

FRET NO MORE: INAPPLICABILITY OF CROWDFUNDING CONCERNS IN THE INTERNET AGE AND THE JOBS ACT'S SAFEGUARDS

KARINA SIGAR*

TABLE OF CONTENTS

Introduction.....	474
I. Crowdfunding: What Is It?	478
A. Mechanism	478
B. Benefits and Costs of Crowdfunding	480
1. Crowdfunding's Benefits.....	480
2. Crowdfunding's Costs.....	481
II. Pre-JOBS Act: Securities Laws Were Unsuitable for Crowdfunding.....	482
A. Registration	482
B. Regulation A.....	484
C. Regulation D	484
1. The Ban on General Solicitation	485
III. Worries About Crowdfunding Reflect Rationales Behind the Rule 502(c) Ban on General Solicitation	486
IV. Removing Concerns: The Internet Age and the JOBS Act's Safeguards.....	489
A. Rationales Behind the Ban on General Solicitation Do Not	

* J.D. Candidate, American University Washington College of Law, 2013; B.A., American University, 2007. It is only appropriate to first thank the one who introduced me to crowdfunding and inspired me to write on it: Alfred Rusch. I would also like to thank the following: Al, Theodore Miles, and the entire Securities Bureau of the D.C. Department of Insurance, Securities, and Banking for teaching me securities law during my first summer internship; Ted Uliassi—the best editor one could have—for guiding me through the process; and the entire ALR team. Most of all, I would like to thank my parents, Frank and Yola, and brother, Putra, for all their support from my beloved home, Indonesia.

Apply to the Current Tech-Savvy Market.....	489
B. The JOBS Act's Safeguards.....	494
1. Limitations on Amounts Raised and Individual Investments	494
2. Fraud Provisions Still Apply	496
3. Registration Requirements for Issuers and Intermediaries	498
4. Self-Regulatory Organization for Crowdfunding Portals	499
V. Implication of Crowdfunding Provisions in the JOBS Act on Other Exemptions.....	502
Conclusion	505

INTRODUCTION

Less than two years after the Dodd–Frank Wall Street Reform and Consumer Protection Act¹ significantly amended the Securities Act of 1933 and the Securities Exchange Act of 1934, and before the Securities and Exchange Commission (SEC) even had the chance to breathe before proposing approximately three-quarters of the rules mandated by that Act,² Congress passed the Jumpstart Our Business Startups Act on March 27, 2012, which President Barack Obama signed into law on April 5, 2012.³ One of the contentious sections of this Act, which the Obama Administration promoted along with many entrepreneurs and scholars, is an innovative method of raising funds for entrepreneurs that has become increasingly popular in the Internet age: crowdfunding. Analogous to the earlier concept of crowdsourcing,⁴ crowdfunding is a capital formation

1. Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010) (codified as amended in scattered sections of 7, 12, 15, 18, 22, 31, and 42 U.S.C.).

2. See *Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml> (last modified May 8, 2012). The Dodd–Frank Act contains ninety provisions that require rulemaking by the Securities and Exchange Commission (SEC). *Implementing the Dodd–Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/dodd-frank.shtml> (last modified May 8, 2012).

3. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012); see Susan Crabtree, *Jobs Act Signing a Show of Bipartisan Support*, WASH. TIMES, Apr. 5, 2012, <http://www.washingtontimes.com/news/2012/apr/5/obama-signs-bipartisan-small-business-bill/> (reporting that the JOBS Act had strong bipartisan support in Congress).

4. Crowdsourcing is the act of involving the community to collectively provide content for technological designs. See Jeff Howe, *The Rise of Crowdsourcing*, WIRED, June 2006, at 177, available at <http://www.wired.com/wired/archive/14.06/crowds.html>.

strategy that raises small amounts of funds from a large group of people through online means. Currently, this fundraising strategy depends on contributions from donors who do not share ownership of the project, but rather only receive token gifts such as signed CD albums, dinner with the director of a film project, or concert tickets.

Due to the successes of raising funds through crowdfunding to jumpstart businesses,⁵ many groups and entrepreneurs have aspired to conduct crowdfunding that would offer equity interests as opposed to mere material rewards.⁶ These entrepreneurs urged the SEC to allow businesses to raise funds through equity-based crowdfunding by exempting crowdfunding from the registration requirements of § 5 of the Securities Act of 1933.⁷

Less than a year after the petition to the SEC for reforms in securities regulations to accommodate crowdfunding, Congress passed the JOBS Act, Title III of which exempts crowdfunding or small-issue offerings from registration with the SEC. The offerings must meet four criteria: (1) the total amount of securities sold by an issuer cannot exceed \$1 million; (2) the total amount sold to a single investor cannot exceed either \$2,000 or \$100,000, depending on the individual's income or net worth; (3) the transaction must be conducted either through a broker or funding portal required to register with the SEC and a self-regulatory organization (SRO); and (4) the issuer must comply with statutory requirements, such as

5. One design project called TikTok+LunaTik Multi-Touch Watch Kits raised \$942,578 through the crowdfunding website Kickstarter in only thirty days. *See Most Funded*, KICKSTARTER, <http://www.kickstarter.com/discover/most-funded?ref=sidebar> (last visited May 14, 2012); TIKTOK+LUNATIK, <http://lunatik.com/about> (last visited May 14, 2012). Two advertisement executives experimented with crowdfunding by offering equity interest in the company Pabst Brewing Co. and had obtained a pledged amount of more than \$200 million when the SEC instituted a cease-and-desist order on June 8, 2011. *See* Chad Bray, *Huge Beer Run Halted by Those No Fun D.C. Regulators*, WALL ST. J. L. BLOG (June 8, 2011), <http://blogs.wsj.com/law/2011/06/08/huge-beer-run-halted-by-those-no-fun-d-c-regulators/>; *In re* Migliozi, Securities Act Release No. 9216, 2011 WL 2246317 (June 8, 2011) (cease-and-desist order).

6. *See Crowdfund Investing—A Solution to the Capital Crisis Facing our Nation's Entrepreneurs: Hearing Before the Subcomm. on TARP, Fin. Serv. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 6 (2011) [hereinafter *Hearings*] (prepared statement of Meredith Cross, Director, Division of Corporate Finance, SEC) (describing how SEC staff met and discussed crowdfunding with business owners and representatives of small business organizations that were pushing for a regulatory reform to accommodate this financing model); Letter from Jenny Kassan, Sustainable Econ. Law Ctr., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (July 1, 2010), available at <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf> (noting that financial investment can bring greater psychological investment than mere donation and can become an even richer source of innovation and capital formation).

7. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2006) (requiring an offering to be registered).

disclosing certain financial and other information.⁸ Additionally, one of the most contentious provisions of the crowdfunding title of the JOBS Act is § 35, which lists crowdfunding securities as “covered securities.”⁹ As a covered security, crowdfunding issuers only need to register their offerings with the SEC, without having to register with each state that requires it.

The JOBS Act mandates the SEC issue rules pursuant to the Act, as the SEC is the main government agency responsible for regulating the securities industry. In issuing any rule, the SEC must fulfill its dual role of facilitating capital formation and protecting investors.¹⁰ There is little dispute that crowdfunding would help businesses raise capital.¹¹ However, before the SEC adopts any rule regarding crowdfunding, it should carefully consider the costs, especially the need to protect investors—vulnerable investors lacking “financial sophistication” in particular—from fraud and bad investments.¹²

Before the JOBS Act mandated a crowdfunding exemption, there were several existing exemptions to the federal securities registration requirements available to small businesses, including Regulation A and Rules 504, 505, and 506 of Regulation D.¹³ However, complying with

8. JOBS Act, Pub. L. No. 112-06, § 302(a)–(b), 126 Stat. 306, 315–20 (2012) (to be codified at 15 U.S.C. §§ 77d, 77d-1).

9. *Id.* § 305(a) (to be codified at 15 U.S.C. § 77r(b)(4)); see Securities Act of 1933 § 13(a), 15 U.S.C. § 77r(a) (exempting a “covered security” from state law, rule, regulation, order, or administrative action regarding registration of securities); *NASAA: The Jobs Act Fails Investors and Entrepreneurs*, N. AM. SEC. ADMIN. ASSOC. (Apr. 5, 2012), <http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/> (“By preempting states, the JOBS Act takes away from state regulators and puts them on us.” (quoting Steve Irwin, Chairman of North American Securities Administrator’s Association’s (NASAA’s) Committee on Federal Legislation)).

10. See *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCH. COMM’N, <http://sec.gov/about/whatwedo.shtml> (last visited May 14, 2012).

11. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2011 COLUM. BUS. L. REV. (forthcoming 2012) (manuscript at 61).

12. See Securities Act of 1933 § 2(a)(15)(ii), 15 U.S.C. § 77b(a)(15)(ii) (2006) (incorporating “financial sophistication” as one factor that would qualify an individual as an “accredited investor” and in effect provide more choices for investing); 17 C.F.R. § 230.501(a), (e)(1)(iv) (2011) (exempting securities offered to accredited investors); Daniel J. Morrissey, *The Securities Act at Its Diamond Jubilee: Renewing the Case for a Robust Registration Requirement*, 11 U. PA. J. BUS. L. 749, 771 (2009) (explaining that Regulation D’s accredited-investor exemption presumes that accredited investors are able to fend for themselves and therefore do not need the disclosure compelled in a registration statement). *But see Hearings*, *supra* note 6, at 7 (statement of Sherwood Neiss, Co-founder, FLAVORx) (criticizing securities laws for presuming that nonaccredited investors are not “‘wealthy,’ ‘smart,’ or ‘responsible’ enough to make their own decisions”).

13. 17 C.F.R. §§ 230.251–.263 (Regulation A); §§ 230.504–.506 (Regulation D).

Regulation A is prohibitively costly for small businesses due to its documentation requirements.¹⁴ Regulation D exemptions are unsuitable for crowdfunding due to their prohibition on general solicitation,¹⁵ which is essentially what crowdfunding is: inviting the public to invest in a business venture.

Because the idea of general solicitation is at the heart of the crowdfunding model, this Comment assesses crowdfunding's investor protection concerns by examining the rationales behind Regulation D's ban on general solicitation. Regulation D was issued three decades ago in 1982,¹⁶ long before people began using the Internet to share information and knowledge with one another.¹⁷ Therefore, the concerns that prompted the provisions of Regulation D may no longer be relevant in today's Internet age.

In addition, the JOBS Act includes rules for crowdfunding issuers and intermediaries that serve as safeguards for investors. This includes a requirement that intermediaries—those facilitating the transactions for crowdfunding securities—register with both the SEC and an applicable SRO the small amount of securities sold and individual investment. The Act also makes applicable the antifraud regime in the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).

This Comment will examine whether, in light of Regulation D's ban on general solicitation in an analogous context and the statutory safeguards introduced by the JOBS Act, there are grounds for concern over crowdfunding offerings. Part I briefly discusses the mechanics of the crowdfunding process and the costs and benefits of crowdfunding. Part II discusses how the federal securities laws prior to the JOBS Act, particularly the registration exemptions of Regulations A and D, could not adequately accommodate crowdfunding offerings. Part III then discusses the crowdfunding concerns that reflect the rationales behind Regulation D's ban on general solicitation as they relate to investor protection. Part IV applies these rationales to the context of today's Internet age and analyzes

14. *See id.* § 230.252(a) (requiring issuers to complete Form 1-A, which includes detailed information about the business).

15. Rule 502(c) prohibits general solicitation for any Regulation D offering, except if in the case of Rule 504 offerings the offering is registered or filed in the state level. *See id.* §§ 502(c), 504(b)(1).

16. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (codified at 17 C.F.R. pt. 230).

17. *See* Olufunmilayo B. Arewa, *Securities Regulation of Private Offerings in the Cyberspace Era: Legal Translation, Advertising and Business Context*, 37 U. TOL. L. REV. 331, 333–40 (2006) (indicating the factors distinguishing the era when the Securities Act was enacted from today's cyberspace era).

the four main statutory safeguards that Congress provides through the JOBS Act. It concludes that because investors' characteristics today are starkly different from those of the 1980s, and because there are adequate provisions in the crowdfunding laws safeguarding investors that concerns about investor protection are unfounded. Part V discusses the implication of the JOBS Act for the other exemptions in the securities laws—that they will become obsolete due to the ban on general solicitation. Finally, this Comment concludes that due to the nature of the Internet age and because of the statutory safeguards in place, the new crowdfunding exemption will not raise the investor protection issues that some fear.

I. CROWDFUNDING: WHAT IS IT?

A. Mechanism

Rooted in the idea of crowdsourcing (the process of creating content based on the collective effort of a large group of people¹⁸), crowdfunding is a fundraising strategy that pools capital, typically in small amounts, from a large group of people.¹⁹ In addition to individual projects and companies that raise money through crowdfunding,²⁰ there are also websites that facilitate the use of crowdfunding as a capital formation strategy. Examples in the United States include Kickstarter, IndieGoGo, and RocketHub.²¹

18. See Howe, *supra* note 4.

19. See Jed Cohen, *How to Explain Crowdfunding*, ROCKETHUB (Dec. 29, 2010, 5:09 PM), <http://rockethub.org/profiles/blogs/how-to-explain-crowdfunding> (analogizing the historical pattern of single wealthy patrons of the arts to many people giving small contributions to support creative projects through crowdfunding); Jonathan Crane, *Artists Cut Out the Middle Man*, WEAL, Oct. 20, 2011, <http://www.theweal.com/2011/10/20/artists-cut-out-the-middle-man/> (“Art has always been crowd-funded, but it’s only recently that someone made up a word and created a website for it . . .”). The founder of crowdfunding platform ArtistShare, Brian Camelio, recently obtained a patent for a financing model that resembles the prevalent crowdfunding model. See U.S. Patent No. 7,885,887 (filed Mar. 31, 2003); Devin Coldewey, *Kickstarter Hit With Patent Claim Over Crowdfunding*, TECHCRUNCH, Oct. 4, 2011, <http://techcrunch.com/2011/10/04/kickstarter-hit-with-patent-claim-over-crowd-funding/> (reporting that the patent owner, Camelio, has filed suit against the largest crowdfunding platform, Kickstarter, for using the crowdfunding financing model).

20. American public radio’s largest source of funds is the general public, with 34.4% of fiscal year 2009 revenue coming from individuals. *Public Radio Finances*, NAT’L PUB. RADIO, <http://www.npr.org/about/aboutnpr/publicradiofinances.html> (last visited May 14, 2012). The British band Marillion raised \$60,000 from fans to fund a tour in the 1990s by utilizing its fan e-mail database. Dave Lee, *How to Crowd-fund Your Stardom*, BBC CLICK (July 3, 2011, 9:58 AM), http://news.bbc.co.uk/2/hi/programmes/click_online/9528224.stm.

21. See INDIEGOGO, <http://www.indiegogo.com> (last visited May 14, 2012) (founded in 2008); KICKSTARTER, <http://www.kickstarter.com> (last visited May 14, 2012) (founded in

Most of the projects funded through crowdfunding websites are from creative industries, such as design, filmmaking, music performance and production, and photography.²² The existing crowdfunding schemes are based on donations, not purchases of equity interests.²³ Crowdfunding websites like Kickstarter and IndieGoGo require fundraisers to offer material rewards—typically products that are related to or are a result of the project itself—in exchange for the contribution.²⁴

If the crowdfunding model offers equity interests in the enterprise as

2009); ROCKETHUB, <http://www.rockethub.com> (last visited May 14, 2012) (founded in 2010); *see also* Robert Andrews, *Crowdfunding: How Does The Scene Stack up?*, PAIDCONTENT, <http://paidcontent.org/table/crowdfunding> (last visited May 14, 2012) (comparing crowdfunding platforms through the number of projects submitted, projects financed and realized, total supporters, amounts pledged and paid out, average pledge amounts, and sites' commission fees). Crowdfunding is also rampant globally, with crowdfunding websites in countries like Germany, the United Kingdom, and the Netherlands. *See, e.g.*, CROWDCUBE, <http://www.crowdcube.com> (last visited May 14, 2012) (United Kingdom); INKUBATO, <http://www.inkubato.com> (last visited May 14, 2012) (Germany); SELLABAND, <http://www.sellaband.com> (last visited May 14, 2012) (the Netherlands and Germany).

22. *See, e.g., Project Guidelines*, KICKSTARTER, <http://www.kickstarter.com/help/guidelines> (last visited May 14, 2012) (requiring creative projects and limiting them to the fields of art, comics, dance, design, fashion, film, food, games, music, photography, publishing, technology, and theater); SELLABAND, http://www.sellaband.com/en/pages/how_it_works (last visited May 14, 2012) (focusing only on music and categorizing projects based on musical genres, such as alternative, hip hop, and rock). There are also other crowdfunding platforms that are dedicated to charities, causes, and short-term projects. *See, e.g., About MicroGiving*, MICROGIVING, <http://www.microgiving.com/about-us> (last visited May 14, 2012); *How It Works*, JUSTGIVING, <http://www.justgiving.com/about-us/how-it-works/for-fundraisers> (last visited May 14, 2012); *Rally to Make Crowdfund Investing Legal*, INDIEGOGO, <http://www.indiegogo.com/Rally-to-Make-Crowdfund-Investing-Legal> (last visited May 14, 2012) (raising funds for a rally to support the crowdfunding bill, H.R. 2930, scheduled for November 17, 2011, in Washington, D.C.).

23. *See, e.g., How Kickstarter Works*, KICKSTARTER, <http://www.kickstarter.com/start> (last visited May 14, 2012) (“Kickstarter is a new form of commerce and patronage, not a place for investment or lending.”). *But see How It Works*, CROWDCUBE, <http://www.crowdcube.com/pg/how-it-works-4> (last visited May 14, 2012) (facilitating equity-based crowdfunding for entrepreneurs and business pioneers in the United Kingdom).

24. *See, e.g., Jon M. Garon, Content, Control, and the Socially Networked Film*, 48 U. LOUISVILLE L. REV. 771, 813–15 (2010) (advising filmmakers how to finance their films through crowdfunding and rewarding donors with presale goods, special thanks credit, and rough and final cuts of the film); Danae Ringelmann, *Want Ideas for VIP Perks? Listen to Nine Inch Nails' Former Drummer*, INDIEGOGO (Feb. 20, 2009, 7:23 PM), <http://www.indiegogo.com/blog/2009/02/want-ideas-for-vip-perks-listen-to-nine-inch-nails-former-drummer.html> (suggesting that material rewards should be related to the fundraiser's project assets); *see also* Steven Kurutz, *On the Web, Dreams Made Real*, N.Y. TIMES, Sept. 22, 2011, at D1 (reporting the upsides and downsides of giving material rewards in return for contributions).

opposed to mere material rewards, these interests probably constitute securities under the Securities Act, particularly if the crowdfunding issuer refers to its equity interests as stocks.²⁵ Under the category of securities known as investment contracts,²⁶ equity crowdfunding interests would constitute securities because an investor would invest money in a common enterprise and would expect profits solely from the efforts of the issuing entrepreneur.²⁷ Therefore, ownership interests in a business venture would be treated as securities, and any offerings or sales of such interests would be subject to the Securities Act and regulations made thereunder. Most importantly, the offering of such securities would be subject to the § 5 registration requirement.²⁸

B. *Benefits and Costs of Crowdfunding*

As an innovative Internet-based capital formation strategy, crowdfunding has costs and benefits inherent in its mechanisms that relate to its role in helping to revive the nation's economy. Crowdfunding's advantages and disadvantages impact the cost-benefit analysis of any rule the SEC could issue under the new provisions on crowdfunding in the Securities Act and the Exchange Act.

1. *Crowdfunding's Benefits*

Crowdfunding has great potential to spark growth among small businesses. Even in its current form, many entrepreneurs have successfully started and developed their business ventures relying in part on crowdfunding. One of the primary challenges faced by small businesses is a

25. See Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006) (listing financial instruments that constitute securities, including stocks and investment contracts); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 (1985) (holding that a real stock is per se a security).

26. See 15 U.S.C. § 77b(a)(1) (“The term ‘security’ means any . . . investment contract . . .”); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (finding that under the Securities Act “an investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party”).

27. The question of whether crowdfunding interests constitute securities may be open to dispute and would require an in-depth analysis that this Comment does not attempt to explore. This Comment's analysis of proposed crowdfunding exemptions is based on the assumption that crowdfunding interests constitute securities. See generally Joan M. Heminway & Sheldon R. Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 885–906 (2011) (analyzing whether crowdfunding interests constitute securities and concluding that they are investment contracts because they satisfy the *Howey* test).

28. 15 U.S.C. § 77e(a) (requiring registration for securities sold in interstate commerce).

capital gap²⁹: small businesses have very limited financing options. Bank loans are often denied due to a lack of collateral, operating history, and a proven track record.³⁰ Private financing from venture capital and angel investors only fund a small number of businesses.³¹ Crowdfunding could bridge this gap by connecting small businesses, which are marginalized from the traditional sources of funding, to the general public.

In addition to crowdfunding's financial benefit, entrepreneurs also use this fundraising method to market their products or services and obtain feedback.³² Crowdfunding becomes a tool for innovators to improve on their business models or products and services before they are offered to the public. By coupling crowdfunding with crowdsourcing, the public can participate in creating these products or services.

Not only does the growth of small businesses benefit the entrepreneurs themselves, it also benefits society. Small businesses accounted for 60%–75% of new jobs created between 1993 and 2009,³³ and small businesses provide consumers with more product and service options.³⁴

2. Crowdfunding's Costs

Crowdfunding has its downsides as well. From the investor protection perspective, it is likely that some fraud will occur through crowdfunding. The Internet, which replaces real-life encounters with virtual meetings, could make it more difficult for investors to know whether an issuer's business is legitimate.³⁵ An additional crowdfunding risk is inherent in the general nature of small businesses: uncertainty about the development of

29. Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 60–63 (1998).

30. *See id.* at 61; Emily Maltby, *Smaller Businesses Seeking Loans Still Come Up Empty*, WALL ST. J., June 30, 2011, at B1 (reporting that most of the loan recipients in 2011 appear to be large independent businesses with multiple revenue streams and significant collateral for loans rather than smaller companies).

31. *See* Fisch, *supra* note 29, at 62–63; *see also* Rutheford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 81 (2006) (arguing that small businesses face structural challenges when entering capital markets and that the absence of available financial intermediation services requires them to find investors on their own).

32. Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd* 9 (CORE Discussion Paper No. 2011/32, 2011), available at <http://ssrn.com/abstract=1578175>.

33. BRIAN HEADD, AN ANALYSIS OF SMALL BUSINESS AND JOBS 10–11 (2010).

34. *See* Campbell, *supra* note 31, at 84–86 (reporting that the percentage of jobs created by small businesses was as high as 75% as of 2006).

35. *See* discussion *infra* Part IV.

unproven products or services.³⁶ Start-up companies are traditionally riskier and have a higher rate of failure than other businesses.³⁷

From the business perspective, crowdfunding issuers may encounter administrative and accounting challenges, since this capital formation strategy involves a large number of investors becoming shareholders. This would require meticulous and laborious bookkeeping of all investments and shares in the business to determine the share of profits to which each investor is entitled to.³⁸ Even with the current form of crowdfunding where donors merely receive rewards, fundraisers are finding the administrative work of recording donor contributions and sending the respective rewards to be onerous.³⁹

II. PRE-JOBS ACT: SECURITIES LAWS WERE UNSUITABLE FOR CROWDFUNDING

Prior to the JOBS Act, the biggest challenge in transforming crowdfunding from a model that only offers token gifts to a model that offers equity in the business was that securities laws were unsuitable for this fundraising strategy. Equity-based crowdfunding cannot operate unless the company receiving the funds registered with the SEC or resorts to one of the exemptions available in the Securities Act and accompanying regulations. Registration would be prohibitively costly for small businesses, and the exemptions of Regulations A and D are unsuitable because of the prohibitive filing requirement and ban on general solicitation.

A. Registration

Section 5(c) of the Securities Act requires business to register securities

36. See Fisch, *supra* note 29, at 61 (acknowledging other risks as well, such as agency costs and informational asymmetries).

37. Heminway & Hoffman, *supra* note 27, at 933.

38. See Sarah E. Needleman & Angus Loten, *When “Friending” Becomes a Source of Start-Up Funds*, WALL ST. J., Nov. 1, 2011, at B1 (reporting that some believe managing cash flow for dividend payments would distract small businesses from attending to their day-to-day operations). A soon-to-be formed crowdfunding platform based in the United Kingdom, Seedrs, addresses this administrative challenge for issuers by aggregating multiple small investments in each business into one large investment. See *Hearings, supra* note 6, at 1–2 (statement of Jeff Lynn, CEO, Seedrs) (limiting the administrative burden by allowing fundraisers to interact with only one legal shareholder).

39. See Crane, *supra* note 19 (explaining that the campaign for a crowdfunding project is time-consuming because fundraisers must constantly utilize social media like Twitter and Facebook to maintain the momentum); Kurutz, *supra* note 24 (reporting that one crowdfunding fundraiser, TikTok, had to send 13,512 products to all its backers and the shipping and handling alone cost approximately \$70,000).

offerings with the SEC.⁴⁰ Registration is the process by which companies disclose material financial information, such as audited balance sheets and income statements, to prospective investors in the form of a registration statement.⁴¹ An issuer may not sell securities until that registration statement has been approved and becomes effective.⁴² Assuming that crowdfunding interests constitute securities, the issuers must submit registration statements to the SEC unless they are able to perfect an exemption.⁴³

However, for small businesses, the costs of registration are too high and in some cases would even exceed the amount of funds they aim to raise.⁴⁴ These costs include registration fees, accounting fees, legal fees, and printing costs.⁴⁵ Understanding the prohibitive costs of registration for small businesses, Congress provided an opportunity for the SEC to create exemptions from registration requirements to help small businesses.⁴⁶ Therefore, like other small businesses that resort to existing exemptions due to the excessive costs of registration, the crowdfunding model also needed an exception.

40. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2006).

41. See 17 C.F.R. pts. 210, 229 (2011).

42. 15 U.S.C. § 77b(a)(3).

43. The laws and regulations in the United Kingdom can accommodate equity-based crowdfunding platforms because of how they determine the offerings that require a prospectus. See Financial Services and Markets Act, 2000, c. 8, §§ 85(1), 86(1)(b) (U.K.) (exempting from registration those securities offered to fewer than 150 persons, and establishing that an offer made to members of a partnership constitutes an offer to a single person); see, e.g., CROWDCUBE, <http://www.crowdcube.com> (last visited May 14, 2012) (equity-based crowdfunding platform in the United Kingdom); SEEDRS, <http://www.seedrs.com/> (last visited May 14, 2012) (same); *Hearings, supra* note 6, at 39 (prepared statement of Jeff Lynn, CEO, Seedrs) (distinguishing donation-based crowdfunding platforms from Seedrs, which provides more intermediation, including disclosure review, legal due diligence, and execution management). See generally *Hearings, supra* note 6, at 39–40 (prepared statement of Jeff Lynn, CEO, Seedrs) (comparing securities laws in the United States and the United Kingdom in their suitability for crowdfunding).

44. See Bradford, *supra* note 11, at 27–28; Fisch, *supra* note 29, at 61 (arguing that many of these costs are fixed).

45. The services of lawyers and accountants are crucial to the registration process because the registration statement must include such information as financial statements, description of the securities offered, risks of the investment, and the offering price of the security. See Todd A. Mazur, Note, *Securities Regulation in the Electronic Era: Private Placements and the Internet*, 75 IND. L.J. 379, 381 (2000) (describing the laborious registration process of securities).

46. See, e.g., Small Business Initiatives, 57 Fed. Reg. 36,442 (Aug. 13, 1992) (codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 249, and 260) (adopting Regulation A exemptions to facilitate capital raising by small businesses and to reduce costs of complying with federal securities laws).

B. Regulation A

The first registration exemption available to businesses is Regulation A.⁴⁷ Regulation A is based on § 3(b) of the Securities Act,⁴⁸ which exempts offerings that do not exceed \$5 million.⁴⁹ Although Regulation A is meant to assist small businesses in raising funds, complying with this regulation is burdensome; it is commonly called a mini-registration due to requirements that resemble § 5 registration requirements.⁵⁰ Fulfilling Regulation A requirements also necessitates the services of lawyers and accountants.⁵¹ Therefore, Regulation A is unsuitable for crowdfunding because many of the issuers targeted by this model would not be able to afford such services and do not have the financial or business history to complete the required information.

C. Regulation D

The remaining exemptions available for crowdfunding prior to the JOBS Act fall under Regulation D.⁵² The first exemption is Rule 506, which exempts transactions that do not involve a public offering⁵³ and limits the number of nonaccredited investors to thirty-five.⁵⁴ As crowdfunding rests on the participation of the “crowd”—which would in most cases exceed thirty-five nonaccredited investors—and would most likely constitute a public offering, this exemption does not suit, and would in fact negate, the nature of the crowdfunding model.

Exemptions in Rule 504⁵⁵ and 505⁵⁶ of Regulation D would be ideal for crowdfunding, since these rules impose caps on the aggregate amount of the offering at \$1 million and \$5 million, respectively;⁵⁷ however, the main

47. Regulation A, 17 C.F.R. §§ 230.251–263 (2011).

48. *Id.* § 230.251.

49. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (2006); 17 C.F.R. § 230.251(b).

50. See 7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 6:5 (1999); see, e.g., 17 C.F.R. § 230.252(a) (requiring issuers to complete Form 1-A, which includes such information as plan of distribution, officers and key personnel of the company, and businesses and properties).

51. See *supra* text accompanying note 45.

52. 17 C.F.R. § 230.501–.508.

53. *Id.* § 230.506(a).

54. *Id.* § 230.506(b)(2)(i)–(ii) (limiting the number of purchasers of securities to thirty-five); *id.* § 230.501(e)(1)(iv) (excluding an “accredited investor” in calculating the number of purchasers).

55. *Id.* § 230.504.

56. *Id.* § 230.505.

57. *Id.* § 230.504(b)(2) (aggregate amount limited to \$1 million); *id.* § 230.505(b)(2)(i) (\$5 million).

barrier that renders Rule 504 and 505 of Regulation D unsuitable for crowdfunding is their prohibition on general solicitation.⁵⁸ Again, the essence of crowdfunding is obtaining capital from the general public through the Internet, where anyone can gain the equity interests offered by the fundraiser.

1. *The Ban on General Solicitation*

Scholars have criticized the ban on general solicitation since the SEC introduced it in Rule 146, the predecessor of Rule 502(c).⁵⁹ They contend that the ban lacks justification⁶⁰ and severely inhibits the growth of small businesses.⁶¹ The ban is particularly problematic for crowdfunding because publishing the business plan and offering an equity interest to the “crowd” is central to the idea of crowdfunding.

General solicitation is not defined in the SEC regulations, but the SEC has determined that permissible solicitation of investment requires a preexisting substantive relationship between the issuers or their representatives and the potential investors.⁶² Preexisting relationship refers to relationships established prior to the solicitation for the offering,⁶³ and *substantive* means that the relationship is such that the issuer can be aware of the financial circumstances or sophistication of the potential investors.⁶⁴ People who fall under this category are typically friends and family members of the issuer. For offerings that involve brokers and dealers, the network of potential investors expands to their customers and clients.⁶⁵

58. 17 C.F.R. § 230.502(c) (banning issuers from offering or selling securities by any form of general solicitation or general advertising).

59. See Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 87 (1989) (stating that two years after Rule 146 was adopted, the SEC began asking for public comment as to whether the rule should be rescinded).

60. See *infra* Part IV.

61. See Daugherty, *supra* note 59, at 70 (describing the ban on general solicitation as “unconscionably vague”).

62. See generally *id.* at 104–08 (discussing SEC staff’s interpretive letters of circumstances that do and do not meet the preexisting substantive relationship requirement of permissible solicitation under Regulation D); William K. Sjostrom, Jr., *Relaxing the Ban: It’s Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 13–14 (2004) (discussing the SEC’s no-action letters to companies confirming that their modes of solicitation do not constitute general solicitation). Daugherty argues the SEC should define such a crucial rule provision through the notice-and-comment procedure to allow the public to address its needs and concerns regarding the rule. See Daugherty, *supra* note 59, at 106–07 n.184.

63. See E.F. Hutton & Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917, at *2 (Dec. 3, 1985); see also Sjostrom, *supra* note 62, at 13.

64. Sjostrom, *supra* note 62, at 13.

65. There are limitations on the scope of efforts by brokers and dealers in soliciting for

This benefit, however, does not extend to all small businesses because many cannot afford the services of brokers and dealers. Additionally, brokers typically impose commission fees of up to 10% of the gross offering;⁶⁶ they usually will not take clients whose offering prices are not high and would therefore result in a small commission for the brokers. Consequently, many small businesses are left with the limited option of resorting to only their friends and families for capital.

This interpretation of general solicitation is highly problematic for crowdfunding because it prohibits entrepreneurs from having a special page online, like the ones on Kickstarter⁶⁷ and IndieGoGo, where anyone can access and gain information about the business plan and invest money.⁶⁸ The whole purpose of crowdfunding is to unlock the door to a limitless pool of capital facilitated by the Internet connecting strangers with one another. Getting funds from people with whom the issuer has no preexisting relationship is a crucial part of a crowdfunding scheme; therefore, the ban on general solicitation makes the Regulation D offerings unsuitable for crowdfunding.

III. WORRIES ABOUT CROWDFUNDING REFLECT RATIONALES BEHIND THE RULE 502(C) BAN ON GENERAL SOLICITATION

Having summarized the benefits and costs of crowdfunding, it is also important to analyze the investor protection concerns related to this new fundraising model, even though the JOBS Act has exempted crowdfunding from registration requirements. At the heart of crowdfunding is the idea of

investment that would be permissible for Regulation D exemptions, such as the use of questionnaires and predeveloped customer lists. *See* Daugherty, *supra* note 59, at 104–08.

66. Sjostrom, *supra* note 62, at 15 (explaining that investment banking firms get compensated with either a commission fee, common stock warrants, or the contractual right to participate in future company offerings).

67. A fundraising project page on Kickstarter typically consists of a video explaining the project, a description of the project and the people behind it, and the tranches of donations and their corresponding material rewards. *See* KICKSTARTER, <http://www.kickstarter.com> (last visited May 14, 2012).

68. The Rule 504-based crowdfunding platform ProFounder facilitates entrepreneurs' fundraising campaigns, but only allows people with whom the entrepreneurs have preexisting substantive relationships to access the relevant entrepreneurs' pages to invest. *Hearings, supra* note 6, at 25 (prepared statement of Dana Mauriello, President, ProFounder). Issuers using ProFounder's services send e-mails to people with whom they have preexisting substantive relationships through a ProFounder application allowing only the e-mail recipient to view the private fundraising website. *Id.* These e-mail invitations contain a unique link that only the recipient can open that cannot be forwarded or shared with others. *Id.* Since its inception in 2009, ProFounder has enabled nineteen companies to raise funds in the totaling more than \$612,000 from 356 investors who are classmates, customers, family members, and friends of the entrepreneurs. *Id.* at 3.

appealing to the general public based on the merits of the business idea and soliciting funds via the Internet to help the business grow. This is essentially synonymous with general solicitation as interpreted by the SEC. To examine crowdfunding's investor protection concerns, it is thus useful to analyze the rationale behind banning general solicitation and to assess whether the underlying concerns that prompted such a rule are still relevant in today's Internet age.

The overarching rationale for prohibiting general solicitation is to protect investors, which is one of the dual functions of the SEC.⁶⁹ Specifically, the SEC intended Rule 502(c) of Regulation D to reduce the potential for abuse by people who would take advantage of a flexible regulation and harm others by advertising offerings and reselling the fraudulent securities to the general public.⁷⁰

The SEC's first justification for Rule 502(c) is in the context of Rule 506's private placement. The SEC believes that prohibiting general solicitation for private placement ensures the private nature of such offerings.⁷¹ This rationale is reasonable for Rule 506 because it is based on § 4(2) of the Securities Act, which exempts transactions that do not involve public offerings.⁷² However, unlike Rule 506, which expressly specifies § 4(2) as the statutory basis for the rule exemption, Rule 504 of Regulation D does not,⁷³ and Rule 505 is based on § 3(b) of the Securities Act, which does not exclude public offerings.⁷⁴ Before the SEC rescinded the ban on general solicitation in 1992,⁷⁵ it had never declared another rationale;⁷⁶

69. See Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7,644, 69 SEC Docket 364 (Feb. 25, 1999) (reiterating that provisions of Regulation D, which include the prohibition on general solicitation, are based on the mandate of investor protection).

70. See *id.* (promulgating an amended rule as a result of "recent fraudulent secondary transactions").

71. See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339, 23 SEC Docket 446 (Aug. 7, 1981); Integration of Abandoned Offerings, Securities Act Release No. 7943, 74 SEC Docket 571, 574 (Jan. 26, 2001) (interpreting general solicitation to "impart a public character to an offering").

72. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2006); 17 C.F.R. § 230.506(a) (2011).

73. 17 C.F.R. § 230.504(a).

74. *Id.* § 230.505(a).

75. See Small Business Initiatives, 57 Fed. Reg. 36,442, 36,443 (Aug. 13, 1992) (codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 249, and 260) (declaring that "there is no proscription on general solicitation" for Rule 504 securities).

76. See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339, 23 SEC Docket 446 (Aug. 7, 1981) (stating only the rule and its

accordingly, commentators criticized the rule for lacking strong ideological foundation.⁷⁷

After the SEC rescinded the rule prohibiting general solicitation, it justified the ban when reintroducing the provision as serving to prevent the “pump and dump” abuses that occurred in the 1990s.⁷⁸ Years after removing the ban on general solicitation, the SEC reinstated it in 1999 due to the recurring pump and dump schemes that took advantage of Rule 504.⁷⁹ These stock manipulation schemes occurred in penny stocks—stocks sold for less than \$1 a share—where unscrupulous brokers entered the market cheaply, marketed the shares through the phone and Internet, and sold them to investors right before they dumped their own holdings and left investors with deflated shares.⁸⁰

The criticisms against crowdfunding exemptions echo the concerns that prompted the ban on general solicitation for Regulation D securities. In her discussion of a possible crowdfunding exemption, SEC Chairman Mary Schapiro underscored the importance of taking the pump and dump experience into account for future exemptions on general solicitation and resale.⁸¹ Critics are concerned that this exemption would bring back the “boiler rooms” of the 1990s Internet stock bubble that financially harmed many investors.⁸²

similarity with its predecessor, Rule 146(c)); Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 24 SEC Docket 1166 (Mar. 8, 1982) (same).

77. See Sjostrom, *supra* note 62, at 34 (“The ban is simply the product of the historic statutory basis of the private placement exemptions . . .”).

78. See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Securities Act Release No. 7644, 69 SEC Docket 364, 366 (Feb. 25, 1999) (arguing that banning general solicitation is an effective way to combat pump and dump abuses); Michael Schroeder, *Despite Reforms, Penny-Stock Fraud Is Roaring Back*, WALL ST. J., Sept. 4, 1997, at A12 (stating that Rule 504 had become a “popular loophole for fraud” and a “playground for the unscrupulous”).

79. See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Securities Act Release No. 7644, 69 SEC Docket 364 (Feb. 25, 1999) (employing interdictions on general solicitation due to misuses of Rule 504).

80. See John R. Stark, *EnforceNet Redux: A Retrospective of the SEC’s Internet Program Four Years After Its Genesis*, 56 BUS. LAW. 105, 110–12 (2001) (citing examples of “familiar frauds” emerging in the age of the Internet); Schroeder, *supra* note 78.

81. Letter from Mary L. Schapiro, Chairman, Sec. & Exch. Comm’n, to Darrell E. Issa, Chairman, H. Comm. on Oversight & Gov’t Reform 23 (Apr. 6, 2011), available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>; see also *Hearings*, *supra* note 6, at 11 (prepared statement of Meredith Cross, Director, Division of Corporate Finance, SEC) (emphasizing the importance of considering the “pump and dump” experience to assess any possible exemption for crowdfunding).

82. Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. TIMES, Mar. 27, 2012, at A12.

IV. REMOVING CONCERNS: THE INTERNET AGE AND THE JOBS ACT'S SAFEGUARDS

Although the investor protection concerns that prompted the general solicitation ban may have been applicable in the 1990s when the Internet was only in its nascent stage, such concerns no longer apply today. In addition, the JOBS Act introduces several rules to accompany the crowdfunding exemption that further protect investors. Therefore, as the investor protection concerns no longer apply in today's Internet age and there are new provisions in the federal securities laws that are designed to prevent fraud, criticisms against crowdfunding are simply unfounded.

A. Rationales Behind the Ban on General Solicitation Do Not Apply to the Current Tech-Savvy Market

The rationale behind fraudulent abuses in the 1990s that prompted the prohibitions on general solicitation and resale do not apply to crowdfunding today. The pump and dump schemes were hatched by brokers and dealers who purchased securities of companies without real products or operations and resold them to unknowing investors.⁸³ Unlike investors in the 1990s, people today are equipped with advanced tools to obtain enormous amounts of specific information at any time. In 1990, approximately 2.2 million people in the United States had access to the Internet.⁸⁴ The Internet was mostly in the hands of professional traders, and until 2006 online use of corporate information was limited to large corporations and institutional investors.⁸⁵ In 2010, the number of Internet users had increased to nearly 240 million people, comprising 77.3% of the U.S. population.⁸⁶ Additionally, of the American population today, 52% use the Internet for commercial activities, 58% use research products and services online, and 46% use social networking sites.⁸⁷ This growing trend shows that the Internet is becoming an increasingly important space for commercial activities.

83. See Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7,644, 69 SEC Docket 364, 366 (Feb. 25, 1999); Schroeder, *supra* note 78.

84. *Internet Users 1990*, WORLDMAPPER, <http://www.worldmapper.org/display.php?selected=335> (last visited May 14, 2012).

85. Arewa, *supra* note 17, at 335 n.21.

86. *United States of America: Internet Usage and Broadband Usage Report*, INTERNET WORLD STATS, <http://www.internetworldstats.com/am/us.htm> (last visited May 14, 2012).

87. Jim Jansen, *Online Product Research: 58% of Americans Have Researched a Product or Service Online*, PEW INTERNET & AMER. LIFE PROJECT 2-3 (Sept. 29, 2010), <http://www.pewinternet.org/~media/Files/Reports/2010/PIP%20Online%20Product%20Research%20final.pdf>.

In addition, among Internet users, the younger the age group the higher the degree of usage. People between the ages of eighteen and thirty-three comprise 35% of the Internet-using population and those between thirty-four and forty-five comprise 21%, with the older age groups comprising less.⁸⁸ This generational gap illustrates that the way of the future lies in cyberspace, as the younger generation conducts many of its activities through the Internet.

Increasing Internet use has also coincided with, if not created, a cyberculture of information sharing. Not only do people provide content for the development of a single product, people also communicate with one another and verify facts as part of their consumption and investment decisionmaking. With advancement in technology and people's shrewdness in utilizing online tools, the growth of crowdfunding platforms will be accompanied by the growth of online information sharing.⁸⁹

Among Internet users, 32% have posted online product comments and 78% have conducted product research online.⁹⁰ As for investments, information on issuers available on the Internet can typically be found on a company's home page, which has product and financial information, broker-dealer websites, financial portals, active message boards, and chat rooms frequented by market participants.⁹¹ Unlike in the 1980s, when people had to depend on brokers and dealers to obtain information about a company, today's conscientious citizenry can obtain information themselves by maneuvering through the increasingly simple and user-friendly Internet infrastructure.⁹²

88. Kathryn Zickuhr, *Generations 2010*, PEW INTERNET & AMERICAN LIFE PROJECT 4 (Dec. 16, 2010), http://pewinternet.org/~media/Files/Reports/2010/PIP_Generations_and_Tech10.pdf.

89. Equity-based crowdfunding investors will probably write reviews on business ventures—as donors to donation-based crowdfunding projects are already doing—and will collectively become a “self-policing community,” like users on eBay and TripAdvisor. *Hearings*, *supra* note 6, at 54 (prepared statement of Sherwood Neiss, Cofounder, FLAVORx). *But see* Merrill Goozner, *Cyberforce Patrols the Internet: as Stock Chat Fraud Mounts, SEC Takes Action*, CHI. TRIB., (Jan. 24, 1999), available at http://articles.chicagotribune.com/1999-01-24/business/9901240315_1_sia-stock-fraud-stock-promoters (reporting the scheme of scam artists who gave false information in online chat groups that triggered the SEC's creation of Cyberforce).

90. Jansen, *supra* note 87, at 2.

91. *See* Robert N. Sobol, *The Benefit of the Internet: The World Wide Web and the Securities Law Doctrine of Truth-on-the-Market*, 25 J. CORP. L. 85, 86–87 (1999); Caroline Bradley, *Information Society Challenges to Financial Regulation*, 37 U. TOL. L. REV. 307, 309–10 (2006) (adding that investors can also access more traditional forms of information through print and broadcast media).

92. *See* John S. D'Alimonte, Mary C. Carty & Thomas Finkelstein, *Securities Law in the New Millennium*, 75 ST. JOHN'S L. REV. 49, 66 (2001) (contending that such Internet access

Public access to information also strengthens the prospective investors' bargaining position vis-à-vis the issuer. The aforementioned data show an increasing number of people accessing the Internet. The Internet reduces the problem of information asymmetry—an imbalance of access to information between issuers and investors⁹³—and therefore prevents the incidence of fraud resulting from the monopoly over information by a small group of people who would take advantage of this position.

Although the large quantity of information available on the Internet may raise questions about its quality and whether prospective investors would know how to use it in their decisionmaking,⁹⁴ people in today's Internet age are quick to respond to issues by utilizing online tools. It is not such a far-fetched idea to expect people to create websites, software, or online tools that could separate the good from the bad and relevant information from irrelevant information. In fact, since the JOBS Act was introduced in Congress on December 8, 2011,⁹⁵ companies, associations, and websites have emerged that attempt to address the concerns about online crowdfunding.

The National Crowdfunding Association (NLCFA) is an association of crowdfunding portals, venture capital firms, attorneys, and other crowdfunding industry participants that formed in March 2012.⁹⁶ As a trade association, NLCFA will be providing annual trade conferences, education materials and opportunities, and even group insurance for its members.⁹⁷

One example of a grassroots crowdfunding tool is Open Crowdfund. Open Crowdfund is an online reputation-checking system that will allow investors to review reports on the companies in which they consider investing.⁹⁸ This project has yet to be launched, and the development of

enables investors to make comparable investment decisions to those by Wall Street professionals); 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, 982–83 (2011) (comparing investors' access to information during the formative years of the SEC and today).

93. Bernard S. Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 92 (1998).

94. *See id.* (arguing that investors' easy access to information on the Internet can encourage issuers to lie about their securities); Bradley, *supra* note 91, at 309–10.

95. *Bill Summary & Status 112th Congress (2011–2012) H.R.3606*, LIBRARY OF CONG.: THOMAS (last visited May 14, 2012), <http://thomas.loc.gov/home/thomas.php> (search for “H.R. 3606”).

96. *About Us*, NAT'L CROWDFUNDING ASS'N, <http://www.nlcfa.org/NLCFA/About.html> (last visited May 14, 2012).

97. *Id.*

98. OPEN CROWDFUND, <http://launch.opencrowdfund.com/> (last visited May 14,

the system itself will be crowdsourced—the public is invited to collaboratively design the program that would best meet the public’s needs.⁹⁹ Open Crowdfund also plans to introduce a “radical transparency process” that will allow investors to see how companies they are investing in are spending the capital they provide, thereby enhancing accountability.¹⁰⁰

Another example of a quick public response to problems and issues surrounding crowdfunding is Cal-X Crowdfund Connect Software.¹⁰¹ This software has fifty-two indicators that help determine a company’s probability-of-survival score before it gets listed in a crowdfunding site.¹⁰² This company seeks to become a marketplace where fundraisers meet investors.

These tools and associations are only a couple of examples of innovative crowdfunding-related projects that are rapidly flourishing in cyberspace. This organic growth within the market illustrates the power and capacity of the public in quickly responding to concerns by creating online solutions to regain information symmetry. They also reflect the way the public resolves its own problems, as enabled by the creativity, online resources, and wisdom of the crowd.¹⁰³

In addition, the common concerns raised by general solicitation do not apply to crowdfunding because today’s advanced technology, and people’s impressive abilities to adjust to it, eliminates the information asymmetry between issuers and the general public.¹⁰⁴ The Internet has changed the information market and leveled the playing field between the issuers and the prospective investors. One of the key investor protection concerns underlying the general solicitation ban is information asymmetry, where some people who lack financial sophistication must be protected because they cannot gain information about the issuing company.¹⁰⁵ The

2012).

99. *Id.*

100. *Id.* (internal quotation marks omitted).

101. *What We Do*, CAL. STOCK EXCH., <http://www.calstockexchange.com/what-we-do.php> (last visited May 14, 2012).

102. *Id.*

103. *See also* World Econ. Forum, CROWD WISDOM: USER-CENTRIC INNOVATION 4–7 (2000), *available at* http://www3.weforum.org/docs/WEF_TP_Brochure_2008.pdf (observing the growing trend of companies recognizing that customers can play a valuable role in creating new ideas, and providing examples of offline user-centric innovation where users innovate collaboratively to address problems).

104. *See Mazur, supra* note 45, at 380 n.9 (arguing that the Internet makes obsolete the legal concepts underlying the federal securities regulation that were premised on a paper-based information technology).

105. *See Hearings, supra* note 6, at 12 (prepared statement of Meredith Cross, Director, Division of Corporate Finance, SEC) (arguing that this imbalance of information is a

preexisting substantive relationship requirement for permissible solicitation presumes that investors who have such a relationship with the issuer know something about the issuer or have access to material information about the securities offered.¹⁰⁶

However, since the Internet dispenses with the need for a personal relationship to exist for people to obtain material information, its use undermines one of the principal rationales of the ban on general solicitation.¹⁰⁷ In addition to people's active pursuit of knowledge by researching on the Internet, the Internet is also flooded with active forums where people share and discuss information.¹⁰⁸ Such methods of communication are currently employed by existing crowdfunding platforms, like Kickstarter and IndieGoGo, that have discussion forums where donors can discuss the projects to which they are about to contribute.

Just as crowdsourcing rests on the collective intellect and knowledge of people to enhance the quality of a product, it also depends on the public—not only for its capital, but also to determine, at the very least, which investments to avoid, if not also which investments are best.¹⁰⁹ With the help of technology, investors can scrutinize investments and the people behind them by communicating with others.

Relatedly, in *SEC v. Ralston Purina Co.*¹¹⁰ the Supreme Court held that if the investors have the bargaining power to demand effective disclosure, there is no practical need to afford them the protection of the registration requirements.¹¹¹ One of the driving forces behind crowd- or community-based efforts is the idea of the power or wisdom of the crowd.¹¹² Such

concern independent from the viability of the business venture or the entrepreneur's commitment).

106. See Daugherty, *supra* note 59, at 80.

107. But see D'Alimonte, Carty & Finkelstein, *supra* note 92, at 66–67 (arguing that the flood of information available on the Internet only reinforces the importance of protecting investors from manipulative practices).

108. See *supra* notes 83–93.

109. The public is both the potential investor and the consumer base that determines the value of products and services. See *Hearings*, *supra* note 6, at 55 (prepared statement of Sherwood Neiss, Cofounder, FLAVORx) (recognizing that the public adds “valuation sophistication” in that the crowd places values on things in the market). But see Angus Loten, *Avoiding the Equity Crowd-Funding*, WALL ST. J. BLOGS (Mar. 28, 2012, 3:00 PM), <http://blogs.wsj.com/deals/2012/3/28/angel-investors-some-entrepreneurs-skeptical-about-benefits-of-equity-crowd-funding> (reporting some angel investors worry that with a lot of unsophisticated investors in the crowdfunding market, they will be unable to get the valuation right).

110. 346 U.S. 119 (1953).

111. *Id.* at 124–25.

112. See *Hearings*, *supra* note 6, at 55 (prepared statement of Sherwood Neiss, Cofounder,

collective efforts provide the group with heightened bargaining power. Despite the small amounts of individual investments, prospective investors are able to create leverage with the issuer by coming together as a group. This bargaining power is further strengthened through popular online forums where people share and discuss information.

Therefore, the nature of the Internet age, as exemplified in both the tools and the people using them, removes some of the concerns about crowdfunding, which resemble those underlying the general solicitation ban.

B. *The JOBS Act's Safeguards*

In addition to the inherent protections that the Internet age provides, the JOBS Act implements safeguards in the crowdfunding provisions of the Securities Act and the Exchange Act. First, the JOBS Act limits the total amount of funds raised and the amount of individual investment for crowdfunding securities. Second, transactions on these securities can only be done through a broker or funding portal, either of which must register with the SEC and applicable SRO. The issuer must also register with the SEC. Both of these registrations require the issuer and intermediary to disclose information. Third, SROs will effectively complement the monitoring and regulating role of the SEC, further protecting investors. Lastly, parties to crowdfunding are still subject to the fraud provisions of the Securities Act and the Exchange Act as well as state enforcement on fraud.

1. *Limitations on Amounts Raised and Individual Investments*

The first safeguard that addresses investor protection concerns is the *de minimis* nature of crowdfunding: a low maximum on the offering size and a low maximum on the individual investment. The amended Securities Act exempts crowdfunding securities only if the total amount raised is not more than \$1 million and the maximum amount of individual investment does not exceed the statutory cap, which is based on the investor's annual income or net worth.¹¹³ These two components—though not required—are also in keeping with the criteria of § 3(b) of the Securities Act which

FLAVORx) (arguing that one reason to trust the crowd is its collective IQ that comprises the diversity of different IQs of Internet users).

113. JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (to be codified at 15 U.S.C. § 77d). If the income or net worth is less than \$100,000, individual investment is capped at the greater of \$2,000 or 5% of the investor's annual income or net worth. If the income or net worth is equal to or more than \$100,000, individual investment is capped at the lesser of \$100,000 or 10% of the investor's annual income or net worth. *Id.*

allows the SEC to issue an exemption that can protect investors by virtue of the small amount involved.¹¹⁴ The underlying rationale behind such provision also applies to the *de minimis* nature of crowdfunding: a low cap on the aggregate amount of offering mitigates the negative impact on the market as a whole.

Unlike Regulation D, which places no limit on individual investments while banning general solicitation,¹¹⁵ the crowdfunding exemption's low cap on individual investment would also mitigate potential harm to investors. A loss on a small investment would not significantly affect the investor's financial condition.¹¹⁶ Losing \$1,000, for example, would not necessarily destroy a person's entire savings.

Additionally, to calculate an investor's income and net worth to determine the individual's cap on investment, the JOBS Act employs the calculation used for an accredited investor¹¹⁷ as delineated in the new Rule 215 under the Securities Act, an amendment mandated by the Dodd-Frank Act.¹¹⁸ In determining whether an individual qualifies as an accredited investor as of 2010, when the Dodd-Frank Act was passed, the calculation of a person's net worth no longer includes a primary residence as an asset.¹¹⁹ This in effect narrows the number of individuals who can invest in crowdfunded securities and excludes those who presumably have more to lose.¹²⁰

114. See 15 U.S.C. § 77c(b) (2006) (permitting exemptions that can protect investors "by reason of the small amount involved"). Regulation A and Rules 504 and 505 of Regulation D were issued pursuant to § 3(b) of the Securities Act. See 17 C.F.R. §§ 230.251, .504(a)(3), .505(a) (2011).

115. Exemptions under Regulation D only have ceiling amounts for the aggregate offering for a twelve-month period and no limit for private placements. See 17 C.F.R. § 230.504(b)(2) (\$1 million); *id.* § 230.505(b)(2)(i) (\$5 million); *id.* § 230.506 (no cap on aggregate offering).

116. See *Hearings*, *supra* note 6, at 24 (prepared statement of Mercer E. Bullard, Associate Professor of Law, The University of Mississippi) (arguing that the small size of the investors' potential losses does not trigger the concerns upon which the registration requirement is based).

117. JOBS Act § 302(b) (to be codified in 15 U.S.C. § 77dA(h)(2)) ("The income and net worth of a natural person under section 4(6)(B) [for limitation on individual investment] shall be calculated in accordance with any rules . . . regarding the calculation of the income and net worth, respectively, of an accredited investor.").

118. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010) (mandating the SEC exclude "primary residence" from the calculation of an individual's net worth); 17 C.F.R. § 230.215 (definition of *accredited investor*).

119. 76 Fed. Reg. 81,793, 81,805 (Dec. 29, 2011) (to be codified at 17 C.F.R. § 230.215(e)(1)(i)) ("The person's primary residence shall not be included as an asset . . .").

120. See Eric Alden, *Primum Non Nocere: The Impact of Dodd-Frank on Silicon Valley*, 8 BERKELEY BUS. L.J. 107, 111 (2011) (referencing SEC Commissioner Luis Aguilar's

2. *Fraud Provisions Still Apply*

As with all other exempt securities and offerings regulated by the SEC, crowdfunding securities are still subject to the fraud provisions in the Securities Act and the Exchange Act even though they are exempt from the registration requirement.¹²¹ The antifraud regime consists of § 17 of the Securities Act and Rule 10b-5 under the Exchange Act.¹²² Not only could the SEC bring an action against the fraudulent actor, but the buyer or seller who suffers from the fraud could also bring an action against the fraudulent actor.¹²³ The JOBS Act also permits purchasers of crowdfunding securities to bring an action against the issuer for any material misstatements or omissions.¹²⁴ Together, these provisions not only deter people from committing fraud,¹²⁵ but also instill public confidence in the market.¹²⁶

Additionally, even though crowdfunding securities are covered securities, the JOBS Act preserves state enforcement authority, including enforcement against fraud.¹²⁷ In fact, the JOBS Act extends the reach of state

argument that without this change in definition there could be investors who would otherwise meet the accredited investor criteria only by virtue of the rise in real estate value that has nothing to do with the investor's financial sophistication). *But see* Net Worth Standard for Accredited Investors, 76 Fed. Reg. at 81,796 (noting that some commenters argued to the SEC that the primary residence exclusion could encourage investors to increase the amount of debt secured by their primary residence to purchase other assets in order to increase their net worth and qualify as accredited investors).

121. JOBS Act § 302(b) (to be codified in 15 U.S.C. § 77dA(h)(2)). *But see* Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 152 (2010) (arguing that government agencies typically do not intervene in most fraud cases until much of the damage has already occurred); Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 PENN. ST. L. REV. 189, 220 (2008) (asserting that retail securities fraud is considered a "low-risk crime" because it is difficult to detect and is therefore only treated as a civil matter with such minimal sanctions as cease-and-desist orders, injunctions, disgorgement orders, and civil penalties).

122. 15 U.S.C. § 77q(a)–(b) (2006); 17 C.F.R. § 240.10b-5 (prohibiting any person from manipulating, misleading, or employing fraud in the sale or purchase of any security).

123. *See* Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971) (recognizing that there is an implied private right of action under Rule 10b-5).

124. JOBS Act § 302(b) (to be codified in 15 U.S.C. § 77dA(c)).

125. *See* Tamar Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 557 (1981) (arguing that plaintiffs function as "private attorneys general" by bringing lawsuits and thereby deterring securities violations); Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 103–04 (2005) (emphasizing that private rights of action implied in regulations, like the antifraud regime in securities laws, deter wrongful conduct and supplement governmental regulatory resources).

126. *See* United States v. Brown, 555 F.2d 336, 339 (2d Cir. 1977) (holding that Congress intended the antifraud provision, § 17(a) of the Securities Act, to protect the integrity of the marketplace).

127. JOBS Act § 305(b) (to be codified at 15 U.S.C. § 774(b)(4)); *see* Securities Act of

jurisdiction regarding fraud from that conducted by brokers or dealers to also include fraud committed by crowdfunding portals and issuers.¹²⁸

In facing potential fraud problems, the SEC would most likely respond through reformed policies and strategies, as it has always done in the past.¹²⁹ For example, in response to the fraud cases in the 1990s, the SEC reinforced its program to fight against Internet fraud through the concerted effort of various SEC divisions and offices: Division of Enforcement, Division of Corporate Finance, Division of Market Regulation, Office of Compliance Inspections and Examinations, Office of the General Counsel, and Office of Investor Education and Assistance.¹³⁰

The SEC has responded to increasing Internet fraud by training seventy staff members to maintain surveillance on the Internet and creating the Office of Internet Enforcement, the most notable division of the antifraud program.¹³¹ People can also report possible securities fraud to the SEC through the Enforcement Complaint Center, which could lead to an SEC investigation.¹³² The Enforcement Division created this program to tap into the self-policing culture; more than 75% of these complaints have been useful for investigations or referrals.¹³³

The SEC also created Cyberforce, a special task force to monitor online bulletin boards and chat rooms, a force consisting of hundreds of lawyers, accountants, and investigators.¹³⁴ The development of this internal structure not only shows the SEC already has resources to deal with Internet fraud, but exemplifies the agency's adaptability and responsiveness

1933 § 18(c)(1), 15 U.S.C. § 77r(c)(1) (preserving state jurisdiction to bring enforcement actions regarding fraud or deceit). *But see NASAA: The JOBS Act an Investor Protection Disaster Waiting to Happen*, N. AM. SEC. ADM'RS ASS'N (Mar. 22, 2012), <http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/> (quoting the NASAA President, who argues states can only take action after a fraudulent sale is made, which provides "little comfort to an investor whose money has been stolen").

128. JOBS Act § 305(b)(2) (to be codified at 15 U.S.C. § 77r(c)(1)).

129. See Joseph J. Cella III & John R. Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, 52 BUS. LAW. 815, 835 (1997) (explaining the SEC's regulatory response to changing industry practices in protecting investors from unethical conduct).

130. Stark, *supra* note 80, at 111–12 (describing the SEC's team effort in combating Internet securities law violations).

131. See MICHAEL J. KAUFMAN, *SECURITIES LITIGATION: DAMAGES* § 5:12 (2011), available at Westlaw SECLITD; Stark, *supra* note 80, at 112–16 (elaborating on the work of the Office of Internet Enforcement).

132. See *Questions and Complaints*, SEC. & EXCH. COMM'N, <http://www.sec.gov/complaint/select.shtml> (last visited May 14, 2012).

133. Cella & Stark, *supra* note 129, at 844–45.

134. See Stark, *supra* note 80, at 113 (explaining the work of Cyberforce, including special projects such as internal "surf days").

to market changes.

Moreover, fraud is a major investor-protection concern that permeates all kinds of offerings—even private ones; therefore, federal securities laws and regulations incorporate a safeguard against this crime. Section 17 of the Securities Act and Rule 10b-5 under the Exchange Act are the principal regulatory tools to address fraud by penalizing fraudulent communication over the Internet.¹³⁵ With a private right of action and basis for prosecution, this antifraud regime not only punishes the fraudulent actor, it also deters people from committing fraud.

3. *Registration Requirements for Issuers and Intermediaries*

The new Securities Act as amended by the JOBS Acts requires both issuers and intermediaries, through whom crowdfunding transactions can be conducted, to register with the SEC.¹³⁶ As part of this registration, issuers are required to provide information to the SEC.¹³⁷ This allows the SEC to review and monitor the issuers and the securities they offer to the public.¹³⁸ Such disclosure is in line with the SEC's approach in regulating securities sold to the public, as evident not only in the general § 5(e) registration requirement but even in the streamlined registration requirements of Regulation A and Regulation D exemptions.¹³⁹

Section 4A of the Securities Act as amended by the JOBS Act requires

135. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006) (prohibiting fraudulent interstate transactions); Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2011) (prohibiting the employment of manipulative and deceptive devices); see also Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "The Reasonable Investor" with "The Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 501–02 (2006) (proposing that the materiality standard for federal securities fraud be a misrepresentation or omission of information found material by "the least sophisticated investor," thereby further protecting underclass investors).

136. JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315–20 (2012) (to be codified at 15 U.S.C. § 77a(a)(2)).

137. *Id.* (requiring issuers to provide such information as physical address, names of directors, officers, each shareholder who owns more than 20% of the issuer's shares, description of business, financial condition, and how the securities are being valued).

138. *But see NASAA: The JOBS Act an Investor Protection Disaster Waiting to Happen*, N. AMER. SEC. ADM'RS ASS'N (Mar. 22, 2012), <http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/> (arguing the SEC has neither the resources nor the time to police the small securities offerings effectively).

139. See Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2006) (registration requirement); 17 C.F.R. § 230.252 (Regulation A's documentation requirement); *id.* .502(c)(2) (Regulation D notice of sales requirement for securities solicited through a seminar or meeting). See generally Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1068–76 (1995) (explaining the history behind SEC's disclosure approach as codified in the Securities Act).

intermediaries for crowdfunding securities to register with both the SEC and an applicable SRO as either a broker or a crowdfunding portal.¹⁴⁰ While the immense amount of information available on the Internet reinforces people's ability to make informed investment decisions, the flood of data could potentially lead to serious abuses by fraudulent actors who would take advantage of such easy access.¹⁴¹ Requiring intermediaries to register would further protect investors¹⁴² as it would pressure them to verify the issuers and oversee online forums where investors share and discuss information about the business ventures. Requiring these securities to be offered through registered crowdfunding portals could also enhance investor confidence in the crowdfunding market.¹⁴³

4. Self-Regulatory Organization for Crowdfunding Portals

In addition to registering with the SEC, intermediaries are required to register with an applicable SRO.¹⁴⁴ This additional set of eyes on activities in the new crowdfunding industry helps to further protect investors. SROs typically establish codes of ethics and rules that apply to members of the industry that they regulate, violations of which are disciplined.¹⁴⁵ These SEC codes and rules address the concerns about fraudulent actors that may emerge in the market.

Congress did not specify in the JOBS Act whether there should be a new SRO or whether crowdfunding portals can register with any existing SRO, such as the Financial Industry Regulatory Authority (FINRA), which

140. JOBS Act § 201 (to be codified at 15 U.S.C. § 77d(b)).

141. See D'Alimonte, Carty & Finkelstein, *supra* note 92, at 66–67.

142. See *Hearings*, *supra* note 6, at 40–43 (prepared statement of Jeff Lynn, CEO, Seedrs) (arguing that investors will hesitate to use platforms that lack some sort of regulatory “seal of approval,” and that such platforms will be most effective if the investors are involved in executing the investment transactions and in managing the post-completion investment); *id.* at 75 (prepared statement of Mercer E. Bullard, Associate Professor of Law, The University of Mississippi) (asserting that as a repeat player, an intermediary would incur relatively low fixed costs in complying with a crowdfunding rule exemption that would otherwise be overly burdensome for the issuers).

143. See *id.* at 75–76 (prepared statement of Mercer E. Bullard, Associate Professor of Law, The University of Mississippi).

144. JOBS Act § 302(b) (to be codified at 15 U.S.C. § 77a(a)(2)).

145. See, e.g., *FINRA Manual: FINRA Rules: 2000. Duties and Conflicts*, FIN. INDUS. REGULATORY AUTH., (2008), http://finra.complinet.com/en/display_main.html?rbid=24-3&element_id=5502 (last visited May 14, 2012) (regulating the duties of broker firms and associated persons); *Ethics & Independence*, PUB. CO. ACCOUNTING OVERSIGHT BD., <http://pcaobus.org/Standards/EI/Pages/default.aspx> (last visited May 14, 2012) (listing rules for public accounting firms that have been approved by the SEC); see also 15 U.S.C. § 78o-3(b)(7) (requiring registered securities associations to discipline their members by such measures as expulsion, fine, censure, or bar).

regulates securities firms and brokers to protect investors.¹⁴⁶ The JOBS Act requires crowdfunding portals to be members of a securities association before they facilitate a transaction or solicit the purchase or sale of any security.¹⁴⁷ Whichever SRO a crowdfunding portal registers with, one important underlying fact remains: another body is monitoring and regulating the portal. The shared regulatory role between an SRO and the SEC for crowdfunding is important in two respects.

First, SROs can effectively complement the SEC in regulating the market and the industry's players due to the flexibility of SROs compared to government agencies, the expertise of SRO members, and the inherent incentives of SROs.¹⁴⁸ Because SROs are not government agencies, they are not subject to the direct monitoring of Congress, constitutional constraints,¹⁴⁹ or the extensive rules of the Administrative Procedure Act.¹⁵⁰

146. See FIN. INDUS. REGULATORY AUTH., GET TO KNOW US 2–3 (2011) (listing the Financial Industry Regulatory Authority's duties, such as enforcing industry rules and federal securities laws, reviewing communications from broker firms to investors, and monitoring markets). Any self-regulatory organization (SRO)—existing or soon-to-be-formed—in the securities industry must comply with the Exchange Act, which governs registered securities associations as one form of SRO. See 15 U.S.C. § 78c(a)(26) (defining *self-regulatory organization* as any national securities exchange, registered securities association, or registered clearing agency); *id.* 78o–3 (regulating registered securities association).

147. JOBS Act § 304(a) (to be codified in 15 U.S.C. § 78c(h)(1)–(2)).

148. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 197 (2008) (explaining that one of SROs' advantages over government agencies is that they can issue rules that are more realistic than government regulations). See generally Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665 (2010) (discussing the various advantages that SROs have over government agencies in regulating the financial industry); J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 817–20 (2007) (same).

149. Courts may still subject SROs to the same constitutional constraints that apply to government agencies if they find that the SRO is essentially acting as the state. See, e.g., *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995) (finding that Amtrak is part of the government for purposes of the First Amendment); see also Karmel, *supra* note 148, at 155–59 (describing the two doctrines—public entity doctrine and state action doctrine—that underlie the determination of whether the Constitution should apply to private entities).

150. Rules issued by SROs must still obtain SEC approval. 15 U.S.C. § 78s(b) (delineating the SEC approval process for SROs' proposed rules). The rulemaking process of SROs in the securities industry also resembles the process mandated by the Administrative Procedure Act applying to government agencies. Compare 15 U.S.C. § 78s(b) (requiring the SEC to notify the public about SROs' proposed rules and allow the public to submit comments), and *Financial Industry Regulatory Authority (FINRA) Rulemaking*, SEC. & EXCH. COMM'N, <http://www.sec.gov/rules/sro/finra.shtml> (last visited May 14, 2012) (inviting public comments on FINRA's proposed rules), with 5 U.S.C. § 553(c) (2006) (requiring agencies to give notice to the public about their proposed rules and an opportunity to participate in the rulemaking process by submitting comments).

In addition, because the regulating members of the SROs are players in the industry, they have the ability to be among the first to access information—crucial to properly regulating the rapidly evolving securities market.¹⁵¹ SROs will also be quicker and more efficient in responding to the market by issuing rules and disciplining bad actors because they are relatively free from bureaucratic constraints, unlike government agencies.

Additionally, SROs have a strong incentive to regulate their respective industries because as members they have a vested interest in maintaining the credibility of the industry to which they belong. Bad actors undermine the industry, which causes potential investors to lose confidence in the market and could destroy the market entirely.¹⁵² Consequently, the industry would deteriorate along with the market. This domino effect motivates SROs to function efficiently—possibly even more efficiently than their government agency counterparts.

In these early stages of developing the crowdfunding industry, governing members of the relevant SRO may be even more zealous in regulating and monitoring the industry players, particularly with the looming skepticism that has dominated much of the discussion around crowdfunding.¹⁵³ Additionally, this incentive to protect the industry by regulating itself is balanced by both the SEC's direct supervision as well as the representation of issuers and investors in the SROs' governing bodies.¹⁵⁴

Second, the shared role between an SRO and the SEC with regard to crowdfunding is particularly important given the substantial overhaul of

151. See Omarova, *supra* note 148, at 669–70 (arguing that the industry has superior ability to assess market information and monitor and regulate business operations on a global basis); Verret, *supra* note 148, at 817–20 (comparing the government with SROs in their respective capacities to efficiently regulate).

152. See Omarova, *supra* note 148, at 674 (describing the views of SRO proponents who argue that SROs enhance a sense of ownership and participation in the rulemaking process); cf. Verret, *supra* note 148, at 816–17 (identifying that SROs have an interest in protecting the market from instability caused by deviant behaviors of investment managers).

153. See, e.g., *The Jobs Act Fails Investors and Entrepreneurs*, N. AM. SEC. ADM'RS ASS'N (Apr. 5, 2012), <http://www.nasaa.org/12092/the-jobs-act-fails-investors-and-entrepreneurs/> (quoting the Chairman of NASAA's Committee on Federal Legislation, Steve Irwin, who criticized the crowdfunding exemption as very risky, as it exposes “unsophisticated, gullible, and vulnerable” investors to fraudulent actors).

154. See Securities Exchange Act of 1934 § 15A(b)(4), 15 U.S.C. § 78o-3(b)(4) (requiring the national securities association to have one or more directors who represent issuers and investors and are not associated with a member of the association, broker, or dealer); Paul R. Verkuil, *Privatizing Due Process*, 57 ADMIN. L. REV. 963, 997–98 (2005) (characterizing SROs in the securities industry, unlike those in other fields, as essentially an arm of the government). *But see* Karmel, *supra* note 148, at 197 (arguing the SEC or Congress should refrain from interfering too much with the SROs so they can effectively respond to the needs and concerns of the securities industry).

securities laws in the past two years and the budget restraints of the main government agency responsible for both creating and enforcing the rules. The Dodd–Frank Act contains ninety provisions that require rulemaking by the SEC,¹⁵⁵ a long process that ends with SEC rules being potentially invalidated by courts.¹⁵⁶ Though SROs in the securities industry are not government agencies, the Exchange Act governs the structure and rulemaking of SROs¹⁵⁷ and places them under the direct supervision of the SEC. Particularly with regard to the SEC’s function in preventing fraud, an SRO for crowdfunding could be more efficient in monitoring fraud, as the governing members are from the industry and have first-hand knowledge of what is happening in the field.¹⁵⁸

V. IMPLICATION OF CROWDFUNDING PROVISIONS IN THE JOBS ACT ON OTHER EXEMPTIONS

After concluding that concerns regarding crowdfunding are unfounded given the various characteristics of today’s Internet age and statutory safeguards in the securities laws, it is also important to analyze one significant implication of the new crowdfunding laws. The exemption for crowdfunding, which in effect allows general solicitation for small issue

155. See *supra* note 2 and accompanying text; see also Sarah N. Lynch, *SEC Chairman Pitches Budget Boost to Congress*, REUTERS (Mar. 6, 2012, 10:16 AM), <http://www.reuters.com/article/2012/03/06/us-sec-budget-idUSTRE8250VG20120306> (reporting that the SEC chairman, Mary Schapiro, requested an 18.5% budget increase to carry out the new responsibilities under the Dodd–Frank Act); Charles Riley, *Broken Budget Process Hurts Wall Street Reform*, CNNMONEY (Feb. 10, 2012, 5:07 AM) http://money.cnn.com/2012/02/10/news/economy/cftc_sec_budget/index.htm (reporting that according to the SEC, the trading volume in the securities markets has more than doubled over the past decade, while the number of staff monitoring and regulating the markets has not changed since 2005).

156. See, e.g., *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1149–51 (D.C. Cir. 2011) (striking down the SEC’s proxy access rule, which was issued pursuant to the Dodd–Frank Act, for failing to meet stringent economic analysis based on available empirical data).

157. Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78o–3(a) (requiring associations of brokers and dealers to register with the SEC as a national securities association); *id.* § 78o–3(b) (listing requirements for SROs, such as issuing rules designed to prevent fraud, disciplining members for violating securities laws and regulations, and assuring a fair representation of its members in the SRO’s board of directors); *id.* § 78s(b) (regulating SROs’ rulemaking process).

158. See 15 U.S.C. § 78o–3(b)(6) (requiring an SRO to design rules that would prevent fraud), *id.* § 78o–3(b)(7) (permitting an SRO to discipline its members for violating the Exchange Act, its regulations, or the SRO’s rules). Compare Karmel, *supra* note 148, at 197 (explaining that SROs can hire experts to be their employees and higher salaries can be financed by assessments on the securities industry), with Lynch, *supra* note 155 (reporting that the SEC Chairman, Mary Schapiro, asked Congress to raise the budget for the SEC to improve outdated technologies and hire experts), and Riley, *supra* note 155 (predicting that Congress will reject additional funding and instead decrease the budget).

offerings, could and should prompt the SEC to reevaluate the unaltered ban on general solicitation for other exemptions. This reassessment would be in line with the recent executive order that instructs government agencies to reevaluate existing rules and regulations.¹⁵⁹ Additionally, as crowdfunding offerings are covered securities and therefore do not have to be registered with states, the crowdfunding exemption could cause the other exemptions, particularly Rule 504 and 505, to become idle or even obsolete.

The same implication may be felt most by states' securities regulators given that Rule 504 and 505 offerings are the only remaining registration exemptions they still have jurisdiction over.¹⁶⁰ Although the presidential order does not extend to state agencies, state securities regulators may also want to reevaluate the ban on general solicitation for Rule 504 and 505 offerings based on the discussions above regarding the obsolete rationale behind this ban.¹⁶¹

Before the entrance of the crowdfunding exemption, Rule 504 and 505 were rarely used, as businesses used Rule 506 more.¹⁶² 78.6% of Regulation D offerings of \$1 million or less were offered under Rule 506, which is the offering size Rule 504 was intended for, while only 14.3% of those were offered under Rule 504.¹⁶³ 91.9% of Regulation D offerings between \$1 million and \$5 million, which is the range of offering size Rule 505 was designed to serve, were offered under Rule 506, with only 3.9% of these offerings made using Rule 505.¹⁶⁴

Some argue that the reason behind the popularity of Rule 506 offerings over Rule 504 and 505 is that the securities of the former are covered

159. Exec. Order No. 13,563 § 1(b), 76 Fed. Reg. 3821, 3821 (Jan. 21, 2011).

160. Compare 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, 940–42 (2011) (arguing that state authority over all Regulation D offerings must be removed in order to restore the intended use of such offerings for small business capital formation), with Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 188–97 (2010) (proposing a return to state supervision of Rule 506 private placements to enhance capital formation and protect investors), and *NASAA: The JOBS Act an Investor Protection Disaster Waiting to Happen*, N. AM. SEC. ADMR'S ASS'N (Mar. 22, 2012), <http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/> (criticizing the preemption of states from reviewing crowdfunding offerings that, given the foreseeable lack of scrutiny by the SEC, would result in many fraudulent transactions).

161. See *supra* Part IV.A.

162. See 17 C.F.R. § 230.504(b)(2) (2011) (limiting the size of securities sold to \$1 million), *id.* § 230.505(b)(2)(i) (limiting the size of the securities sold to \$5 million); *id.* § 230.506 (providing no limit on the size of the offering).

163. Campbell, *supra* note 160, at 928.

164. *Id.*

securities while those of the latter are not.¹⁶⁵ Even though Rule 504 does not require issuers to disclose financial or other information to the purchasers and has no limitation on the number of purchasers, issuers still elect to offer securities under Rule 506 instead.¹⁶⁶ This is so even though Rule 506 has many criteria, such as requiring that the purchasers have knowledge and experience in financial and business matters, that they meet the criteria to qualify as an accredited investor, and that their total number does not exceed thirty-five.¹⁶⁷ However, despite the requirements, Rule 506 issuers need only register with the SEC and do not need to register with any state agency, unlike Rule 504 and 505 issuers whose securities are not included in the list of covered securities.

With a crowdfunding exemption now in place, Rule 504 and 505 exemptions will further dissipate in use. Not only can crowdfunding securities be offered to a larger pool of investors,¹⁶⁸ many of whom were previously unable to invest, but they must only be registered with a single agency as opposed to multiple agencies across the nation.¹⁶⁹ If Congress has gone so far with the JOBS Act as to allow crowdfunding and even lifted

165. See Securities Act of 1933 § 13(a), 15 U.S.C. § 77r(a) (2006) (“[N]o law, rule, regulation, or order, or other administrative action of any State . . . requiring, or with respect to, registration or qualification of securities . . . shall directly or indirectly apply to a security that (A) is a covered security”); *id.* § 13(b)(4)(D) (including as covered securities those securities sold pursuant to Section 4(2) of the Securities Act); 17 C.F.R. § 230.506(a) (basing Rule 506 offerings on § 4(2) of the Securities Act); Campbell, *supra* note 160, at 932–33. Peculiarly, the JOBS Act frees Rule 506 offerings from the restriction on general solicitation, while preserving the ban for Rules 504 and 505 offerings. JOBS Act § 201, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d(b)) (exempting Rule 506 offerings from the ban on general solicitation).

166. See 17 C.F.R. § 230.502(b) (requiring issuers selling securities under Rules 505 or 506 to any purchaser who is not an accredited investor to provide such information as an audited balance sheet, marketing arrangements, and risk factors).

167. See 17 C.F.R. § 230.506(b)(2) (listing the criteria for purchasers of Rule 506 securities), *id.* § 230.501(e)(1)(iv) (excluding accredited investor from the calculation of number of purchasers for purposes of Rules 505 and 506), *id.* § 230.501(a) (defining accredited investor).

168. Because Rule 504 and 505 securities cannot be solicited to people with whom there is no preexisting relationship—as a consequence of the ban on general solicitation—the sale of securities is in effect restricted to family and friends of the issuers. See *supra* notes. 59–68 and accompanying text. Conversely, with no such limitation on the manner of crowdfunding offerings, crowdfunding issuers can sell their securities not only to their family and friends, but also to the general public.

169. Rule 504 and 505 issuers must register their securities with the relevant state agencies, unless the securities or offerings are exempt in the respective states. Such state securities laws are commonly referred to as “blue sky laws.” See Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 229 (2003) (tracing the history behind blue sky laws).

the ban on general solicitation for Rule 506 nonpublic offerings,¹⁷⁰ then the Rule 502(c) prohibition on general solicitation for the remaining exemptions should also be removed. Even prior to the JOBS Act, many scholars had already questioned the need for the ban.¹⁷¹

As the President has recently instructed government agencies to conduct a retrospective analysis of rules that may be outmoded and modify them,¹⁷² the SEC should reevaluate the general solicitation provision in Rule 502(c) that still applies to Rule 504 and 505 offerings. The ban availability in the Securities Act was already in question when the crowdfunding exemption was introduced in the JOBS Act.¹⁷³ Although some attribute the idleness of Rule 504 and 505 to the fact that the Rules are not covered securities, the ban on general solicitation may also be part of the reason. Unless the SEC removes the ban on general solicitation for these exemptions, crowdfunding offerings may dominate the small business offerings market, making Rule 504 and 505 superfluous.

CONCLUSION

In light of growing concerns about the stagnant economy and the state of small businesses, the public celebrated the passing of the JOBS Act. Under its theme of capital formation, the Act recognizes the popularity and effectiveness of crowdfunding as a viable financing model by exempting it from registration requirements with the SEC. As with every novel idea, it does not come as a surprise that many are concerned about this new model. Much of this concern is shadowed by the penny-stock fraud incidents in the 1990s that traumatized people in the securities industry and led to Regulation D's ban on general solicitation.

However, these worries about investor protection are unfounded in light of the characteristics of the public and the tools available in this Internet age. The democratization of access to information—facilitated by the Internet—levels the playing field between issuers and prospective investors. In addition, the JOBS Act puts in place sufficient safeguards to remove concerns about investor protection. The *de minimis* amounts of securities and individual investments permitted mitigate an extensive negative impact on either an individual's or the nation's economic condition. Though

170. JOBS Act § 201(a)(1) (to be codified at 15 U.S.C. § 77d(b)) (mandating that the SEC revise Rule 506 by exempting it from the ban on general solicitation so long as the purchasers of Rule 506 securities are accredited investors).

171. See, e.g., C. Steven Bradford, *The Cost of Regulatory Exemptions*, 72 UMKC L. REV. 857 (2004); Daugherty, *supra* note 59; Sjostrom, *supra* note 62.

172. Exec. Order No. 13,563 § 6(a), 76 Fed. Reg. 3821, 3822 (Jan. 21, 2011).

173. See *supra* note 171 and accompanying text.

crowdfunding is now exempted from the § 5 registration requirements, issuers must still register with the SEC, and intermediaries must register with both the SEC as well as an applicable SRO. Further, as none of the other exemptions stand outside the antifraud regime in securities laws, neither does the crowdfunding exemption.

The JOBS Act potentially makes crowdfunding the most popular exemption that businesses could use to raise funds. Issuers need only file basic information with the SEC; they do not have to register with any state because crowdfunding securities are covered securities, and crowdfunding allows them to solicit investments from virtually the whole nation. Such advantages would effectively render the other exempt securities and offerings—Rule 504 and 505—obsolete. In light of President Obama’s recent directive to reevaluate existing rules while maintaining a regulatory system that promotes “economic growth, innovation, competitiveness, and job creation,”¹⁷⁴ the SEC should reevaluate the ban on general solicitation that still applies to these other small-offering exemptions.

With the nature of today’s tech-savvy market and the JOBS Act safeguards in place, skeptics should join in the celebration for the great prospects that crowdfunding has to offer to the economy, particularly small businesses.

174. Exec. Order No. 13,563 § 1(a), 76 Fed. Reg. at 3821.