

I. *III's a Crowd: The Implementation of the JOBS Act's Title III Crowdfunding Provisions*

The Jumpstart Our Business Startups Act (the JOBS Act), passed in 2012, paved the way for the SEC to implement new rules governing exemptions for crowdfunding campaigns offering equity shares as a capital-raising method.¹ The SEC's finalized rule, Regulation Crowdfunding, is set to enter into force on May 16, 2016.² In pertinent part, Regulation Crowdfunding implements the JOBS Act's limits on the amount of equity-based capital a crowdfunding campaign can raise in one year, restrictions on how much individuals may invest in such campaigns based on salary and net worth levels, and disclosure requirements.³

Advertised as a measure aimed at providing an easier avenue for small businesses to raise capital, Regulation Crowdfunding pushes equity-based crowdfunding into the domain of the 1933 Securities Act and 1934 Securities Exchange Act.⁴ The increased regulatory oversight and investor protection should increase investor confidence in engaging in such investment and further invigorate crowdfunding as an effective method of equity financing.⁵

Following a brief discussion of securities regulation framework in Part A and the 2012 JOBS Act in Part B, this article examines the implementation of Regulation Crowdfunding in Part C and evaluates its expected effects and industry speculation about its chances for success in Part D.

A. Background and Regulatory Framework

It is helpful to begin with a working definition of "crowdfunding." In an Exchange Act Release, the SEC explained that crowdfunding is:

¹ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

² See Crowdfunding, Securities Act Release No. 9974, Exchange Act Release No. 76,324, 80 Fed. Reg. 71,388, 71,388 (Nov. 16, 2015).

³ See *id.*

⁴ *Id.*

⁵ *Id.* at 71,388 ("The crowdfunding provisions of the JOBS Act were intended to help provide startups and small businesses with capital by making relatively low dollar offerings of securities, featuring relatively low dollar investments by the 'crowd' less costly.").

[A] relatively new and evolving method of using the Internet to raise capital to support a wide range of ideas and ventures. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. Individuals interested in the crowdfunding campaign—members of the ‘crowd’—may share information about the project, cause, idea or business with each other and use the information to decide whether to fund the campaign based on the collective “wisdom of the crowd.”⁶

Crowdfunding burst into the collective public consciousness with the visible success of numerous crowdfunding campaigns.⁷ Oculus VR, for example—the company responsible for the creation of the much-anticipated Oculus Rift virtual reality gaming hardware—found enthusiastic (rabid, even) support via the Kickstarter platform.⁸ Notably, Facebook recently acquired Oculus VR for \$2 billion.⁹ Whether for the tchotchkes investors receive in return for pledging funds, or for the experience of contributing to an entrepreneurial dream’s realization, crowdfunding platforms like Kickstarter and Indiegogo enjoy enormous public popularity.¹⁰

⁶ *Id.*

⁷ See, e.g., Charles Luzar, *Ranked: The 50 Biggest Kickstarter Campaigns Of All Time*, CROWDFUND INSIDER (Sept. 13, 2013), <http://www.crowdfundinsider.com/2013/09/22637-ranked-the-50-biggest-kickstarters-of-all-time/> [perma.cc/A83Z-XH2H] (compiling a list of successful crowdfunding campaigns).

⁸ See David M. Ewalt, *Palmer Lucky: Defying Reality*, FORBES (Jan. 5, 2015), <http://www.forbes.com/sites/davidewalt/2015/01/05/palmer-luckey-oculus-rift-vr/#2715e4857a0b571e31944fa0> [https://perma.cc/QS8Y-3VUW] (recalling that, shortly after its appearance on Kickstarter, the campaign “leaped past the \$250,000 mark in less than two hours.”).

⁹ See *id.*

¹⁰ See, e.g., *Crowdfunding? How About Crowdfunding?*, BLOOMBERG VIEW (April 17, 2015), <http://www.bloombergvew.com/articles/2015-04-17/regulators-harm-u-s-economy-by-slow-walking-crowdfund-rules> [perma.cc/KL23-QQTT] (“Tens of thousands of . . . projects, from filmmakers and software developers to food-truck vendors and clothing designers, have raised close to \$2 billion from sites such as Kickstarter and Indiegogo.”).

It is important to note, however, that although they share the “crowdfunding” name in common parlance, there is a functional distinction between *crowdfunding* and *crowdinvesting*. While the aforementioned successful crowdfunding campaigns and platforms offer investors the opportunity to support entrepreneurial vision, such platforms do not provide investors the option to obtain an equity stake in the campaign, nor do they intend to do so in the near future.¹¹ Sites like Kickstarter and Indiegogo epitomize the *crowdfunding* side of the coin. As such, these sites will likely fall outside the purview of Regulation Crowdfunding, which, perhaps counterintuitively, governs only *crowdinvesting*.¹² The SEC acknowledges the distinction by distinguishing “reward-based” crowdfunding, “where funders receive a ‘reward,’ such as a perk or pre-order of a product”¹³ On the other side are platforms that offer investors the chance to become equity shareholders in campaigns and, thus, a share of whatever success or failure the resultant business may enjoy.¹⁴

In common practice, when an issuer¹⁵ offers securities publicly, it must register those securities pursuant to Section 5 of the

¹¹ Kendall Almerico, *Will Equity Crowdfunding Laws Be the Death of Kickstarter?*, ENTREPRENEUR (Jan. 29, 2014), <http://www.entrepreneur.com/article/231085> [perma.cc/KEH7-VUSN] (“Kickstarter has already said it will not participate in equity crowdfunding, and most other rewards-based crowdfunding sites will not do so either, primarily because of the extremely high cost of compliance.”).

¹² See Crowdfunding, Securities Act Release No. 9974, Exchange Act Release No. 76,324, 80 Fed. Reg. 71,388, 71,388 (Nov. 16, 2015) (“Regulation Crowdfunding prescribes rules governing the *offer and sale of securities* under new Section 4(a)(6) of the Securities Act of 1933.”) (emphasis added).

¹³ *Id.* at 71,488 (citing MASSOLUTION, 2015CF CROWDFUNDING INDUSTRY REPORT: MARKET TRENDS, COMPOSITION AND CROWDFUNDING PLATFORMS 42 (2015), available at http://reports.crowdsourcing.org/index.php?route=product/product&product_id=54).

¹⁴ Adam Bergman, *New SEC Rules Kickstart Crowdfunding*, FORBES: GREAT SPECULATIONS (Nov. 2, 2015), <http://www.forbes.com/sites/greatspeculations/2015/11/02/new-sec-rules-kickstart-crowdfunding/#2f19551c44813b965fb44816> [https://perma.cc/6QSN-JUN6?type=image] (“Crowdfunding is an evolving method of raising capital that has been used to raise funds through the Internet for a variety of projects. Title III of the JOBS Act created a federal exemption under the securities laws so that this type of funding method can be used to offer and sell securities.”).

¹⁵ As defined in the Securities Act of 1933 § 2(a)(4), 15 U.S.C. § 77b(a)(4) (2012).

Securities Act of 1933 unless it is exempt from Section 5's requirements.¹⁶ The Securities Act includes a limited "private offering" exemption for securities not offered to the public generally.¹⁷ The private offering exemption does not contemplate the kind of large scale, public issuance at issue in crowdfunding offerings.¹⁸ Because registering securities is a costly endeavor, the SEC sought to lighten the burden on small issuers unable to afford the costly and complex registration process by enacting Regulation D.¹⁹ Regulation D provides several specific exemptions for issuers offering securities to a small group or for a limited amount.²⁰ Most applicable here is Rule 504, which exempts from registration an issuer offering less than \$1 million worth of securities.²¹ Regulation D, however, provided an inadequate framework for the innovative, internet-based crowdfunding, which expanded the potential investor pool for securities offerings.²² With its implementation of Regulation Crowdfunding, the SEC seeks to provide a more stable regulatory

¹⁶ *Id.* § 5.

¹⁷ A Section 4(a)(1) private offering exemption would not apply here, as it exempts only offerings to a limited group of individuals. Courts have traditionally looked at the sophistication of, and the amount of information available to, investors in this context. *See, e.g., SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) ("[T]he applicability of [Section] 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

¹⁸ Crowdfunding offerings target the public at large via the internet and are *prima facie* incompatible with a "private offering" distinction.

¹⁹ *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251, 11,251 (Mar. 16, 1982) ("This study has revealed a particular concern that the registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers.").

²⁰ 17 C.F.R. §§ 230.504-506.

²¹ *Id.* § 230.504(b)(2) ("The aggregate offering price for an offering of securities . . . shall not exceed \$1,000,000 . . .").

²² *See* Crowdfunding, Securities Act Release No. 9974, Exchange Act Release No. 76,324, 80 Fed. Reg. 71,388, 71,389 (Nov. 16, 2015) ("Limitations under existing regulations . . . have made private placement exemptions generally unavailable for crowdfunding transactions, which are intended to involve a large number of investors and not be limited to investors that meet specific qualifications.").

environment and framework for startups seeking to raise capital and investors alike.²³

B. Current Regulatory Regime

Enacted in 2012, the JOBS Act empowered the SEC to decree rules relating to exemption for equity-based crowdfunding campaigns.²⁴ The JOBS Act created an interim regulatory regime under which, subject to certain restrictions, investors could fund a campaign on approved platforms in return for an equity stake in the company.²⁵ Specifically, the JOBS Act added Section 4(a)(6) to the Securities Act of 1933.²⁶ Among its provisions, Section 4(a)(6): (1) limits the total amount a crowdfunding campaign can raise, via equity offering, in any 12-month period;²⁷ (2) limits aggregate individual investments in crowdfunding campaigns based on the individual's income and net worth;²⁸ (3) restricts the types of platforms on which campaigns may conduct offerings;²⁹ and (4) creates new disclosure requirements.³⁰

Prior to the JOBS Act, securities regulation—in particular, the Securities Act of 1933—did not allow broad equity capital issuance in

²³ See *supra* note 5 and accompanying text.

²⁴ See Crowdfunding, 80 Fed. Reg. at 71,388.

²⁵ See *id.*

²⁶ Securities Act of 1933 § (4)(a)(6), 15 U.S.C. § 77d(a)(6).

²⁷ See Crowdfunding, 80 Fed. Reg. at 71,389 (“The amount raised must not exceed \$1 million in a 12-month period.”).

²⁸ See *id.* (“[I]ndividual investments in all crowdfunding issuers in a 12 month period are limited to: [t]he greater of \$2,000 or 5 percent of annual income or net worth, if annual income or net worth of the investor is less than \$100,000; and 10 percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual net income or net worth of the investor is \$100,000 or more . . .”).

²⁹ See *id.* (“[T]ransactions must be conducted through an intermediary that either is registered as a broker-dealer or is registered as a new type of entity called a ‘funding portal.’”).

³⁰ See *id.* (explaining the requirement that “issuers and intermediaries that facilitate transactions between issuers and investors in reliance on Section 4(a)(6) provide certain information to investors and potential investors, take other actions and provide notices and other information to the Commission . . .”).

crowdfunding transactions.³¹ Rather, the SEC limited such issuance to “accredited investors,” defined in the relevant portion of the 1933 Securities Act as “any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.”³² In effectuating Regulation D, the SEC obliged in prescribing a definition. Rule 501 provides, in relevant part, that an accredited investor includes “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000.”³³

C. Regulation Crowdfunding

Effective May 16, 2016, Regulation Crowdfunding brings equity-based crowdfunding within the extensive disclosure requirements regulating issuers in the 1933 Securities Act.³⁴ The regulation is intended to increase investor confidence in contributing capital to crowdfunding endeavors by providing regulatory oversight.³⁵ As set forth in the JOBS Act, Regulation Crowdfunding implements a number of requirements and restrictions intended to protect investors. First, the regulation imposes a limit on individual investment in securities-based crowdfunding transactions.³⁶ Next, it

³¹ See Bergman, *supra* note 14 (“Before the new rules, private companies could seek money only from ‘accredited investors,’ defined as individuals who own more than \$1 million in assets, excluding their primary residence, or have maintained an income of more than \$200,000 for at least two years.”).

³² Securities Act of 1933 § 2(a)(15)(ii), 15 U.S.C. § 77b(a)(15)(ii).

³³ 17 C.F.R. § 230.501(a)(5) (explaining factors to be included and excluded in calculating an individual’s net worth). Note that “accredited investor” also includes banks, private businesses, investment companies, and a number of other entities. For the purposes of this article, however, it is sufficient to observe simply that even individuals who cannot claim the accredited investor moniker may, under the new statute, invest a limited amount in equity-based crowdfunding offerings.

³⁴ See Crowdfunding, 80 Fed. Reg. at 71,388.

³⁵ See *id.* at 71,388, n.3 (statement of Sen. Carl Levin) (“Our bill creates new opportunities for crowdfunding but establishes basic regulatory oversight . . . that will give investors the confidence to participate in this promising emerging source of money for growing companies.”).

³⁶ *Id.* at 71,390 (“Individual investors, over the course of a 12-month period, are permitted to invest in the aggregate across all crowdfunding offerings up

officially limits the amount of money an issuer can raise using the crowdfunding exemption from the 1933 Securities Act.³⁷ The regulation also imposes disclosure requirements on issuers for certain information about their business and securities offering.³⁸ It also creates a regulatory framework for broker-dealers and “funding portals,” which will “facilitate the crowdfunding transactions.”³⁹

In addition to its requirements of equity-based offerings, Regulation Crowdfunding also proposes changes to a number of extant rules. In particular, the regulation proposes amendments to intrastate crowdfunding provisions, which aim to modernize the rule for intrastate offerings—Securities Act Rule 147.⁴⁰ In its current form, Rule 147 is a safe harbor under Securities Act Section 3(a)(11).⁴¹ The regulation also suggests a change to Regulation D’s Rule 504. Namely,

to: . . . \$2,000 or 5 percent of the lesser of their annual income or net worth. If both their annual income and net worth are equal to or more than \$100,000, then 10 percent of the lesser of their annual income or net worth; and [d]uring the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed \$100,000.”).

³⁷ *Id.* (“An issuer is permitted to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period.”).

³⁸ *Id.* (explaining that the rules require “[i]nformation about officers and directors as well as owners of 20 percent or more of the issuer; [a] description of the issuer’s business and the use of proceeds from the offering; [t]he price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount . . .” and a number of other informational disclosures).

³⁹ *Id.* (“Under Regulation Crowdfunding, offerings must be conducted exclusively through a platform operated by a registered broker or a funding portal, which is a new type of SEC registrant. The rules require these intermediaries to: [p]rovide investors with educational materials; [t]ake measures to reduce the risk of fraud; [m]ake available information about the issuer and the offering; [p]rovide communication channels to permit discussions about offerings on the platform; and [f]acilitate the offer and sale of crowdfunded securities.”).

⁴⁰ *See* Press Release, Sec. & Exch. Comm’n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), <http://www.sec.gov/news/pressrelease/2015-249.html> [perma.cc/7D7N-W6EG] (explaining that the proposed amendments would “permit companies to raise money from investors within their state without concurrently registering the offers and sales at the federal level.”).

⁴¹ *See* Crowdfunding, 80 Fed. Reg. at 71,484, n.1239 (“Securities Act Rule 147, a safe harbor under Section 3(a)(11), limits resales to person residing in-state for a period of nine months after the last sale by the issuer.”).

it recommends that the rule exempt transactions of up to \$5 million instead of the previously allowed ceiling of \$1 million.⁴² As detailed briefly above, Rule 504 currently exempts securities offerings of up to \$1 million from registration and disclosure requirements under Section 5 of the 1933 Securities Act.⁴³ Finally, in the name of investor protection, Regulation Crowdfunding proposes adding a bad actor disqualification from Rule 504 offerings.⁴⁴

D. Trends and Implications

Industry reaction to the newly implemented rule appears to be largely positive.⁴⁵ The JOBS Act provisions make raising capital easier for small companies that are unable or unwilling to shoulder the financial burden of Section 5 registration.⁴⁶ Moreover, it makes investment in crowdfunding campaigns more feasible for small investors by featuring low investment costs.⁴⁷ Ultimately, small offerings circumvent the difficulties of officially and publicly offering stock. While registered offerings are costly in the amount of preparation required to satisfy stringent reporting guidelines, the

⁴² See Press Release, *supra* note 40 (“The proposed amendments to Rule 504 . . . would increase the aggregate amount of securities that may be offered and sold under Rule 504 in any 12-month period from \$1 million to \$5 million.”).

⁴³ 17 C.F.R. § 230.504(b).

⁴⁴ Press Release, *supra* note 40 (Adding that the proposed amendments to Rule 504 would also “disqualify certain bad actors from participation in Rule 504 offerings”).

⁴⁵ See, e.g., Devin Thorpe, *Experts Explain New Crowdfunding Rules*, FORBES (Nov. 18, 2015), <http://www.forbes.com/sites/devinthorpe/2015/11/18/experts-explain-new-crowdfunding-rules/#9dde28240ad26181fb1e40ad> [https://perma.cc/7S4U-VDYC] (“Todd Crosland, CEO and Founder of Seed Equity Ventures, a broker dealer already operating and doing crowdfunding type equity raises under the SEC’s Regulation D 506(c) rules for general solicitations, says, ‘I believe the SEC passing Title III will be a watershed event for both startups and investors. Startups and the general investing public will be forever changed.’”); Kendall Almerico, *What the New Equity Crowdfunding Rules Mean for Entrepreneurs*, ENTREPRENEUR (Nov. 2, 2015), <http://www.entrepreneur.com/article/252315> [perma.cc/GZM7-94TX] (“Will equity crowdfunding work under the new SEC rules? Some may disagree, but I believe there is a workable model here that startups will be able to use to raise capital.”).

⁴⁶ See *supra* note 5 and accompanying text.

⁴⁷ See *supra* note 5 and accompanying text.

limited exception for crowdfunding should stimulate investment from sectors to which small capital raisers did not have access previously.⁴⁸ One industry observer voiced his agreement that the new regulations have great potential:

The new crowdfunding rules could be a great boon for the economy, including allowing for high risk-high reward projects to get funded or helping a real estate investment fund raise quick cash to flip homes. It also can offer potential investment diversification to ones [sic] personal or retirement portfolios, keeping in mind the potential for the application of the UBTI tax rules. However, crowdfunding is not without risk, including business failure and the potential for fraud.⁴⁹

This opinion provides tempered optimism but expresses hope that Regulation Crowdfunding will stimulate growth and creativity in capital raising endeavors as well as adequately protect small investors.⁵⁰

Despite the optimism of those raising capital and investors alike, investing in startups remains a risky endeavor.⁵¹ Indeed, the SEC notes that “[t]here is broad evidence that many of these potential issuers are likely to fail after receiving funding.”⁵² The risk remains that inexperienced investors making use of the new exemption may have unrealistic expectations as to the viability of startup investments.⁵³ Moreover, small investors, eager to share in the same

⁴⁸ See, e.g., Thorpe, *supra* note 45 (“EnergyFunders founder Philip Racusin says, ‘We hope to . . . attract more small operators to use our platform, which will provide them project funding traditionally denied to them by banks.’”).

⁴⁹ Bergman, *supra* note 14.

⁵⁰ *Id.* (“[T]he new crowdfunding rules will undoubtedly provide smaller companies and various investment projects with innovative ways to raise capital . . . while providing investors with a relatively high degree of protection.”).

⁵¹ See, e.g., *id.*

⁵² See, e.g., Crowdfunding, 80 Fed. Reg. at 71,489 (referring to, among others, a study finding “that for 16,315 VC-backed companies that received their first institutional funding round between 1980 and 1999, approximately one-third failed after the first funding round.”).

⁵³ See, e.g., Scott Martin & Yuka Hayashi, *SEC Opens Way for Wider Pool of Investors to Take Stakes in Startups*, WALL ST. J. (Oct. 30, 2015, 3:36 PM),

investment opportunities as their wealthy counterparts, may prove to be more susceptible to fraudulent offering practices.⁵⁴ That said, the SEC's rigid disclosure and monitoring regime should prove a formidable barrier stemming the flow of scam artists looking to take advantage of inexperienced investors.⁵⁵ Other concerned commentators cautiously note the sluggish SEC response time in dealing with internet-based developments in investment technologies.⁵⁶

The efficacy of investor protection mechanisms aside, industry insiders suggest that Regulation Crowdfunding may actually *disincentivize* tech startups from generating capital via the new exemption.⁵⁷ Specifically, the new regulation requires that, upon reaching a certain number of investors or a specified asset threshold, a company file disclosures similar to those required in an initial public offering.⁵⁸ If a startup cannot use Regulation Crowdfunding mechanisms to avoid the high costs of IPO-type disclosure, there is

<http://www.wsj.com/articles/sec-opens-way-for-wider-range-of-investors-to-take-stakes-in-startups-1446233635> [perma.cc/442E-ZNM3] (“[C]rowdfunding initiatives that fall under the new classification could attract the wrong type of investors from ‘people who compare investing in startups to investing in a mutual fund, which would have relatively guaranteed outcomes, when that is not the reality of startup investing.’”).

⁵⁴ See *id.* (“The level of scrutiny and due diligence in the crowdfunding market will likely be far weaker than the scrutiny applied by VC firms and sophisticated angel investors. That simple fact will make crowdfunding more appealing to less scrupulous ‘entrepreneurs,’” said Joseph Grundfest, a law professor at Stanford who was previously an SEC commissioner.”).

⁵⁵ See, e.g., Christopher Mims, *Tech Startup Crowdfunding Isn't All It's Cracked Up to Be*, WALL ST. J. (Dec. 7, 2015, 12:01 AM), <http://www.wsj.com/articles/tech-startup-crowdfunding-isnt-all-its-cracked-up-to-be-1449464460> [perma.cc/4C59-QGV8] (“The current regulations, as written, seem almost draconian in their cautiousness.”).

⁵⁶ See, e.g., *Crowdfunding? How About Crowdinvesting?*, *supra* note 10 (“Yes, the Internet is a whole new venue for ruses that securities regulators need to worry about. But their bigger worry should be how to adapt their rule to new financial markets, technologies and business models.”).

⁵⁷ See Mims, *supra* note 55 (“The SEC . . . included rules . . . that are a powerful disincentive for high-growth startups to use what the SEC calls ‘regulated crowdfunding.’”).

⁵⁸ See, e.g., *id.* (“These rules stipulate that any company that takes on more than 500 individual investors or grows to a size greater than \$25 million in assets must start filing regular disclosures just like a publicly traded company. It is all the pain of an IPO without the benefits of the IPO.”).

little incentive to make use of the exemption.⁵⁹ The logical endpoint is that higher-quality tech startups will avoid equity-based crowdfunding altogether, opting instead for more traditional capital generation, while less sophisticated investors will be left with “lower-quality companies that couldn’t get funding by other means.”⁶⁰

E. Conclusion

Whether the SEC’s Regulation Crowdfunding will actually stimulate creative capital generation mechanisms remains to be seen. The new regulation, however flawed in the eyes of some skeptical observers, creates an avenue by which small startups can access new potential capital streams and by which investors previously excluded from obtaining equity stakes in startups can acquire shares in entrepreneurial vision. The strict limits on aggregate individual equity investment and crowdfunding limits for those seeking to generate capital should provide adequate protection as investors and businesses experiment with the new exemption.

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⁵⁹ *See id.*

⁶⁰ *Id.*

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