficial shareholders without incurring any additional disclosure obligations.[274] This seems jarring considering that retail crowdfunding has an explicit and unprecedented exclusion from the Section 12(g) trigger and a specially-tailored annual disclosure requirement.

From an investor protection perspective, the incentives-based theory shows why it would be suboptimal for the SEC to preserve the status quo. Since investors need stronger incentives to fend for themselves where the protections of the securities laws are sparse (i.e., accredited crowdfunding) than where the protections are more abundant (i.e., retail crowdfunding), accredited crowdfunding should be encouraged to have fewer investors with larger stakes than retail crowdfunding. Such investors would, in turn, be

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[272] It is notable that Representative Michael Capuano proposed a broader variation of this proposal that would apply not just to Rule 506(c) offerings, but to all private offerings. It was rejected by the House in the lead-up to the JOBS Act. *See* 158 Cong. Rec. H1280-81 (daily ed. Mar. 8, 2012) (statement of Rep. Capuano); *see also* Fried Frank Memorandum, *House Passes Bill Raising Limit on Number of Shareholders an Issuer May Have Before Being Required to Register with the SEC and Relaxing Rules Prohibiting General Solicitation in Regulation D Offerings* (Mar. 13, 2012), *available at* http://www.friedfrank.com/siteFiles/Publications/3-13-12-%20TOC%20Memo-House%20Passes%20Bill%20Raising%20Limit%20on%20Number%20of%20Shareholders%20an%20Issuer%20May%20Have%20Before%20Being%20Required%20to%20Register%20with%20the%20SEC.pdf [hereinafter, the Fried Frank JOBS Act Memo].

[273] *See supra* Part II.A.iii.e.

[274] While each fund will generally count as one record shareholder for purposes of the 2,000 record holder test, Section 3(c)(1) of the Investment Company Act will generally cause the beneficial holders of each fund to be limited to a maximum of 100 individual investors. *See supra* note 159.

more motivated to protect themselves than more investors with smaller stakes. This would work against the potential collective action problem in accredited crowdfunding. The SEC's blueprint,[275] however, would encourage the opposite.[276]

Preserving the status quo, moreover, may not only undermine investor protection, but it may also threaten capital formation. It may lead to poor results in accredited crowdfunding from a lack of proper vetting and monitoring. This could tarnish the reputation of this market and cause future issuers and investors to avoid it. There could be a spillover effect into retail crowdfunding. If accredited investors will not crowdfund, retail investors might be spooked.

Accordingly, a meaningful shareholder threshold in accredited crowdfunding or minimum investment amounts could be another mechanism to help prevent the potential collective action and lemons problems in accredited crowdfunding. But importantly, any such rule would have to be narrowly tailored to Rule 506(c) offerings in light of Congress's prior rejection of the broader formulation.[277] Adopting the change solely in conjunction with the liberalization of general solicitation and advertising seems justified, as it is narrow and distinguishable.

C. Verification

The third proposal is that the SEC should allow a lower verification requirement in retail crowdfunding than the newly adopted verification mandate in accredited crowdfunding.[278] A number of commentators have recommended this proposal, citing the high costs of verification, while there are others who have cautioned against it.[279] In retail crowdfunding, the SEC is ordered to require the crowdfunding sites to make such efforts as it deems appropriate to ensure that each investor is complying with his or her individual investment limits.[280] Accordingly, the SEC has discretion to equalize ver-

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[275] *See* THE RULE 12g5-1 REPORT, *supra* note 151 and accompanying text.

[276] Another potential way of encouraging investors to have skin-in-the-game is to require high minimum investment amounts. This is also raised for the SEC's consideration in Part V herein.

[277] *See* the Fried Frank JOBS Act Memo, *supra* note 272.

[278] *See* General Solicitation Adopting Release, *supra* note 8.

[279] *See, e.g.,* Bradford *supra* note 44, at 10 ("Issuers and Crowdfunding Intermediaries Should Be Able to Rely on Self-Certification by Investors of their Annual Income and Net Worth"); Letter from Catherine T. Dixon, Chair, Fed. Reg. of Sec. Comm., A.B.A. to U.S. Sec. & Exch. Comm'n (Mar. 20, 2013), *available at* https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-227.pdf (regarding Request for Public Comments on SEC Regulatory Initiatives under the JOBS Act Title III –Crowdfunding) [hereinafter the Dixon Letter]. *But see* Schwartz, *supra* note 86, at 59–60 (advising the SEC to be cautious in allowing self-certification and recommending as an exception to his general rule that even high costs in enforcing the individual investment limits are "probably worth it, because the whole statutory scheme depends on it").

[280] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(a)(8) (2012).

ification under both exemptions or give retail crowdfunding an advantage on this element.

From an investor protection perspective, there may be good reason for a more onerous verification requirement in accredited crowdfunding. Such a requirement would motivate issuers to accomplish each capital raise with as few investors as possible, which would encourage larger stakes from each investor. This, in turn, would strengthen such investors' incentives to fend for themselves. Since the incentives-based theory of investor protection dictates that investors should have stronger incentives to fend for themselves in accredited crowdfunding than in retail crowdfunding, such a differential seems justified.

From a capital formation perspective, verification is more likely to deter the participation of retail investors than accredited investors. Submitting tax forms, bank statements, and similar documents can be daunting and intrusive. The labor involved is another form of skin-in-the-game. In accredited crowdfunding, the benefit of filtering out less sophisticated accredited investors and blocking access to retail investors likely weighs positively against the detriment of less capital. It should result in a smaller pool of smarter and more committed capital. But this same strategy would only impede capital formation in retail crowdfunding without the same investor protection benefits. Indeed, the main investor protection benefit of verification in retail crowdfunding is to protect those who accidentally or intentionally falsify their eligibility. Yet, there are less intrusive ways of preventing accidental errors, and it is unlikely that the benefits of policing intentional misbehavior outweigh the costs of less available capital.

D. Liquidity risk

The fourth proposal is that the SEC should decrease liquidity risk in retail crowdfunding and facilitate a secondary market by removing statutory underwriter risk with respect to permitted transfers. Crowdfunding sites, such as SeedInvest, have supported proposals to increase the liquidity of startup and small business securities.[281] Some academics have also supported increased liquidity for young firms.[282] There is currently ambiguity with respect to the transferability of retail crowdfunding securities because Congress was silent on statutory underwriter risk while adopting literal language that suggests free transferability under certain circumstances.[283] In accredited crowdfunding, by contrast, it is clear that the murky and complicated Section

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[281] *See* Charles Luzar, *How Crowdfunding's Secondary Market Could Evolve*, VENTUREBEAT.COM (Feb. 6, 2013), http://venturebeat.com/2013/02/06/how-crowdfundings-secondary-market-could-evolve.

[282] *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531 (2012) (arguing that U.S. equity markets fail to offer a satisfactory listing venue for emerging firms and proposing a "lifecycle model" where regulations would adapt to firms as they age).

[283] *See* JOBS Act § 302(b) as codified in 15 U.S.C. § 77d-1(e) (2012).

4(1½) exemption applies prior to a one-year holding period, while such securities, when resold by non-affiliates, are freely transferable after one year.[284]

From an investor protection perspective, less liquidity translates into greater incentives to fend for oneself.[285] Knowing *ex ante* that an investment will be hard to exit, investors will have more incentive to do due diligence than if they believe exit will be easy. Likewise, investors will have more incentive to monitor and help improve a company's long-term prospects. By contrast, where exit is easy, the opposite is true: investors would be more likely to sell out. Private monitoring is more important in accredited crowdfunding since there are fewer investor protections. As a result, the incentives-based theory would dictate that such securities should be less liquid than securities in retail crowdfunding. This would motivate more due diligence and monitoring in accredited crowdfunding. In retail crowdfunding, there is no reason to incentivize such due diligence and monitoring because retail investors will not otherwise have enough skin-in-the-game or sophistication to perform this work.

There may be different reasons, however, to restrict resales in retail crowdfunding for at least one year. First, a secondary market in retail crowdfunding may look much like the fraud-ridden Rule 504 market of the 1990s: "thin capitalization, low share prices and little or no analyst coverage."[286] While the SEC has played down concerns that history would repeat itself to the extent the market is comprised solely of accredited investors, there is reason to be skeptical.[287] The logic rests on the assumption that accredited investors are sophisticated and are thus better equipped to resist aggressive sales tactics than are retail investors. However, many accredited investors qualify for this status on the basis of wealth, which does not equate to sophistication.[288] More importantly, informed professional trading is unlikely to gain traction in this market because nano-cap and micro-cap companies do not generate large investment banking fees and the required disclosure may be too stripped-down to elicit analyst interest.[289] This means that this market will have no reliable mechanism to keep prices closely tied to underlying values. While some have suggested that a market comprised

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[284] *See* The Section "4(1½)" Phenomenon, *supra* note 180.

[285] *See* Coffee, *Liquidity Versus Control, supra* note 227, at 1281 (suggesting that less liquidity will increase the incentives of institutional investor to monitor: "a trade-off exists and must be recognized between liquidity and control. Investors that want liquidity may hesitate to accept control.").

[286] General Solicitation Adopting Release, *supra* note 8, at 44,799.

[287] *See* General Solicitation Adopting Release, *supra* note 8, at 44,799 (explaining that "schemes involving price manipulation to defraud unknowing investors in the immediate resale of securities purchased directly from issuers" are less likely when the pool is limited to accredited investors).

[288] *But see, e.g.*, Jennifer J. Johnson, *Fleecing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993 (2012).

[289] *See*, *e.g.*, Stephanie Loiacono, *How To Evaluate A Micro-Cap Company*, INVESTOPEDIA.COM (Oct. 6, 2012), http://www.investopedia.com/articles/stocks/07/micro_cap.asp.

solely of accredited investors would lead to efficient capital formation, this too rests on the assumption that accredited investors (who are mostly not professional traders) have the necessary time and sophistication to evaluate investments.[290] This may be true to the extent the right incentives are in place, but if not, such a market may be marred by inefficient investments and speculation. Since this market will lack the primary protection afforded to investors in the public market, the SEC should be cautious in facilitating an unfettered resale market in retail crowdfunding, even if it is limited to accredited investors.

Nonetheless, after a one-year holding period, removing statutory underwriter risk is the standard approach across most privately offered securities.[291] In the absence of evidence that resales held for one year are harming investors under other exemptions, there would seem to be good reason to equalize liquidity risk in the retail crowdfunding exemption as a starting point.

E. Integration and aggregation

The fifth proposal is that the SEC should clarify how the application of integration and aggregation applies to retail and accredited crowdfunding. There is currently silence with respect to integration and ambiguity with respect to aggregation. Some proposals have recommended an integration safe harbor for retail crowdfunding, limiting aggregation in retail crowdfunding to only offerings utilizing it, and encouraging concurrent and back-to-back retail offerings alongside or following accredited-only offerings.[292]

From an investor protection perspective, an integration safe harbor combined with the elimination of aggregation risk between retail crowdfunding offerings and other exemptions is the best way to encourage retail crowdfunding offerings to follow accredited-only offerings. Accredited investors, in theory, are more likely than retail investors to have the capacity to protect themselves in their negotiations with issuers. This, however, depends

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[290] *See* A.C. Pritchard, *Revisiting "Truth in Securities Revisited": Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 Seattle U. L. Rev. 999, 1002 (2013) (proposing "a two-tier market for both primary and secondary transactions keyed to investor sophistication. The private market would be limited to accredited investors, while the public market would be accessible to all." Arguing that "[t]his regulatory framework would go a long way toward both promoting efficient capital formation and eliminating the waste currently associated with IPOs. A happy byproduct would be more vigorous protection for unsophisticated investors.").

[291] Rule 144 of the Securities Act as codified in 17 C.F.R. § 230.144 (2014).

[292] *See*, *e.g.*, Bradford June 2012 Testimony *supra* note 44, at 9 (suggesting a rule that would prevent integration between retail crowdfunding and prior offers or sales or securities and that would limit integration risk for subsequent private offerings to a three month window); Bradford *supra* note 32, at 121 (stating that, for purposes of aggregation, "[s]ecurities sold in non-crowdfunded offerings should not count against the exemption's limit"); the Dixon Letter, *supra* note 279 (arguing that retail investors could benefit from the work of accredited investors if retail crowdfunding offerings could be "conducted concurrently (or shortly after) Rule 506(c) transactions").

upon whether they have sufficient bargaining incentives. If so, through vetting and negotiation, such investors are more likely to help set a fair price, weed out fraud, bring to light important disclosures, and obtain other important deal protections.[293] Retail investors could piggyback off the work of accredited investors in this private market much like they piggyback off the work of underwriters and professional traders in the public markets.[294] Since retail investors are not likely to have the protection of such actors in the crowdfunding context, encouraging accredited investors to be the first line of defense before retail investors could be the best conceivable substitute. Likewise, the offering amounts in the accredited-only context should not count against the $1 million offering cap in retail crowdfunding. If they did, this would eat up the cap and prevent such back-to-back offerings.

Not only could such rules help address the viability of retail crowdfunding, but they could also help address the market for lemons problem. This, however, would require at least two further reforms to help retail investors distinguish the good offerings from the bad. First, the SEC should consider requiring prominent disclosure of prior capital-raising results. This would help retail investors identify success and failure in initial attempts with accredited investors and instances where retail investors are the first line of defense.

Second, the SEC should consider requiring prominent disclosure of whether issuers are providing retail investors with most-favored nation ("MFN") protection. An MFN clause would require issuers to give investors the best terms it makes available to any other passive investor. This, however, should not apply to a lead investor who would be given superior terms as an incentive to work on behalf of the crowd. Disclosure of whether such a clause is being provided could be useful because it would signal that financings to accredited investors are not being conducted at the expense of retail investors. If there is no MFN protection, on the other hand, retail investors could draw the opposite conclusion. Investors may be more likely to pay attention to simple MFN disclosure like this than complicated disclosure that advises, in fine print, that an investor's rights may "be materially limited, diluted, or qualified by the rights of" of a different class of securities.[295] Such disclosure could provide a second way for retail investors to decipher whether or not a follow-on investment would be aligned or in conflict with the prior work done by accredited investors and how future raises would affect their interests.

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[293] *See* the Dixon Letter, *supra* note 279, at 7 (citing other deal protections).

[294] *See supra* notes 243–48 and accompanying text.

[295] JOBS Act § 302(b) as codified in 15 U.S.C. § 77d (2012) (requiring issuers to disclose the "terms of the securities of the issuer being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer").

From a capital formation perspective, these changes would encourage the use of retail crowdfunding as a follow-on method. This would make retail crowdfunding more viable and would also have the advantage of giving more retail investors the opportunity to participate in private deals.[296] Most importantly, it would help prevent retail crowdfunding from becoming a market for lemons by providing retail investors easy-to-process signals to help distinguish the good companies from the bad. Down the line, surveys regarding investor decision-making might provide empirical evidence that simple and prominent disclosure like this is more effective than the significant disclosure required in retail crowdfunding.

Concurrent accredited and retail crowdfunding offerings, however, would not offer the same advantages as a follow-on structure. First, since accredited-only exemptions like Rule 506(c) have different conditions from retail crowdfunding, there are practical problems with respect to how the conditions of both could ever be met simultaneously while preserving the benefits unique to each. Second, even if issuers agreed to use the more restrictive rules under each exemption for all investors,[297] the more dispersed audience of investors would tend to undermine the negotiating power of the accredited investors (including any lead investor) who presumably might work on behalf of retail investors. While the capital formation and retail inclusion benefits would be the same, undercutting this crucial investor protection benefit counsels against the SEC taking this approach.

F. Substantial compliance

The sixth proposal is that the SEC should harmonize the substantial compliance rules in retail and accredited crowdfunding. A number of commentators have weighed in on this proposal.[298] Currently, retail crowdfunding requires compliance with a slew of detailed requirements as a condition to the exemption. This exposes issuers to draconian consequences, such as rescission, even if there is only a minor instance of non-compliance.[299] By contrast, in accredited crowdfunding, there is a substantial compliance rule.[300]

From an investor protection point of view, a substantial compliance rule motivates *ex ante* due diligence by limiting the ability of investors to recover through litigation *ex post*. Since such motivation is more important in accredited than retail crowdfunding on account of the incentives-based theory, the current balance appears to be properly oriented.

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[296] *See* Obama's Signing Statement, *supra* note 23 (suggesting that the democratization of angel investing is a goal of retail crowdfunding).

[297] *See*, *e.g.*, the Dixon Letter, *supra* note 279, at 8.

[298] *See*, *e.g.*, Bradford June 2012 Testimony, *supra* note 44; the Dixon Letter, *supra* note 279.

[299] *See supra* Part II.A.ii.h.

[300] *See* 17 C.F.R. § 230.508 (2014).

But from a capital formation perspective, the complexity of complying with the retail crowdfunding regime combined with the severity of the consequences (most notably, the liability provisions) could have an outsized influence on the use of retail crowdfunding by issuers. This is partly because the crowdfunding websites, and not the issuers, bear some of the compliance burden. Since this is outside of the issuer's control, many issuers might view the risk of a good faith error to be simply too high. This could unnecessarily undercut the viability of retail crowdfunding. Moreover, the legislative history is silent on the importance of a litigation remedy for a minor instance of non-compliance as a condition to the rule. It seems more likely that this differential was not intended to be a distinguishing factor. In light of the many other intentional investor protections built into retail crowdfunding, an equal, but not more severe, substantial compliance rule appears justified. Nonetheless, the SEC should consider whether the satisfaction of some conditions is so important that they should be carved out of a substantial compliance rule.

G. The accredited investor definition

The final proposal is that the SEC should raise the accredited investor standard. A number of commentators have discussed this issue.[301] The SEC is specifically authorized to adjust the definition with respect to natural persons as it deems appropriate.[302] But because it is practically prohibited from reviewing the net worth test[303] until July 21, 2014,[304] the immediate focus is placed on the income test.[305]

From an investor protection point of view, raising the income standards would cause the pool of accredited investors to shrink. A smaller pool would give those remaining investors more incremental leverage and would likewise increase the likelihood that each investor takes a larger stake. According to the incentives-based theory, such a move may be justified as it would increase the incentives of such accredited investors to fend for themselves.

From a capital formation perspective, however, raising the accredited investor standards would simply reallocate investors from the accredited pool to the retail pool. This may be a zero-sum or negative-sum game to the

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[301] *See*, *e.g.*, Thompson & Langevoort, *Redrawing*, *supra* note 4; Letter from Mercer Bullard, J. Robert Brown, Jr. & Barbara Roper to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n, (Aug. 28, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf.

[302] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(b)(1)(B), 124 Stat. 1376, 1578 (2010).

[303] The net worth test allows persons with a net worth of $1 million or more (excluding the value of such person's primary residence) to qualify as an accredited investor.

[304] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010).

[305] The income test allows individuals to qualify as accredited investors if, in each of the last two years, they made an income of $200,000 or more with an expectation of the same in the coming year, or had a joint income of $300,000 with their spouses.

public in light of the difficult line-drawing exercise. Since the accredited investor definition applies to a broad range of private offering exemptions (not just accredited crowdfunding) and since issuers are likely to prefer accredited crowdfunding, raising the accredited investor standards too high could depress overall capital formation more than it increases successful deals. If the pool of accredited investors is too large, on the other hand, there is an opposite threat to capital formation based on the collective action problem discussed earlier. But this seems to be more a function of the right to generally solicit and advertise than the accredited investor definition. The ban on general solicitation and advertising makes any pool only as big as an issuer's (and its broker's) rolodex of accredited investors. The SEC may thus want to focus first on collecting empirical data relating to the impact of general solicitation and advertising before focusing on how to recalibrate the accredited investor definition, if at all, in accordance with the competing concerns of capital formation and investor protection.

V. Recommendations

This final part seeks to put theory to practice by providing targeted recommendations. Specifically, I recommend four types of rulemakings, studies, and considerations to minimize the potential problems: (1) strengthen investor bargaining power in accredited crowdfunding by encouraging pooled investments managed by a sophisticated and financially aligned lead investor and by encouraging fewer passive investors in each deal who take relatively larger stakes; (2) encourage retail investors to piggyback off of the work of accredited investors by taking specific measures to facilitate back-to-back offerings (accredited-only offerings followed by retail crowdfunding offerings) where retail investors and passive accredited investors (but not the lead investor) participate on the same terms; (3) harmonize the resale and substantial compliance rules; and (4) generate data for future empirical research to enable a special study on capital-raising impediments and investor protection.

A. Strengthen accredited investor bargaining power

The SEC can strengthen accredited investor bargaining power through the following three potential measures.

(i) Encourage certain pooled investments managed by a lead investor in accredited crowdfunding

First, the SEC should collect empirical data about the various compensation models allowed in retail and accredited crowdfunding. Some, such as

the Angel Advised Deals model,[306] require an experienced venture capital investor with significant financial stakes and the opportunity for carried interest. Others permit only transaction-based fees or other more limited forms of compensation that do not necessarily align active sophisticated investors with passive co-investors.[307] This Article predicts that the Angel Advised Deals model will provide the best incentives for producing allocatively efficient deals. Data from the success of different models could be used to test this theory and could later lead to a formal codification of a refined version of the SEC's current no-action positions.

(ii) Tighten the 12(g) trigger and/or mandate minimum investment amounts in accredited crowdfunding

Second, the SEC should tighten the Section 12(g) shareholder threshold in Rule 506(c) offerings to encourage fewer than 2,000 individual investors where issuers seek to use general solicitation and advertising.[308] The theory is that fewer investors will necessarily need to take larger stakes. Since the JOBS Act recently raised the public company regulation trigger to 2,000 holders of record, the SEC likely lacks authority to deviate from this figure.[309] But a hard beneficial ownership look-through using this figure would likely be justified as a tradeoff for the new right to generally solicit and advertise. The SEC could amend Rule 12g5-1(b)(3), commonly known as the anti-evasion rule, by inserting the language in BOLD and *underline* below:

> If the issuer *sells securities under 17 CFR 230.506(c)* OR knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d) of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.

This proposal is distinguishable from the broader formulation rejected by Congress.[310] It would discourage issuers who use accredited crowdfunding from selling securities to more than 1,999 individual investors, regardless of the form of holding, unless they are willing to incur public company obligations.[311]

[306] Fore more information about this model, see *supra* Part IV.A.
[307] *See id.*
[308] *See supra* Part IV.B.
[309] *See* JOBS Act § 501, codified at 15 U.S.C. § 78l(g) (2012).
[310] *See supra* note 272.
[311] It is notable that 1,999 investors may be viewed by many to be a widely dispersed capital structure. Accordingly, the collective action problem may not be solved by this limit, but currently the SEC does not have authority to make it any lower. This would have to come from Congress. To the extent empirical data later shows that Rule 506(c) offerings with a large number of investors fail more often than traditional private placements with fewer investors, there may be good reason for Congress to lower the threshold.

Alternatively or conjunctively, the SEC should consider mandating minimum investment amounts in accredited crowdfunding. The purpose of such a requirement would be to forcibly increase the stakes of each investor in accredited crowdfunding. Higher stakes would motivate due diligence and monitoring. This recommendation could strengthen a hard beneficial ownership look-through under Section 12(g) to the extent companies seek to maximize the size of the accredited pool and thereby weaken the bargaining power of investors.

For different reasons, however, mandating minimum investment amounts may not be necessary at the current time. First, it is not clear that companies will often desire a widely dispersed shareholder base. It may come with bothersome expenses, such as the need for an outside transfer agent to manage transfers. In addition, the 12(g) recommendation combined with the new verification rules in 506(c) offerings may be enough to motivate sales to few shareholders in this context. Next, the market may require such minimums without legal compulsion. For example, SecondMarket and SharesPost currently require minimum investment amounts of $100,000 and $25,000 respectively.[312] For a $1 million capital raise, the SecondMarket requirement would limit the shareholder base to only ten investors, while the SharesPost requirement would limit the base to forty. Finally, there could be a drawback to flat minimum investment amounts that do not take proportionate wealth into account. For instance, such a minimum could cause an unsophisticated, but wealthy investor, to over-invest and thereby expose his or her wealth to too much risk.[313]

The SEC could thus wait on implementing minimum investment amounts until they gather and analyze empirical data on how the average 506(c) shareholder base differs from the average 506(b) shareholder base before acting.[314] To the extent empirical data shows that Rule 506(c) offerings with a large number of investors fail more often than traditional private placements with fewer investors, there may be good reason to later mandate minimum investment amounts. As of now, however, only a hard beneficial ownership look-through under 12(g) seems justified.

(iii) Allow a lower verification requirement in retail crowdfunding

Third, the SEC should adopt a slightly bulked-up form of its proposed self-certification requirement in retail crowdfunding. It is proposing to allow issuers and intermediaries to "rely on an investor's representations concern-

[312] *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3405–06 (2013).

[313] *See* SEC Proposed Rule on Lifting GS&A Ban, *supra* note 141, at 54,469; *The Veronica Mars Movie Project*, *supra* note 54.

[314] The SEC is currently proposing to require disclosure necessary to gather this data in Item 14 of Form D. *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 and 239).

ing compliance with the investment limitation requirements concerning the investor's annual income, net worth, and the amount of the investor's other investments made pursuant to Section 4(a)(6)."[315] While this self-certification rule strikes the right balance with respect to capital formation, it makes no effort to balance accidental misrepresentations against intentional fabrication from an investor protection perspective.

There may be a simple solution: a "Bart Simpson-style"[316] self-certification, whereby the investor must write out and sign under penalty of perjury (manually or electronically) a statement that the investor understands and accurately stated its obligations. This should go a long way towards weeding out accidental misrepresentations. While retail investors may not have the sophistication to evaluate what deal protections they may need, the following requirement should generally prevent accidental misrepresentations by honest and competent adults:

Each issuer and intermediary in a transaction involving the offer or sale of securities pursuant to Section 4(a)(6) of the Securities Act shall be deemed to have satisfied its obligation in Section 4A(a)(8) of the Securities Act if, as a condition to a potential investor viewing an offering, the intermediary describes the two applicable investment limits set forth in Section 4(a)(6)(B) and Regulation Crowdfunding and each potential investor writes out (manually or electronically) their total annual investment limit, how much of that limit has already been used in the prior twelve months, and the following statement to be signed under penalty of perjury: "Under penalty of perjury, I understand and have accurately stated my annual investment limit and how much has been used in the prior twelve months, and any investment I make on this platform will not exceed the remaining amount allowed."

B. Encourage retail investors to piggyback

Assuming measures, such as those recommended above, are taken to strengthen accredited investor bargaining power, the SEC should next take the following measures to allow retail investors to piggyback off the work of accredited investors (including any applicable lead investor).

(i) Adopt complimentary integration safe harbors to allow retail crowdfunding deals to follow accredited-only Regulation D offerings

First, the SEC should adopt an integration safe harbor to prevent follow-on retail crowdfunding offerings from being deemed part of earlier accredited-only offerings under Regulation D. In its proposed Regulation

[315] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,470.

[316] The cartoon character Bart Simpson famously began each episode of "The Simpsons" by writing out a long phrase on a blackboard over and over again. *See* BART'S BLACKBOARD, http://bartsblackboard.com (last visited Mar. 5, 2014).

Crowdfunding, the SEC did not suggest adopting an integration safe harbor, even though it appears to favor non-integration.[317] Such a safe harbor would require an amendment to Rule 502(a) of Regulation D as well as new language within Regulation Crowdfunding. The former amendment could be made after the second sentence in Rule 502(a) as follows:

> Offers and sales that are made pursuant to Section 4(a)(6) of the Securities Act and Regulation Crowdfunding after (but not concurrently with) a Regulation D offering, to the extent the Regulation D offering is limited to accredited investors, will not be considered part of that Regulation D offering.

This would clarify that retail crowdfunding is permitted (from the perspective of Regulation D) as a follow-on to an offering limited to accredited investors only, but that concurrent offerings would be integrated.

The complimentary safe harbor in Regulation Crowdfunding could be drafted as follows: "Offers and sales made in reliance on Section 4(a)(6) will not be integrated with prior offers or sales of securities made exclusively to accredited investors under Regulation D."

(ii) Eliminate aggregation risk between retail crowdfunding offerings and accredited-only deals

The SEC should also follow through on its proposal to eliminate aggregation risk between retail crowdfunding offerings and deals under different exemptions.[318] This would allow the full $1 million offering cap to be available in retail crowdfunding offerings that follow Regulation D offerings limited to accredited investors.

(iii) Require disclosure of prior capital-raising and most-favored nation protection

To combat the potential market for lemons problem, the SEC should require that any issuer using retail crowdfunding prominently disclose prior capital-raising results and whether there is most-favored nation protection. This should include whether prior offerings were accredited-only, how much was raised, and whether the retail offering is the first attempt. This would inform retail investors as to whether accredited investors had passed on earlier opportunities to invest or made investments, and whether retail investors will be able to participate on the same terms as other passive investors (but not any applicable lead investor). The SEC is currently proposing disclosure of other exempt offerings conducted in the past three years, including the date of the offering, exemption relied upon, the type of securities offered, the

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[317] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,432.
[318] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,431–32.

amount of securities sold, and the use of proceeds.[319] While this appears to be useful disclosure, this recommendation advises further disclosure, as described above, to allow retail investors to better evaluate their level of alignment with earlier accredited investors and whether they are piggybacking on an attractive investment, jumping on the bandwagon with fewer rights, or buying securities that accredited investors already passed over. Such prominent disclosure might help retail investors with a limited attention span avoid problematic investments. Empirical evidence that could be gathered on how retail investors make their decisions in this market might later show that such disclosure is more valuable to investors in this market than the extensive disclosure that is currently required in retail crowdfunding.

C. Harmonize the resale and substantial compliance rules

The penultimate recommendations are to harmonize the resale and substantial compliance rules under both exemptions. These amendments are meant to eliminate unnecessary costs borne only by retail crowdfunding. The SEC could harmonize the substantial compliance rule by adopting its current proposal in Regulation Crowdfunding.[320] It could harmonize the resale rules by inserting in Rule 144(a)(3)(ii), the following language: "Securities acquired from the issuer that are subject to the resale limitations of § 230.502(d) under Regulation D, *§ 4A(e) of the Securities Act*, or § 230.701(c)."

D. Generate empirical data and conduct a special study

My final recommendations are that the SEC generates empirical data as described herein[321] and conducts a special study on capital-raising impediments and investor protection. A special study is in order because the JOBS Act mandates substantial changes to the menu of capital-raising options even though no rigorous study to identify impediments was ever conducted.[322] This omission is particularly relevant in light of recent empirical data that suggests that the pre-JOBS Act menu of options may have been functioning adequately. In fact, it may have been channeling too many offerings into the private realm and away from public regulation.[323] In 2012, "registered offerings accounted for $1.2 trillion of new capital compared to $1.7 trillion

[319] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,552–53.

[320] *See* SEC Proposal on Crowdfunding, *supra* note 2, at 66,500.

[321] *See* Parts IV.A and V.A (intermediary compensation models), Parts IV.G. and V.A.ii. (the impact of general solicitation and advertising on shareholder incentives to assess the need for changes to the accredited investor definition, the 12(g) holder-of-record trigger, and the need for minimum investment amounts); Part V.B.iii. (how retail investors make investment decisions to assess the extent of needed disclosure).

[322] *See supra* note 23.

[323] *See* Ivanov & Bauguess July 2013 Study, *supra* note 9.

raised through all private offering channels."[324] Scholars have begun to question whether the growth of the private market strikes the right balance between capital formation and investor protection.[325] While this question is outside the scope of this Article, the trend towards a dominant private market is evident and may be bolstered by the liberalization of general solicitation and advertising, the new shareholder threshold in Section 12(g), and other recent JOBS Act changes, such as the liberalization of Regulation A (also outside the scope of this Article) that affect the spectrum of public and private capital-raising options.[326]

Generating new data for empirical research will be essential to any such study. The SEC, in its recent rule proposals, took a step in the right direction by proposing additional disclosure on Form D and new disclosure on Form C.[327] This kind of data could help Congress and the SEC better understand which offerings are most likely to be allocatively efficient and which pose the greatest dangers to investors. In particular, data could help the SEC and Congress encourage the best intermediary compensation models, fashion the proper lines for the shareholder threshold in Section 12(g) and the accredited investor definition, assess the need for minimum investment amounts in Rule 506(c) offerings, and assess whether the required disclosure in retail crowdfunding is excessive. Better data will be essential in shaping future policy with respect to public and private capital-raising. Accredited and retail crowdfunding merely serve as two examples that can help inform a larger debate.

Conclusion

This Article demonstrates the differences between retail and accredited crowdfunding to help the SEC decide on retail crowdfunding rules and offsetting changes to accredited crowdfunding. It assesses some of the SEC's potential options and applies an incentives-based theory of investor protection to recommend rules that aim to minimize potential problems in both retail and accredited crowdfunding and promote social welfare. It recommends a package of rules that, in chief, would strengthen the bargaining incentives of accredited investors and would encourage retail investors to piggyback off their work. This Article hopes to begin the discussion on how to strike the right factual and theoretical balance between these two crowdfunding exemptions as well as other alternate options outside the scope of this Article.

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[324] Ivanov & Bauguess July 2013 Study, *supra* note 9, at 8.

[325] *See*, *e.g.*, Sjostrom, *Rebalancing*, *supra* note 117.

[326] *See* JOBS Act, tit. 1, 4.

[327] *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230 and 239); SEC Proposal on Crowdfunding, *supra* note 2, at 66,524–25.

Appendix I: Comparison Chart

Elements	**Retail Crowdfunding (RC)**	**Accredited Crowdfunding (AC)**	**Better for Issuers**
Offering Cap	$1M in each 12-months	None. Unlimited funds can be raised.	AC
Aggregation	Ambiguous, but SEC proposes that amounts sold under other exemptions will not reduce the cap.	None	**Open**. Equal if SEC proposals become law.
Eligible Issuers	Primarily US-based private companies	All companies, except bad actors	AC
Liability Exposure	12(a)(2) and antifraud	Antifraud only	AC
Mandatory Disclosure	Financial and non-financial disclosure required	None, except limited Form D information	AC
Intermediation	Intermediary required (choice of two) and each has mandatory duties	No intermediary required (but choice of four) with no mandatory duties	AC
State Law Preemption	Covered securities	Covered securities	Equal
Public Company Regulation	Exclusion from 2,000 holder of record count. Annual reporting required.	Exclusion from public company obligations may be a choice.	**Open**. No indication that SEC will clarify
Verification	SEC discretion to require verification; proposes only self-certification	Verification required	**Open. RC**, if SEC proposal becomes law
Liquidity Risk	Ambiguous, but SEC suggests free transferability to accredited investors and others immediately	Resales are freely transferable after a one-year holding period under Rule 144 and can be sold earlier through 4(1½).	**Open. RC**, if SEC proposal is clarified with respect to 4(1½) and becomes law
Substantial Compliance	SEC proposed a parallel rule to Rule 508 under Regulation D	Substantial compliance rule (Rule 508)	**Open.** Equal, if SEC proposal becomes law
Integration	No integration safe harbor	6 month integration safe harbor	AC, but open.
Marketing Restrictions	General advertising limited to teasers, but SEC proposes none until Form C is filed.	General solicitation and advertising allowed without content restrictions, but SEC may adopt certain filing, legend, and disclosure requirements.	AC
Eligible Investors	All retail investors (approximately 300 million, subject to caps). May increase if accredited investor standards raised	Only accredited investors (approximately 8 million), but this pool controls over 70% of available capital in both pools	**RC.** But SEC may alter accredited investor definition.
Investor Protection	Individual investor limits, risk warnings, duties imposed on crowdfunding sites, prevention of conflicts of interest, and funding goals	None	AC