

CROWDFUNDING: FLEECING THE AMERICAN MASSES

*Zachary J. Griffin**

This Note was completed March 14, 2012, prior to the JOBS Act passing into law on April 5, 2012. The fundamental basis of this Note foreshadows the consequences of exempting equity crowdfunding from the registration requirements contained in the Securities Act of 1933. To preserve the author's foresight, this Note has not been modified to reference the crowdfunding exemption subsequently created by the JOBS Act. However, the issues addressed in this Note are still applicable despite the new exemption.

I. INTRODUCTION

As the United States economy continues to sputter along like a beat-up station wagon, politicians in Washington are searching for new ways to boost its prospects. Many, including President Barack Obama, look to small business growth as a solution to our economic woes.¹ However, such growth has been stymied by the lack of capital available to small businesses. As U.S. House Representative Patrick McHenry stated, "Lending to job creators and entrepreneurs remains dismal, [and] we must find new and modern means for capital formation to ignite our sputtering economy."² Such "ignition" will come from crowdfunding, or at least politicians seem to think so.

Crowdfunding is a means of capital formation that connects entrepreneurs with investors over the Internet.³ Entrepreneurs can post their business plans on crowdfunding websites, and anybody

* J.D. Candidate, Case Western Reserve University School of Law

1. *Fact Sheet: The American Jobs Act*, THE WHITE HOUSE (Sept. 8, 2011), <http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-american-jobs-act> (outlining President Obama's plan to create jobs and "get the economy moving").
2. *Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight and Gov. Reform*, 112th Cong. 2 (2011) [hereinafter *Crowdfunding Hearing*] (opening statement by Representative McHenry describing the United States' poor economic environment), available at <http://oversight.house.gov/wp-content/uploads/2012/06/9-15-11-Subcommittee-on-Tarp-FInancial-Services-Hearing-Transcript.pdf>.
3. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 12 COLUM. BUS. L. REV. 1, at 5 (2012) (defining crowdfunding and explaining how it works).

connected to the Internet can contribute, or invest, in these companies.⁴ However, there is a catch; investors are limited in the types of returns they can receive from their capital contributions.⁵ Currently, investors cannot receive any form of security because “crowdfunding does not mesh with federal securities regulation[s].”⁶ The Securities Act of 1933 makes it illegal to offer or sell any security unless the issuer has complied with the registration requirements under section 5 of the Act or has met a registration exemption.⁷ “Entrepreneurs seeking debt or equity financing through crowdfunding will often be selling [unregistered] securities,”⁸ as compliance with the registration process is too expensive for most entrepreneurs⁹ and the Act’s exemptions do not fit with the crowdfunding model.¹⁰ As such, there is a tremendous push in Washington to create a new exemption for securities issued through crowdfunding.¹¹

Unfortunately, the movement to exempt crowdfunded securities overlooks the devastating consequences of such an exemption. In this Note, I argue that securities offerings using crowdfunding should not be exempted from the registration requirements of the federal securities laws. Section II introduces the concept of crowdfunding and its five different categories. Section III examines the registration requirements under the Securities Act of 1933, why registration is not feasible for most crowdfunded ventures, and the conflicts between crowdfunding and the current registration exemptions. Section IV discusses why crowdfunding should not be exempted, specifically focusing on how such an exemption would severely weaken investor protections and open the door for fraud to permeate the market. In

4. *Id.* at 5.

5. *See* 15 U.S.C. § 77(e) (2006) (banning the sale of securities unless a registration statement is in effect as to the offering; and barring the offering of securities until the registration statement has been filed with the Securities and Exchange Commission (“SEC”).)

6. *See* Bradford, *supra* note 3, at 6 (explaining the legal barriers to crowdfunding under current federal securities regulations).

7. *See* 15 U.S.C. §77(e) (2006) (section 5(a) bans the sale of securities unless a registration statement is in effect as to the offering; section 5(c) bars the offering of securities until the registration statement has been filed with the SEC).

8. *See* Bradford, *supra* note 3, at 6 (discussing how entrepreneurs seeking funding will often be selling securities that require registration or an exemption under the federal securities laws).

9. *See infra* Part III(B).

10. *See* Bradford, *supra* note 3, at 6 (“The current exemptions from the registration requirement . . . do not fit crowdfunding well.”).

11. *Id.* at 89 (predicting a future statutory crowdfunding exemption).

Section V, I address the arguments supporting a crowdfunding exemption. Finally, in Section VI, this Note explains the flaws of the proposed exemption passed by the House of Representatives.

II. WHAT IS CROWDFUNDING?

A. Generally

“Crowdfunding” is a term describing a new twist on a relatively old practice of raising money. In the broadest sense, crowdfunding “is used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal.”¹² The “new twist” is that crowdfunding now can involve raising capital over the Internet, giving fundraisers access to exponentially more contributors of capital. Internet-based crowdfunding has been utilized in a variety of situations, such as funding political campaigns, charities, and art projects.¹³ For example, President Barack Obama used “advanced crowdfunding” during the 2008 presidential election, raising over \$100 million from small contributions.¹⁴ Although various people and organizations can use crowdfunding, this Note focuses on Internet-based crowdfunding used in business, specifically by small start-up companies.

As the poor economy has made accessing capital even more difficult, many small businesses are looking for viable alternatives to traditional lending.¹⁵ In response, various crowdfunding websites have privately developed platforms for entrepreneurs to raise money through crowdfunding. Websites such as ProFounder and Kiva help entrepreneurs tap into the crowdfunding market.¹⁶ One can think of

-
12. *Crowdfunding Hearing*, (written statement of Meredith B. Cross, Dir. Div. of Corp. Fin., S.E.C.) available at <http://www.sec.gov/news/testimony/2011/ts091511mbc.htm>.
 13. *See Crowdfunding Hearing*, *supra* note 2, at 2 (opening statement of Representative McHenry) (providing background on crowdfunding).
 14. *See id.* (describing an example of large-scale crowdfunding).
 15. John Tozzi, *Entrepreneurs Turn to Alternative Finance*, BLOOMBERG BUSINESSWEEK (Sept. 1, 2009, 10:50 AM), http://www.businessweek.com/smallbiz/content/sep2009/sb2009091_103601.htm (describing banks constricting their lending after the credit crash, leaving entrepreneurs “shut out of traditional loans and even credit cards. . .”).
 16. *See How It Works*, PROFOUNDER, <https://www.profounder.com/how-it-works> (last visited Nov. 10, 2011) (outlining the necessary steps for an entrepreneur to obtain financing for a project); *See also How Kiva Works, the Long Version*, KIVA, <http://www.kiva.org/about/how/even-more> (last visited Nov. 1, 2011) (describing the borrowing and lending functions of the website).

crowdfunding as posting a classified advertisement on a website like Craigslist.com. However, instead of advertising a used bicycle, an entrepreneur advertises a business concept and requests funding from interested parties. The creator of Profounder described her website as one by which “entrepreneurs come to our platform, create[] a pitch, [and] create[] their term sheets.”¹⁷ Usually the pitch is in the form of a business plan, detailing the business’s goods or services and the entrepreneur’s plans for using the money.¹⁸ The term sheets inform the contributor what, if anything, he will receive in return for his capital contribution.¹⁹

Crowdfunding websites display the business plan/funding requests on their site, where anyone with an Internet connection can view them.²⁰ If a viewer likes a pitch or business plan, he “can contribute anything from a few dollars to the total amount the entrepreneur is seeking.”²¹ The contribution is made over the Internet, and the exchange of funds between the contributor and the entrepreneur is facilitated by the crowdfunding website, which acts as an intermediary between the two parties.²²

As society grows more comfortable with Internet transactions, the world of crowdfunding is rapidly expanding. Since 2005, one crowdfunding website has facilitated funding for over 600,000 entrepreneurs.²³ A study found that the median amount raised on that website for each entrepreneur was \$28,583.²⁴ Many supporters of crowdfunding tout the “small” amounts raised as an indication of low risk,²⁵ but this argument overlooks statistical outliers. Some

-
17. *Crowdfunding Hearing*, *supra* note 2, at 22 (statement of Dana Mauriello, Profounder founder).
 18. *See* Bradford, *supra* note 3, at 10 (describing crowdfunding).
 19. *Id.*
 20. *Id.* at 5.
 21. *See id.* at 10 (describing how investors find crowdfunded businesses and the amount they can invest).
 22. *See How Kiva Works*, *supra* note 16; *See also* Bradford, *supra* note 3, at 10 (elaborating on the transfer of funds between investors and entrepreneurs).
 23. *See Statistics*, KIVA, <http://www.kiva.org/about/stats> (last visited Nov. 1, 2011) (listing the latest statistical information regarding Kiva users and loans).
 24. Bradford, *supra* note 3, at 11 (citing Paul Belleflamme, Thomas Lamber, and Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 2 (Jan. 24, 2011), available at <http://ssrn.com/abstract=1836873>).
 25. *See id.* at 81 (discussing the individual investment caps placed on investors under a proposed exemption by the Sustainable Economies Law Center).

entrepreneurs have raised substantial amounts of money; “the largest amount raised in that same study was \$82.1 million.”²⁶

B. What Are the Categories of Crowdfunding?

Even though each funding request is unique, there are five broad, yet distinct, types of crowdfunding differentiated by what the contributor receives from the entrepreneur in exchange for his capital.²⁷ These five categories of crowdfunding are: “(1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.”²⁸

1. The Donation Model

As the name indicates, under the donation model contributors receive nothing for their contribution,²⁹ “not even the eventual return of the amounts they contributed.”³⁰ Although the majority of donation sites are for charities and non-profit institutions, a few websites seek donations for businesses.³¹ However, since the leading crowdfunding websites do not use the donation model, the majority of small businesses will utilize one of the other models.³²

2. The Reward and Pre-Purchase Models

The reward and pre-purchase crowdfunding models are very common and tend to be used together.³³ Under the reward model, businesses give the capital contributor some sort of “reward” other than interest or a percentage of profit.³⁴ The rewards can range from a “thank you” to a “personal assistant/cabana boy for 2 weeks.”³⁵

26. See *id.* at 11 (citing Paul Belleflamme, Thomas Lamber, and Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 2 (Jan. 24, 2011), available at <http://ssrn.com/abstract=1836873>).

27. *Id.* at 14-15 (“One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions . . .”).

28. See *id.* (outlining the five different forms of crowdfunding).

29. See I.R.C. §§ 170, 501(c)(3) (2011) (describing how a contributor may receive a tax deduction if the contributor itemizes and donates to a qualified organization under the Internal Revenue Code).

30. Bradford, *supra* note 3, at 15.

31. See *id.* (describing donation model users).

32. *Id.* at 16.

33. See *id.* (describing that even though the pre-purchase and reward models are distinctly separate, they are typically used together).

34. See *id.* (providing an example of the many types of rewards that entrepreneurs can offer to potential contributors).

35. *Id.* at 18-19.

Under the pre-purchase model, contributors “receive the product that the entrepreneur is making,”³⁶ or “the right to buy the [product] at a reduced price upon completion.”³⁷ For example, when Josh Freese, the former Nine Inch Nails drummer, sought funding for a new album, he offered a combination of reward and pre-purchase benefits to potential contributors.³⁸ If someone contributed \$50 to the new album, they would receive a “CD/DVD set, T-shirt, [and] a ‘[t]hank you’ phone call from Josh.”³⁹ Here, the reward elements are the T-shirt and phone call, and the pre-purchase element is the CD/DVD set.

3. The Lending Model

The lending model of crowdfunding is also quite popular, although it is often referred to as peer-to-peer lending.⁴⁰ In the lending model, contributors loan the entrepreneurs money and expect repayment at the end of a mutually scheduled period.⁴¹ Depending on the crowdfunding site, some contributors receive interest on their loans and others do not.⁴² On the leading peer-to-peer website, Kiva.org, contributors do not receive interest.⁴³ The lending model may involve the sale of securities and conflict with the federal securities laws;⁴⁴ however, that topic is outside the scope of this Note.

4. The Equity Model

“Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund.”⁴⁵ Prior to halting operations, ProFounder was a prominent United States-based equity

36. *Id.* at 16.

37. *Id.*

38. *Id.* at 17-18.

39. *Id.* at 18.

40. *See id.* at 20 (introducing the lending model of crowdfunding, which is an established and popular method of financing entrepreneurs and their projects).

41. *See How Kiva Works*, *supra* note 16 (outlining how the premier lending model crowdfunding site works); *See also* Bradford, *supra* note 3, at 20 (describing generally the lending model of crowdfunding).

42. Bradford, *supra* note 3, at 20.

43. *See How Kiva Works*, *supra* note 16 (noting that not all lending model sites give their contributors interest on the money loaned).

44. *See* 15 U.S.C. § 77b(a)(1) (2006) (stating that “the term ‘security’ means any note...”); *See also* *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (leading case on “notes” as securities).

45. Bradford, *supra* note 3, at 24 (describing the types of returns investors can expect on equity model crowdfunding sites).

crowdfunding website. Its co-founder, Dana Mauriello, testified before the U.S. House of Representatives that her website offered “two term sheet templates, either equity or revenue share.”⁴⁶ Entrepreneurs could decide which term sheet to offer, but Ms. Mauriello said, “It could have been anything that was a security.”⁴⁷ Of all the crowdfunding offerings that give something to the contributor, one-third of them offer stock.⁴⁸ Since the equity model involves offering securities without registering them with the Securities and Exchange Commission (“SEC”), it directly conflicts with the Securities Act of 1933; as such, equity model crowdfunding sites no longer operate in the U.S.⁴⁹ Equity model crowdfunding websites continue to operate outside of the U.S., yet they lack approval from a major securities regulator.⁵⁰ However, that may change as an equity model site called “Seedrs” is currently seeking authorization from Britain’s Financial Services Authority to operate in the United Kingdom.⁵¹ If approved, it would “be the first equity crowdfunding platform anywhere in the world to be expressly approved by a major securities regulator.”⁵²

Although each model presents its own interesting questions, this Note will focus specifically on the equity model. The equity model is the one that clearly involves the sale of securities and is currently in conflict with the registration requirements of the Securities Act of 1933.

46. *Crowdfunding Hearing*, *supra* note 2, at 22 (statement of Dana Mauriello, ProFounder founder) (testifying how her equity model crowdfunding site, ProFounder, allowed entrepreneurs to choose what type of equity return investors would receive).

47. *Id.*

48. *See* Bradford, *supra* note 3, at 24 (describing how many crowdfunding offerings offer stock as opposed to some other form of equity).

49. *See* Bradford, *supra* note 3, at 25 (introducing why there is a need for a crowdfunding exemption under the securities laws).

50. *See* Bradford, *supra* note 3, at 24 (“Because of the regulatory issues it raises, the equity crowdfunding model is not common in the United States. Equity crowdfunding is more common elsewhere, however.”).

51. *See Crowdfunding Hearing*, *supra* note 2, at 36 (opening statement of Jeff Lynn, Seedrs founder).

52. *Id.*

III. SECURITIES REGISTRATION UNDER THE SECURITIES ACT OF 1933

The Securities Act of 1933 (hereinafter the “33 Act”) primarily regulates the process companies use to offer securities to the public.⁵³ Subject to certain exemptions, the ‘33 Act makes it “unlawful for any person . . . to offer to sell or offer to buy . . . any security, unless a registration statement has been filed as to such security.”⁵⁴

A. *Historical Context*

The ‘33 Act⁵⁵ was the first federal securities regulation in the United States, enacted as part of the New Deal in response to the 1929 Wall Street crash.⁵⁶ The 1929 Wall Street crash involved a large number of “fraudulently floated securities,” and the congressional hearings that led to the Act were filled with examples of “outrageous conduct by securities promoters.”⁵⁷ The ‘33 Act was considered the “first federal consumer protection statute,”⁵⁸ and it focused on disclosure to investors.⁵⁹ The ‘33 Act’s underlying philosophy came from Justice Louis D. Brandeis’s famous statement that “sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”⁶⁰ Congress shared Brandeis’s view, as it established a framework of full disclosure in the ‘33 Act, thereby letting the sunlight “shine in” on prospective securities offerings.⁶¹ “The theory

53. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 15 (Thompson West ed., rev. 5th ed. 2006) (establishing the regulatory framework for securities).

54. 15 U.S.C. § 77e(c) (2006) (describing the necessity of filing a registration statement).

55. The Act is often referred to as the “Truth in Securities Act.” *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/laws.shtml> (last visited Mar. 10, 2012).

56. HAZEN, *supra* note 53, at 21 (describing the historical context in which the ‘33 Act was passed).

57. *Id.*

58. Marilyn B. Cane & Peter-Ferola, *Back to the Future the States’ Struggle to Re-Emerge as Defenders of Investors’ Rights*, 5 U.C. DAVIS BUS. L.J. 15 (2005) (citing THOMAS LEE HAZEN, *FEDERAL SECURITIES LAW* 1 (Federal Judicial Center 2d ed. 2003)).

59. HAZEN, *supra* note 53, at 21 (“Instead, under the guidance of a federal agency, the Act focuses on disclosure. The focus on disclosure was based on the conclusion that sunlight is the best disinfectant.”).

60. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY: AND HOW THE BANKERS USE IT* 92 (Frederick A. Stokes Co. 1914).

61. HAZEN, *supra* note 53, at 21 (describing how the ‘33 Act’s framework is “based on the conclusion that sunlight is the best disinfectant”).

behind the federal regulatory framework is that investors are adequately protected if all relevant aspects of the securities being marketed are fully and fairly disclosed.”⁶² Moreover, such “information enables investors, not the government, to make informed judgments about whether to purchase a company’s securities.”⁶³ One of the foundational ideas is that investors should be able to make “their own evaluations of available investments,” which eliminates the “more costly and time-consuming governmental merit analysis of the securities being offered.”⁶⁴

B. Registration Requirements Under Section 5(c)

The key provision requiring registration of securities is found in section 5(c) of the ‘33 Act. Essentially, section 5(c) makes it illegal for someone to buy or sell any security unless (1) a registration statement has been filed for the particular security’s offering,⁶⁵ or (2) a registration exemption applies. Thus, companies wanting to use equity crowdfunding to raise money have two options: (1) register their securities with the SEC, or (2) issue securities under one of the applicable exemptions. Although this seems like a simple decision, neither option is feasible for the majority of small businesses.

The main reason registering crowdfunded securities is not a viable option is that it is too expensive. As commentators note, the cost of registering a securities offering is prohibitive for many small businesses.⁶⁶ Typical registration expenses include the SEC registration fee, the Financial Industry Regulation Authority (FINRA) filing fee, accounting fees and expenses, legal fees and expenses, and printing/engraving expenses.⁶⁷ Further, there is usually a significant discount paid to the underwriters marketing the issued securities.⁶⁸ The total expense of registering a securities offering can

62. *Id.* at 22 (describing the underlying theory of full disclosure and why it is embodied in the federal securities registration requirements).

63. *The Laws That Govern the Securities Industry*, *supra* note 55.

64. HAZEN, *supra* note 53, at 22 (indicating that when federal regulators analyze securities offerings they focus on full disclosure, not merit, of the underlying business).

65. See 15 U.S.C. § 77e(c) (2006).

66. Marvin R. Mohney, Note, *Regulation D: Coherent Exemptions for Small Businesses Under The Securities Act of 1933*, 24 WM. & MARY L. REV. 121, 123 (1982); See also Bradford, *supra* note 3, at 42 (“Unfortunately, registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital.”).

67. See GNC Holdings Inc., Registration Statement Under the Securities Act of 1933 (Form S-1) (Mar. 1, 2012) (listing its registration expenses).

68. Henry Blodget, *ZipCar’s IPO Underwriters Just Screwed the Company to the Tune of \$50 Million*, BUS. INSIDER (Apr. 14, 2011) <http://articles.businessinsider.com/2011-04->

easily exceed \$100,000,⁶⁹ while the SEC registration fee and FINRA filing fees alone can cost upwards of \$85,000.⁷⁰ Moreover, such costs do not even take into account the time spent “by the company’s own employees in preparation for registration.”⁷¹ The median amount raised through crowdfunding is \$28,583; thus, for most crowdfunded ventures the costs of registering the securities would eclipse the amount of money raised.⁷² As such, the registration process is not a feasible option for the majority of businesses looking to use equity crowdfunding.

C. Applicable Exemptions from the Registration Requirements

Since registration with the SEC is not economically viable for equity crowdfunding, entrepreneurs will look to the applicable registration exemptions. Sections 3 and 4 of the ‘33 Act carve out registration exemptions for a variety of securities and transactions, saving a company from the costs of SEC registration.⁷³ The most applicable registration exemptions for equity crowdfunding are: the statutory private placement exemption under section 4(2) of the ‘33 Act, and Rules 504, 505, or 506 of Regulation D.⁷⁴

1. § 4(2) Private Placement Exemption

Section 4(2)’s private placement exemption is “the most widely used statutory exemption” under the ‘33 Act.⁷⁵ Section 4(2) exempts “transactions by an issuer not involving any public offering” from the registration requirements of section 5.⁷⁶ The key distinction is whether an offering is considered a “public offering.”

14/news/29964429_1_zipcar-ipo-price-goldman-clients (discussing the discount the underwriters of ZipCars received and how it totaled \$50 million).

69. See GNC Holdings Inc., *supra* note 67 (listing a total of \$680,000 in securities registration expenses).

70. See Dunkin’ Brands Group, Inc., Registration Statement Under the Securities Act of 1933 (Form S-1) (May 4, 2011) (listing \$46,440 for SEC registration fee and \$40,500 for FINRA filing fee).

71. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 24 (2001).

72. See *infra* Part II(a).

73. See 15 U.S.C. §§ 77c-77d (2006) (stating registration exemptions).

74. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 912 (2011) (detailing which exemptions under the ‘33 Act are possible for companies engaging in crowdfunding).

75. Mohney, *supra* note 66, at 124.

76. 15 U.S.C. § 77d(2) (2006).

Unfortunately, the definition of “public offering” is unclear, as it “is not defined in [the ‘33 Act] or in [the] SEC rules under the statute.”⁷⁷ Initially, it would seem that the distinction turns on the number of people offered the security; however, the Supreme Court in the seminal case *S.E.C. v. Ralston Purina Co.* drew a different distinction.⁷⁸ The Court looked to the “statutory purpose” of the ‘33 Act and stated, “the applicability of §4(1) should turn on whether the particular class of persons affected needs the protection of the Act.”⁷⁹ If an offering is made to persons who are “able to fend for themselves,” then it is considered non-public, because such persons do not need the protection of the ‘33 Act registration requirements.⁸⁰

“*Ralston Purina* and its progeny have established two overarching factors that indicate whether offerees are able to ‘fend for themselves,’”⁸¹ thereby making the offering non-public. The first factor is that “no offeree needs the protection that registration affords.”⁸² This factor focuses on the knowledge, or sophistication, of the potential investors.⁸³ According to the SEC, potential investors are considered sophisticated enough for this exemption if they have “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment.”⁸⁴ The rationale behind this factor is that sophisticated investors can “fend for themselves” if they have access to the right information.⁸⁵ As such, the second factor is whether potential investors have “access to the kind of information which registration would disclose.”⁸⁶ The Court in *Ralston Purina* said that each investor must have “access to the same kind of information that the [‘33 Act] would make available in the form of a registration

77. Heminway & Hoffman, *supra* note 74, at 912.

78. 346 U.S. 119 (8th Cir. 1953) (rejecting the SEC’s recommendation that the exemption include a quantity factor).

79. *Id.* at 125.

80. *Id.*

81. Heminway & Hoffman, *supra* note 74, at 914.

82. J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 §11.03[1] (West Group 1st ed. 2001)

83. Potential investors are often referred to as “offerees.” *See id.* at § 11:55 (discussing how an issuer “must prove, among other things, that all of its offerees are sophisticated”).

84. 17 C.F.R. § 230.506 (1982).

85. Heminway & Hoffman, *supra* note 74, at 914 (“where the offerees ‘are shown to be able to fend for themselves,’ they do not need the protection of the [‘33 Act] registration requirement . . . ” (citation omitted)).

86. *Ralston Purina Co.*, 346 U.S. at 127.

statement.”⁸⁷ Thus, most courts have interpreted this to mean that “section 4(2) requires an issuer to make available information ‘similar’ to, ‘the factual equivalency of,’ or . . . the ‘sort’ or ‘kind,’ which would have been found in a registration statement.”⁸⁸

Both of the aforementioned factors ‘sound the death knell’ for businesses hoping to use the private placement exemption for equity crowdfunding. First, it would be very difficult for crowdfunding websites to verify and ensure that all individuals visiting the site meet the requisite sophistication levels. Some crowdfunding proponents have suggested implementing a quiz to gauge visitors’ financial and business sophistication; then, only those who pass the quiz would receive access to the crowdfunding website.⁸⁹ In theory the quiz idea sounds promising; however, it is impractical. Even the most unsophisticated investors facing an at-home online quiz will find a way to pass, be it through “Googling” the answers or having someone take the quiz for them; the results will not reflect their true level of financial and business knowledge. Such a quiz will not be adequate to keep out unsophisticated investors that need the ‘33 Act’s protection.

Even if a quiz is found adequate to exclude unsophisticated investors, the cost of complying with the “access to information” factor is prohibitively high. Since investors must have access to the same type of information found in a registration statement, “the costs associated with providing the appropriate level of information to offerees over the Internet . . . are high in relation to the benefit sought, which in most cases is a relatively small amount of funding.”⁹⁰

Moreover, the most prohibitive language under § 4(2)’s private placement exemption is the restriction on public solicitation or advertising. The SEC has indicated that any “public advertising of the offerings would, of course, be incompatible with a claim of private offering.”⁹¹ Yet, crowdfunding relies on public solicitation and advertising to draw in the “crowd” of investors.⁹² The whole point of utilizing the Internet is that it allows entrepreneurs to advertise their

87. *Id.* at 125-26.

88. HICKS, *supra* note 82, at § 11:108 (citing *Koehler v. Pulvers*, 614 F. Supp. 829, 842 (S.D. Cal. 1985); *Bayoud v. Ballard*, 404 F. Supp. 417, 423 (N.D. Tex. 1975); *Parvin v. Davis Oil Co.*, 524 F.2d 112, 118 (9th Cir. 1975); *Van Dyke v. Coburn Enters, Inc.*, 8973 F.2d 1094, 1098 (8th Cir. 1989)).

89. *See Crowdfunding Hearing*, *supra* note 2, at 98 (statement of Lynn, Seedrs founder) (discussing the quiz that investors will have to take in order to invest on Seedrs).

90. Heminway & Hoffman, *supra* note 74, at 916.

91. Non-Public Offering Exemption, Sec. Act Release No. 33-4552, 1962 WL 69540, 2 (Nov. 6, 1962).

92. *See supra* Part II(A).

business and solicit investments from anyone in the world.⁹³ As such, an issuance of securities through crowdfunding would be in direct violation of the restriction on public solicitation and advertising; thus, it would be considered a public offering⁹⁴ and render the private placement exemption inapplicable.

2. Regulation D: Rules 504, 505, and 506

Through the '33 Act, Congress empowered the SEC to adopt additional exempted securities if the SEC found that enforcing registration was unnecessary to protect investors and the public interest.⁹⁵ As such, the SEC enacted Regulation D, which is a set of rules that "provide exemptions principally for small [securities] issues and small issuers."⁹⁶ The Regulation D exemptions are found in Rules 504, 505, and 506.⁹⁷ Rules 504 and 505 were adopted to fit under section 3(b) of the '33 Act, which allows for exemptions of public offerings up to \$5 million.⁹⁸ Rule 506 is a safe harbor for private placement offerings under section 4(2) of the '33 Act, and it does not restrict the size of the offering.⁹⁹ There are two important characteristics that are common to all three rules, except in limited circumstances under Rule 504: (1) the securities offered under these exemptions are considered restricted securities, meaning that they "cannot be resold absent registration or the availability of an applicable exemption;" and (2) "issuers and their agents may not offer or sell securities under Regulation D using 'any form of general solicitation or general advertising.'"¹⁰⁰

93. *See supra* Part II(A).

94. HICKS, *supra* note 82, at § 11:134 (discussing how mass advertising/solicitation to people with no pre-existing relationship to the offeror violates the prohibition on general solicitation or advertising, and it does not matter if all of the offerees are accredited investors (citing Kenman Corp., Exchange Act Release No. 21962 (April 19, 1985), [1984-1985 Transfer Binder] CCH Fed. Sec. L. Rep. ¶83,767)).

95. *See* 15 U.S.C. § 77c(b) (2006) (stating that registration enforcement may not be necessary because of the "small amount involved or the limited character of the public offering").

96. Heminway & Hoffman, *supra* note 74, at 916.

97. *Regulation D Offerings*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/regd.htm> (last visited Mar. 4, 2012).

98. *See* 15 U.S.C. § 77c(b) (2006).

99. *See* HICKS, *supra* note 82, at § 11:24 (describing how an issuer can rely on the requirements of the rule instead of the interpretations of section 4(2) and what is considered a non-public offering).

100. Heminway & Hoffman, *supra* note 74, at 916.

i. Rule 504

Rule 504 exempts up to \$1,000,000 of securities sold within a twelve-month period.¹⁰¹ Under this Rule, there are no restrictions on the number of people that can be offered the securities.¹⁰² Further, there are no affirmative disclosure requirements,¹⁰³ unless issuers want to sell freely tradable securities.¹⁰⁴

Rule 504 seems like the perfect exemption for equity crowdfunding; however, the Rule still subjects crowdfunding to general solicitation and advertising restrictions,¹⁰⁵ which are in direct conflict with its fundamental nature.¹⁰⁶ The only exception to the general solicitation restriction “is if the Rule 504 offering is subject to state registration requirements or sold pursuant to a state exemption that limits sales to accredited investors.”¹⁰⁷ Yet, both exceptions are prohibitively expensive in their own regard.

Registering a 504 offering at the state level could be extremely expensive for many of the same reasons it is when registering with the SEC.¹⁰⁸ As discussed in Part III(B), formally registering a securities offering is prohibitively expensive for most businesses that would utilize crowdfunding.¹⁰⁹ In regards to the second exception, limiting a crowdfunding offering to accredited investors takes away the “power of the crowd” that makes crowdfunding work. Generally, accredited investors are institutional investors or individuals with a high net-worth/annual income.¹¹⁰ An individual accredited investor is someone with: (1) a net-worth of \$1 million, excluding the value of the person’s primary residence; or (2) an annual income exceeding \$200,000 for the past two years and “a reasonable expectation of the same income level

101. *Rule 504 of Regulation D*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/rule504.htm> (last visited Mar. 4, 2012) (introducing the purpose of a Rule 504 exemption).

102. *See id.* (describing generally the lowered restrictions and requirements under a Rule 504 exemption).

103. *See id.*

104. *See id.*

105. *See id.*

106. *See supra* text accompanying notes 95 and 98.

107. Bradford, *supra* note 3, at 47.

108. *See* Heminway & Hoffman, *supra* note 74, at 920 (“[T]he cost of complying with multiple state laws [in registering a 504 offering] could be high, if not prohibitive.”).

109. *See* Bradford, *supra* note 3, at 48.

110. *See Accredited Investors*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/accred.htm> (last visited Mar. 4, 2012) (providing a list of accredited investors as defined by federal securities laws).

in the current year.”¹¹¹ Limiting crowdfunding offerings to such individuals takes away the majority of prospective investors,¹¹² handicapping the model’s impact and reach. Since neither exception works for crowdfunding, it would still be subject to the restrictions on solicitation and advertising, rendering the Rule 504 exemption useless.

ii. Rule 505

Rule 505 exempts up to \$5,000,000 of securities sold within a twelve-month period.¹¹³ This exemption allows an issuer to “sell to an unlimited number of accredited investors and up to thirty-five other persons who do not need to satisfy the sophistication or wealth standards.”¹¹⁴ The rule requires that the issuer give non-accredited investors disclosure documents similar to those used in registered offerings.¹¹⁵ Further, like the other exemptions, issuers may not use general solicitation or advertising to sell the securities.¹¹⁶ For the same reasons discussed in the previous sections, the restriction on general solicitation and advertising is fatal to crowdfunding.¹¹⁷ Also, limiting the investment pool to accredited investors and thirty-five non-accredited investors severely weakens the “power of the crowd” that is crucial to the crowdfunding model of raising money.¹¹⁸ As such, Rule 505 is also useless to those issuing securities through equity crowdfunding.

111. *Id.*

112. Approximately 1% of Americans would be considered accredited investors. See Robert Frank, *U.S. Has Record Number of Millionaires*, WALL ST. J. (June 22, 2011, 10:30 AM), <http://blogs.wsj.com/wealth/2011/06/22/u-s-has-record-number-of-millionaires/> (listing the number of Americans with net worth of over \$1,000,000); See also *Americans Making More than \$250,000*, ANNENBERG PUB. POLICY CTR., (Apr. 20, 2008), <http://www.factcheck.org/2008/04/americans-making-more-than-250000/> (listing the number of Americans making more than \$250,000).

113. *Rule 505 of Regulation D*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/rule505.htm> (last visited Feb. 15, 2012) (outlining the key purposes of Rule 505 of Regulation D).

114. *Id.*

115. *Id.* (“[C]ompanies must give non-accredited investors disclosure documents that generally are equivalent to those used in registered offerings.”).

116. See *id.*

117. See *supra* text accompanying notes 95 and 98.

118. See *supra* text accompanying notes 114-16.

iii. *Rule 506*

Rule 506 exempts an unlimited amount of securities sold, and is a “safe harbor” for the section 4(2) private placement exemption discussed in Part III(C)(1).¹¹⁹ Similar to Rule 505, Rule 506 limits the number of non-accredited investors to thirty-five and requires affirmative disclosures to such investors.¹²⁰ However, Rule 506 goes further and imposes sophistication requirements on the thirty-five non-accredited investors.¹²¹ The non-accredited investors, “either alone or with a purchaser representative . . . must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.”¹²² Moreover, Rule 506 prohibits the use of general solicitation and advertising.¹²³ Therefore, for all of the same reasons as the previous Rules, Rule 506 is useless to securities issued under the crowdfunding model.¹²⁴

Thus, the current state of the ‘33 Act and its exemptions make equity crowdfunding essentially inoperable in the United States, as entrepreneurs using crowdfunding are prohibited from taking money from the masses and issuing securities in return.¹²⁵

IV. WHY CROWDFUNDING SHOULD NOT RECEIVE AN EXEMPTION

Given that the equity model of crowdfunding conflicts with the registration requirements of the ‘33 Act, there has been a recent political push to create an exemption for crowdfunded securities. On September 8, 2011, President Barack Obama unveiled the American Jobs Act, which some have characterized as an “ambitious plan to

119. See HICKS, *supra* note 82, at § 11:24 (describing how an issuer can rely on the requirements of the rule instead of the interpretations of section 4(2) and what is considered a non-public offering).

120. *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/rule506.htm> (last visited Feb. 18, 2012) (discussing key provisions of Rule 506).

121. *See id.*

122. *Id.*

123. *Id.* (“The company cannot use general solicitation or advertising to market the securities.”).

124. *See supra* text accompanying notes 95 and 98 (discussing how crowdfunding is incompatible with both private and public offerings).

125. Equity crowdfunding could be used in the United States, however, the website would have to restrict access to accredited investors. As previously discussed, such a system is not ideal because it does not harness the full power of the crowd. *See supra* text accompanying notes 115-116 (discussing how the Rule 504 exemption is rendered useless).

create jobs across the country and [] put more money in the pockets of American workers and businesses.”¹²⁶ Included in the President’s plan is a call for “boosting access to capital for high-growth companies.”¹²⁷ President Obama specifically mentioned that something should be done to responsibly allow entrepreneurs to raise money through crowdfunding.¹²⁸ Days later, on September 14, 2011, Representative McHenry introduced a bill, H.R. 2930, into the House “to amend the securities laws to provide for registration exemptions for certain crowdfunded securities.”¹²⁹ As will be explained, such an exemption for crowdfunded securities under the ‘33Act is flawed in both theory and fact.

A. *Flawed In Theory*

Beyond the specifics enumerated in H.R. 2930, the general idea of exempting crowdfunding should cause pause, not only to those at the SEC, but also to mainstream America. People quickly forget how new the Internet really is, and that largely, it remains the modern day “wild west.” The Internet is certainly a blessing in many regards, but it lacks systematic regulation and established legal precedent. An exemption for equity model crowdfunding would likely open the door for massive fraud, leave investors with virtually no protection, and undermine the very purpose of the ‘33 Act.

1. Massive Fraud

Unfortunately, the Internet and fraud tend to go hand-in-hand, and this will only become more apparent if equity crowdfunding receives a registration exemption. Most people have heard of cyber-crime and Internet fraud,¹³⁰ and such activity is only becoming more

126. Aneesh Chopra & Tom Kalil, *The President’s American Jobs Act: Fueling Innovation and Entrepreneurship*, THE WHITE HOUSE (Sept. 8, 2011, 11:20 PM), <http://www.whitehouse.gov/blog/2011/09/08/president-s-american-jobs-act-fueling-innovation-and-entrepreneurship> (discussing the unveiling of the American Jobs Act).

127. *The American Jobs Act*, *supra* note 1 (discussing how President Obama will help entrepreneurs and small businesses access capital and grow).

128. Chopra & Kalil, *supra* note 126 (detailing how heightened access to crowdfunding is a goal of the American Jobs Act).

129. *See* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (as reported by H. Comm. on Fin. Servs., Sept. 14, 2011).

130. *See* James Marson, *Small Victory in the Fight Against Global Cybercrime*, TIME BUS. (June 21, 2010), <http://www.time.com/time/business/article/0,8599,1998055,00.html> (describing scareware: “one of the fastest-growing and most prevalent types of Internet fraud”); *See also* Michael Rothfeld, *D.A. Cracks Down on Internet Crime*, WALL ST. J., Dec. 30, 2011, at A17 (The Manhattan District Attorney stated that

prevalent. The Assistant Director of the Federal Bureau of Investigation's ("FBI") Cyber Division, Gordon Snow, testified before the Senate, "It is difficult to overstate the potential impact [cyber] threats pose to our economy, our national security, and the critical infrastructure upon which our country relies."¹³¹ Further, "the number and sophistication of cyber attacks has increased dramatically over the past five years and is expected to continue to grow."¹³² An exemption for equity crowdfunding would likely create another opportunity for cyber criminals to take advantage of innocent citizens, compounding an already worsening situation.

History often provides the best lessons for dealing with current problems; however, it seems the Obama Administration has either forgotten, or ignored, the massive amounts of securities fraud conducted via the Internet during the mid-1990s. In 1992, the SEC sought to "facilitate capital raising by small businesses by reducing the compliance burdens placed on those companies by the federal securities laws."¹³³ Specifically, the SEC wanted to reduce the burden of complying with the '33 Act's registration requirements, so it revised the Rule 504 exemption under Regulation D to "eliminate[] all restrictions on the manner of offerings and on resales under Rule 504."¹³⁴ The SEC's revision to Rule 504 allowed "a non-reporting company [to] offer up to \$1,000,000 of securities in a twelve-month period and be subject only to the antifraud provisions and other civil liability provisions of the federal securities laws."¹³⁵ One of the main revisions was that issuers could use general solicitation and advertising in offering their securities.¹³⁶ Unbeknownst to the SEC at the time, this revision fostered massive securities fraud using the Internet.

After the revision to Rule 504 in 1992, there were numerous cases of securities fraud.¹³⁷ One of the main categories of Internet securities

"cybercrime is just, put simply, among the most prevalent crimes that are confronting the office.").

131. Gordon M. Snow, *Statement Before the Senate Judiciary Committee, Subcommittee on Crime and Terrorism*, FED. BUREAU OF INVESTIGATION (Apr. 12, 2011), available at <http://www.fbi.gov/news/testimony/cybersecurity-responding-to-the-threat-of-cyber-crime-and-terrorism>.

132. *Id.*

133. Revision of Rule 504 of Regulation D, The "Seed Capital" Exemption, 63 Fed. Reg. 102, 29170 (proposed May 28, 1998).

134. *Id.*

135. *Id.*

136. *Id.*

137. See *id.* (discussing the significant number of allegations of fraud involving microcap companies).

fraud involved “pump and dump” schemes.¹³⁸ Pump and dump schemes involved the stock of “microcap” companies, which are “characterized by thin capitalization, low share prices, limited public information and little or no analyst coverage.”¹³⁹ Schemers would purchase the microcap stocks at extremely low prices and promote them “over the Internet through the use of unsolicited email ‘spam,’ chat rooms, bulletin boards, investment websites, or investment newsletters.”¹⁴⁰ These promotion (“pump”) efforts would temporarily drive up the stock prices, at which point the promoters would sell (“dump”) the stocks to unsuspecting investors in the secondary market.¹⁴¹ The promoter would make a huge profit at the expense of other investors; the promotion materials often involved misrepresentations of the microcap stock, and subsequently the price would crash after the promoter dumped his position, leaving investors with virtually nothing.¹⁴² This type of scheme was facilitated because the SEC removed, among other things, the restriction on general solicitation and advertising.¹⁴³

In response to rampant pump and dump schemes, the SEC made another revision to Rule 504 in 1998; however, this time it increased the restrictions on Rule 504 offerings to their pre-1992 levels.¹⁴⁴ The SEC seemed to realize that the cost of fraud outweighed the benefit of easing capital formation for small businesses. The lesson that the SEC learned in the mid-1990s is one that our current congressional representatives should take to heart, especially since it involves the same policy concerns about small businesses’ access to capital. Moreover, an exemption for crowdfunding will likely have the same unintended consequence of creating massive fraud over the Internet.

138. Constance Z. Wagner, *Securities Fraud in Cyberspace: Reaching the Outer Limits of the Federal Securities Laws*, 80 NEB. L. REV. 920, 922 (2001) (outlining the basics of pump and dump schemes).

139. Revision of Rule 504 of Regulation D, The “Seed Capital” Exemption, 63 Fed. Reg. 102, 29169 (proposed May 28, 1998).

140. Wagner, *supra* note 138, at 922.

141. *See id.* (discussing how such activity could involve fraud “if the promoter makes material misrepresentations . . .”).

142. *Pump and Dump Schemes*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/pumpedump.htm> (last visited Mar. 1, 2012).

143. *See* Revision of Rule 504 of Regulation D, The “Seed Capital” Exemption, 63 Fed. Reg. 102, 29169 (proposed May 28, 1998) (stating that “general solicitation and general offerings are permitted for all Rule 504 offerings.”).

144. *See id.* at 29170 (imposing resale restrictions on securities issued under Rule 504).

As oft stated, “Those who cannot remember the past are condemned to repeat it.”¹⁴⁵

2. Inadequate Investor Protection

Many proponents of equity crowdfunding have advocated for an exemption from the federal and state registration requirements, arguing that the nature of crowdfunding makes compliance with the regulations economically infeasible.¹⁴⁶ Commentators argue the cost of registering with the SEC is too expensive for entrepreneurs who are raising small amounts of money.¹⁴⁷ Further, since modern crowdfunding is Internet-based, many of the offerings would be subject to the registration requirements of multiple states, compounding the expense associated with registration compliance.¹⁴⁸ However, exempting crowdfunding from the federal and state registration requirements takes away the majority, if not all, of the investor protections under the securities laws.¹⁴⁹

A crowdfunding exemption would eliminate the strongest level of investor protection. Generally speaking, securities laws protect investors in two ways: (1) registration requirements that impose mandatory disclosures; and (2) anti-fraud laws.¹⁵⁰ The registration prong is arguably the strongest level of investor protection.¹⁵¹ Within that prong, there are state registration requirements (also known as Blue Sky laws) and federal registration requirements.¹⁵² The state registration requirements vary, but some can have “a significant

-
145. GEORGE SANTAYANA, *THE LIFE OF REASON OR THE PHASES OF HUMAN PROGRESS: REASON IN COMMON SENSE* 284 (2nd ed., Charles Scribner's Sons, 1905).
146. See 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, 974 (2011) (stating how the SEC's “current rules are too restrictive and choke off nascent business with overregulation”).
147. See *id.*; See also *Community Enterprise*, SUSTAINABLE ECON. L. CTR., <http://www.thesec.org/programs/community-supported-entrepreneurship/> (last visited Mar. 1, 2012).
148. Heminway & Hoffman, *supra* note 74, at 920 (arguing that “the cost of complying with multiple state laws could be high, if not prohibitive”).
149. See *id.*
150. Interview with David Porter, Visiting Professor, Case W. Res. Univ. School of Law, in Cleveland, Ohio (Oct. 26, 2011); see also LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 28-30 (Aspen Publishers, 5th ed. 2004).
151. Porter, *supra* note 150.
152. See LOSS & SELIGMAN, *supra* note 150, at 9-15, 93 (describing state and federal adoption of Blue Sky laws).

impact on regulating fraudulent transactions.”¹⁵³ Additionally, “[u]nlike the federal securities regulation, state securities acts generally permit a merit analysis of the investment before certain securities can be offered for sale within that state’s borders.”¹⁵⁴ As such, state regulators can evaluate the substance of a business and its prospects for the future and thus can effectively vet out fraudulent or pipe dream offerings.¹⁵⁵ The federal registration requirements are uniform in nature, yet they do not provide for a merit evaluation of the securities offered.¹⁵⁶ Rather, the federal registration laws focus on full disclosure and SEC verification of key information, so investors have adequate information to make investing decisions.¹⁵⁷

The second, and arguably weaker, level of protection comes from the state and federal anti-fraud provisions. If Congress creates a crowdfunding exemption, the registration protections will be eliminated and the only investor protection will come from the anti-fraud provisions, which alone are wholly inadequate to deal with the type of fraud that will likely be perpetrated through crowdfunding.¹⁵⁸

i. Post Facto Enforcement

First, the anti-fraud provisions only allow private actors or the SEC to sue after the fraud has occurred.¹⁵⁹ The anti-fraud laws do not contain provisions for fraud prevention, because arguably that is the role of the state and federal registration requirements.¹⁶⁰ The mere existence of anti-fraud provisions does have some deterrent effect on bad actors, but if the registration requirements are

153. HAZEN, *supra* note 53, at 330.

154. *Id.*

155. See LOSS & SELIGMAN, *supra* note 150, at 14-15 (discussing how a coordination procedure is “achieved without sacrificing the traditional regulatory philosophy of the states to the disclosure philosophy of the federal statute.”).

156. *Id.* at 35-36 (discussing the competing philosophies of merit analysis and full disclosure, and how the later was ultimately the basis of the ‘33 Act).

157. See *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/laws.shtml#secact1933> (last visited Mar. 1, 2012) (discussing the “truth in securities” law).

158. Porter, *supra* note 150.

159. *Id.*; see also 15 U.S.C. § 77q (2006) (the individual must take some action – “use of any means or instruments” – to deceive or defraud, before the anti-fraud provisions take effect; thus, any enforcement would have to logically come after the person committed a deceitful or fraudulent act).

160. Porter, *supra* note 150.

eliminated, there will be no warning signs for investors.¹⁶¹ To clarify this idea, consider a different crime—murder. Imagine yourself walking down a dark alley in a sketchy neighborhood. Murder statutes have some deterrent effect on the unscrupulous actors lurking in the shadows, but there are warning signs that something bad might happen—the dark alley, the bad side of town, among other things. With securities, you do not have warning signs of fraud without the registration requirements. Instead, you are left with professional salesmen telling you that a particular micro-cap stock is going to be the next Google, and you lack any information with which to assess his truthfulness.

As such, unscrupulous actors will certainly commit fraud, and investors can only hope that the anti-fraud provisions will be there to clean up the mess afterwards. However, this is clearly a flawed strategy. “The key to protecting investors is to be able to act before a fraudulent offering is made, not after the fact when the con artist and the investor’s money have disappeared.”¹⁶² Exempting crowdfunding puts the SEC in a permanent state of “reaction,” limiting its investor protection efforts to situations that have already gone wrong. Such a decision is simply poor public policy.

ii. Lack of Enforcement Resources

Second, the evasiveness of unscrupulous actors on the Internet makes enforcement of the anti-fraud provisions an insurmountable task that the SEC is ill equipped to handle. “As cyber crime groups increasingly recruit experienced actors and pool resources and knowledge, they advance their ability to be successful in crimes against more profitable targets and . . . learn the skills necessary to evade the security industry and law enforcement.”¹⁶³ Combating cyber-crime takes a tremendous amount of resources; as the FBI stated, “one agency cannot combat the threat alone.”¹⁶⁴ The significantly understaffed SEC is certainly not in the position to enforce the anti-fraud provisions against widespread crowdfunding abuse.¹⁶⁵ The SEC could recruit the assistance of other agencies like

161. Porter, *supra* note 150 (Jan. 27, 2012).

162. Marlene Y. Satter, *Crowdfunding Bill Paves Way For Fraud: NASAA, ADVISORONE* (Oct. 28, 2011), <http://www.advisorone.com/2011/10/28/crowdfunding-bill-paves-way-for-fraud-nasaa> (quoting North Am. Sec. Adm’rs Ass’n President Jack Herstein).

163. Snow, *supra* note 131 (demonstrating that cyber criminals are becoming more and more difficult to stop).

164. *Id.*

165. See Ben Protess, *S.E.C. Is Severely Understaffed, Review Finds*, N.Y. TIMES DEALBOOK (Mar. 7, 2011, 11:12 AM),

the FBI; however, those agencies are similarly overloaded. In order to handle its cyber-crime caseload, the FBI had to reach out to “[twenty] law enforcement and intelligence community . . . entities, including the Central Intelligence Agency, Department of Defense, Department of Homeland Security . . . and the National Security Agency.”¹⁶⁶ Although the scope of Internet crimes that the FBI handles is broader than the SEC’s, it still shows the magnitude of resources required to combat cyber threats.

As Professor Mercer Bullard stated before the House Committee on Oversight and Government Reform, “There is no question that any liberalization of the exemption rules will result in some incremental increase in fraud.”¹⁶⁷ It seems preposterous to pass a law that creates an imminent threat, knowing that the Government lacks proper resources to handle it.

iii. Economically Inefficient to Enforce

Even if enforcement resources are increased and unscrupulous actors are caught, most of these types of cases will be economically inefficient to try. Securities fraud cases are difficult to prove because the plaintiff or Government must show that the bad actor had scienter, or intent to defraud.¹⁶⁸ As such, the plaintiff’s bar will not want to take crowdfunding fraud cases because litigation costs will often exceed the amount the investors collectively lost.¹⁶⁹ This will leave the SEC and the Justice Department to bear the full expense of bringing fraudulent actors to trial. Unfortunately, the Government is already spending far beyond its means¹⁷⁰ and is in no position to take on the extra expense of litigating against these fraudulent actors.

<http://dealbook.nytimes.com/2011/03/07/s-e-c-severely-understaffed-review-finds/> (quoting a Bloomberg News report that an SEC internal review concluded that the agency needs to add 400 new employees).

166. Snow, *supra* note 131 (discussing how the FBI partners with other government organizations to fight cyber crime).
167. *Crowdfunding Hearing*, *supra* note 2, at 95 (statement of Mercer Bullard, Assoc. Professor of Law, Univ. of Miss.).
168. See LOSS & SELIGMAN, *supra* note 150, at 1018-31 (explaining that in securities law, ‘scienter’ refers essentially to intent); see also Lyle Roberts, Paul Chalmers & Scott Lowry, Wilson Sonsini Goodrich & Rosati, *Recent Issues In the Pleading of Scienter in Securities Fraud Claims* (2005) (explaining scienter analysis in the context of securities fraud), http://www.wsgr.com/pdfsearch/pleading_of_scienter.pdf (last visited Mar. 5, 2012).
169. Porter, *supra* note 150 (Jan. 27, 2012).
170. *Why it Matters*, FACING UP TO THE NATION’S FINANCES,, <http://www.facingup.org/why> (last visited Mar. 5, 2012) (describing how the United States has amassed a “staggering amount of national debt and unfunded federal liabilities”).

3. Undermines the Purpose of the Securities Act of 1933 and Harms
Those Most in Need of Protection

If Congress exempts crowdfunding from the registration process, it will completely undermine the basic principles of the '33 Act, harming those most in need of its protection. As noted in Part III(A), the '33 Act is considered the "first true consumer protection law," and its focus is on full disclosure.¹⁷¹ The securities laws have always maintained a paternalistic approach to protecting investors without financial sophistication or significant wealth.¹⁷² If an unregistered offering is made to such investors, the federal securities laws place significant restrictions on the size of the offering, promotional methods used, and the transferability of the securities offered.¹⁷³ The paternalistic approach may be an attack on the intelligence of many Americans; however, there is some credibility to the idea, especially since the Bernie Madoff scandal showed that even financially sophisticated and accredited investors can be duped into fraud.¹⁷⁴

An exemption for crowdfunding would take away all meaningful protection for the unaccredited and unsophisticated investor. The only "protection" left for such an investor, besides the anti-fraud provisions, is that he will be capped on the amount that he can invest through crowdfunding. Proposals have placed the individual cap at \$10,000, or 10 percent of income, whichever is less.¹⁷⁵ However, \$10,000 or 10 percent of an individual's income is not a *de minimis* amount, especially for those on the lower rungs of the socioeconomic ladder. Yet, the crowdfunding model depends on middle to lower class investors because they comprise the "crowd" the platforms rely on for numerous contributions.¹⁷⁶ So, an exemption seems to "mak[e] it much easier for scam artists to sell unregistered securities to families living below the poverty line or seniors barely surviving on Social Security."¹⁷⁷ Not only is that bad public policy,¹⁷⁸ it sends the

171. HAZEN, *supra* note 53, at 21 (introducing the '33 Act and briefly explaining the historical circumstances under which it was passed).

172. *Crowdfunding Hearing*, *supra* note 2, at 95 (statement of Mercer Bullard, Assoc. Professor of Law, Univ. of Miss.).

173. *See supra* Part III(C) (discussing the registration exemptions under the '33 Act).

174. For an overview of the Bernie Madoff scandal and the investors affected, *see* Robert Lenzner, *Bernie Madoff's \$50 Billion Ponzi Scheme*, FORBES (Dec. 12, 2008, 6:45 PM), http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in_rl_1212croesus_inl.html.

175. *See* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2 (2011).

176. *See supra* Part II(A).

177. *Crowdfunding Hearing*, *supra* note 2, at 63 (statement of Mercer Bullard, Assoc. Professor of Law, Univ. of Miss.).

message that Congress no longer cares about protecting unsophisticated and unaccredited investors. Such a sentiment completely undermines the very reason that the '33 Act was enacted in the first place.¹⁷⁹

V. COUNTER ARGUMENTS

Despite the enormous risks associated with a registration exemption for equity crowdfunding, there is a strong movement to push through such an exemption. As crowdfunding supporters seem to be perennial optimists, they tend to focus on the possibility that crowdfunding could revolutionize the financial industry. However, when met with skepticism about rampant fraud, they generally defend an exemption using four arguments: (1) crowdfunding's legitimate benefits to society will outweigh the costs of fraud; (2) the Internet community will flush out fraudulent actors; (3) investment caps provide adequate investor protection; and (4) that crowdfunding websites have an incentive to independently drive out fraud.

A. *Redirect and Weigh*

When presented with arguments about potential fraud, crowdfunding supporters respond with the "redirect and weigh," meaning that they avoid addressing the risks of fraud and argue that the benefits of crowdfunding far outweigh the costs. Essentially, their argument is that "the increase in fraud will be offset by the increase in legitimate business activity stimulated by the reduced costs of raising capital for many of our most innovative and productive companies."¹⁸⁰

Setting fraud aside, equity crowdfunding has the potential to jumpstart our economy by closing the gap between small businesses and their access to capital. Currently, small businesses have a tremendously difficult time accessing capital for growth. Institutional investors, like private equity and venture capital firms, reject 99% of the business plans they receive.¹⁸¹ Those institutional investors are focused on what business "has the greatest chance for a 10x return in the shortest period of time," rather than "who will create the majority

178. *Id.*

179. See HAZEN, *supra* note 53, at 21 (discussing disclosure to all investors as a primary reason why the '33 Act was passed).

180. Heminway & Hoffman, *supra* note 74, at 936 (quoting Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPREN. BUS. L.J. 369, 379 (2006)).

181. Bradford, *supra* note 3, at 103 (demonstrating the extreme selectivity of venture capitalists).

of net new jobs.”¹⁸² Often, the same can be said for “angel investors,”¹⁸³ leaving few funding options available for entrepreneurs.

Moreover, a recent study showed that:

[M]ost startups use lines of credit, such as credit cards . . . to finance their businesses. The difficulty with this is twofold: fewer people have access to credit lines or home equity sufficient to start a business. And second, . . . using a credit card with high interest rates . . . makes it tremendously difficult to finance a new business.¹⁸⁴

As such, it is likely that many promising small businesses go unfunded, “costing the [United States] an unknown number of jobs and innovations.”¹⁸⁵ Many proponents believe that equity crowdfunding could help generate “over 500,000 companies and over 1.5 million net new jobs over the next five years”¹⁸⁶ if given an exemption under the ‘33 Act. Indeed, closing the gap between small businesses and available financing could give the economy the boost it needs.

As much as I support economic growth and re-building America from the grassroots, I still do not believe the benefits outweigh the costs of fraudulent actors stealing from the venerable masses. The statistics cited by crowdfunding supporters are speculative at best and they lack credible support. This is not the first time our country has experienced a recession,¹⁸⁷ and it is difficult to see what is so different today that we should be compelled to change eighty years of securities doctrine.

182. *Crowdfunding Hearing*, *supra* note 2, at 45 (statement of Sherwood Neiss, FLAVORx Co-Founder).

183. Bradford, *supra* note 3, at 103 (“So-called ‘angel investors,’ wealthy individuals with substantial business and entrepreneurial experience, . . . often invest on a smaller scale than venture capital firms A typical financing round for an angel investor ranges from \$100,000 to \$2 million.”).

184. *Crowdfunding Hearing*, *supra* note 2, at 2 (statement of Representative McHenry giving insight on the financing difficulties startup businesses often face).

185. Bradford, *supra* note 3, at 100.

186. *Crowdfunding Hearing*, *supra* note 2, at 46 (statement of Sherwood Neiss, FLAVORx Co-Founder).

187. *A History of Recessions*, CNBC (Sept. 4, 2007, 11:09 AM), http://www.cnbc.com/id/20510977/A_History_of_Recessions (citing the National Bureau of Economic Research; indicating that the United States has been through twenty-two recessions since 1902).

B. *Vigilant Internet Crowds*

Another argument crowdfunding supporters raise is that the Internet disseminates information quickly and efficiently, thereby allowing the large web community to “whittle out people committing fraud.”¹⁸⁸ As one supporter stated, “Time and again we see if you make a false move on the Internet it will only take hours before millions of people know about it.”¹⁸⁹ As social media, blogs, and messages boards provide an easy means for Internet communication, it is possible for someone to expose a fraudulent business to the rest of the world by merely posting it on the Internet.

Putting this into a crowdfunding context, imagine yourself browsing a crowdfunding website and finding an amazing business plan for a doughnut shop in Biloxi, Mississippi. The business plan looks so good that you find yourself thinking it is going to be the next Krispy Kreme—the plan includes details about the business model, growth projections, and the address of the first shop. Since you do not live near Biloxi, Mississippi, you cannot verify the first shop’s location and that such an address actually exists. Luckily, someone who lives in Biloxi sees the business’s plan and knows that the address posted is for the local cemetery, not a prime piece of commercial property. The Biloxi native posts all over the web that the securities offering is a sham. You quickly learn about the sham and abandon your plan to invest in the doughnut shop.

Theoretically, web forums and message boards will “ferret[] out frauds that have been overlooked by the platform.”¹⁹⁰ Commentators have coined what happened in the doughnut shop example as “the wisdom of the crowds.”¹⁹¹ The basic concept is that “even if most of the people within a group are not especially well-informed or rational . . . [the group] can still reach a collectively wise decision.”¹⁹² This phenomenon is not new, and can easily be observed on Amazon.com

188. *Crowdfunding Hearing*, *supra* note 2, at 98 (statement of Sherwood Neiss).

189. *Id.* at 45.

190. Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 464 (2012) (showing that where they have data, users of web forums and message boards frequently perform monitoring functions).

191. Bradford, *supra* note 3, at 28 n.123 (citing JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS* 16-17 (2004) (describing Google as an example of the wisdom of the crowds)).

192. Bradford, *supra* note 3, at 114 (quoting JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS* xiii-xiv (2004)).

or eBay.com; on each of those sites, previous customers rate and review sellers they have interacted with.¹⁹³ If a seller misrepresents a product to a previous buyer, future buyers will be on notice because of the seller's poor rating and customer reviews.¹⁹⁴

The "wisdom of the crowds," sounds good in theory, but it will not work for equity crowdfunding. In scenarios like the sham doughnut shop, crowdfunding supporters rely on three huge assumptions: (1) that someone will uncover fraudulent information in business plans; (2) that the individual will post the "truth" on the Internet; and (3) that crowdfunding investors will see and read the posts about fraudulent business plans before investing. If any one of these assumptions fails, the whole theory collapses. Moreover, the eBay and Amazon "wisdom" will not carry over to crowdfunding, because those systems rely on consumer feedback after a transaction.¹⁹⁵ In crowdfunding, after the transaction is too late—the fraudulent actor will have taken the investors' money and run. Submitting negative reviews or ratings about the "entrepreneur" will not be effective because it is doubtful a fraudulent actor will ever post another business plan under the same username. In addition, there will be a problem of false or inflammatory posting.¹⁹⁶ It will be difficult, if not impossible, to discern whether the commentator is being truthful. "Any scam artist worth his salt will figure out how to overload the comment system with false positives."¹⁹⁷ Therefore, while the "wisdom of the crowds" theory can work for some Internet business models, it will not be effective for equity crowdfunding.

C. Investment Caps on Individual Investors

Another argument that crowdfunding supporters raise is that equity crowdfunding poses little risk to individual investors because an exemption will cap the amount each individual can invest in crowdfunded securities.¹⁹⁸ The proposed cap on individual investors is \$10,000, or 10% of their annual income.¹⁹⁹ The theory behind the

193. See *Rating a Seller*, AMAZON.COM, <http://www.amazon.com/gp/help/customer/display.html?nodeId=537806> (last visited Mar. 10, 2012); see also *Feedback Scores, Stars, and Your Reputation*, EBAY, <http://pages.ebay.com/help/feedback/scores-reputation.html> (last visited Mar. 10, 2012).

194. See EBAY, *supra* note 193.

195. See AMAZON.COM, *supra* note 193; EBAY, *supra* note 193.

196. Porter, *supra* note 150 (Mar. 5, 2012).

197. *Id.*

198. Bradford, *supra* note 3, at 122 (suggesting that it is sensible to limit the amount that individual investors may invest).

199. See Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 2 (2011).

individual cap is that it prevents “investors ‘from incurring significant financial risk’ because ‘even a total loss . . . is unlikely to be financially crippling for anyone.’”²⁰⁰ Essentially, even if the investment completely flops, investors should be able to handle the loss because they were not allowed to invest their life savings. The main assumption underlying this theory is that most people can afford to lose \$10,000 or 10% of their income. This assumption may work if people are fiscally conservative and save a lot of their disposable income; however, that is not reflective of contemporary society and its spending habits.

The average American is not a “saver,” and he cannot afford to lose \$10,000 or 10% of his income. Americans spend almost all of their disposable income,²⁰¹ which is the “amount of money that a household earns each year after taxes.”²⁰² In the U.S., the average household’s disposable income was \$37,690.²⁰³ The average American saves 3.5% of his disposable income each year,²⁰⁴ which equates to \$1,319.15. With the proposed crowdfunding investment caps set at \$10,000 or 10% of an individual’s income, many Americans could suffer catastrophic losses. A 10% loss would cost the average American \$3,769, possibly leaving that person unable to afford necessary expenses. Such a loss would wipe out a year’s worth of savings, and then some. The negative consequences are even more pronounced for the poor receiving governmental supplements. Those individuals cannot afford to lose any money, and if they are allowed to participate in crowdfunding we are essentially letting them gamble with taxpayer money.²⁰⁵ Unless the proposed caps are significantly lowered to amounts like \$100 or 2% of disposable income, they are an illusory form of protection.

D. Crowdfunding Websites Policing Fraud

The final, and likely strongest argument supporting an exemption is that crowdfunding websites have a unique incentive to police their

200. Bradford, *supra* note 3, at 123 n.626 (quoting Request for Rulemaking to Exempt Securities Offerings up to \$100,000 with \$100 Maximum Per Investor from Registration, SEC, File No. 4-605, *available at* <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>).

201. *See Personal Income and Outlays: November 2011*, U.S. DEP’T OF COMMERCE (Dec. 23, 2011, 8:30 AM), <http://www.bea.gov/newsreleases/national/pi/2011/pi1111.htm>.

202. Blaire Briody, *Better Life Index: U.S. Doesn’t Rank at the Top*, FISCAL TIMES (May 24, 2011), <http://www.thefiscaltimes.com/Articles/2011/05/24/Better-Life-Index-US-Doesnt-Rank-at-the-Top.aspx#page1>.

203. *Id.*

204. *See Personal Income and Outlays, supra* note 201.

205. Porter, *supra* note 150.

own sites and prevent fraud. On a micro level, each website will have a strong incentive to develop a reputation for protecting investors and punishing fraudulent actors. Otherwise, if it develops a reputation for rampant fraud, customers (investors) will leave and seek more reputable websites.²⁰⁶ The founder of Seedrs, Jeff Lynn, stated the amount of fraud “among good crowdfunding platforms is actually going to be very minimal.”²⁰⁷ Mr. Lynn indicated that Seedrs would “very quickly and very publically” pursue any entrepreneur that tries to defraud investors, and that it would press criminal charges against such actors.²⁰⁸ As such, Seedrs will “establish a reputation as one of the least favorable places to try to run a scam.”²⁰⁹ It is logical that other crowdfunding platforms would take similar actions against fraudulent actors in order to maintain their good reputation and keep a solid customer base.

On a macro level, if websites do not collectively establish reputations for punishing fraud, the whole crowdfunding market could collapse. As commentators note, “Any perception of market unfairness or distrust may have serious effects on investor confidence and investment behavior.”²¹⁰ “Without a broad-based investor perception of legitimacy, people will not invest in the market”²¹¹ This means if investors perceive that the crowdfunding market is saturated with fraud, they will put their money elsewhere, like traditional stocks and bonds. Thus, crowdfunding websites have both a macro and micro level incentive to take a hard-line approach against fraud, making the risk of fraud from an exemption quite low.

The micro and macro level arguments may be true in theory, but they still rely on attenuated assumptions. Websites like Seedrs may have the best intentions to drive out fraud from their sites, but there is no guarantee that all crowdfunding websites will follow suit. In the long-term, websites do have an incentive to pursue fraud and support the crowdfunding market; however, pure market theory is not a strong enough protection for the masses of unsophisticated investors. As can be seen from the recent economic crisis, putting too much faith in the self-correcting power of free markets can have devastating

206. Bradford, *supra* note 3, at 142 (“Reputational constraints should also moderate a site’s interest in pushing investors toward inappropriate investments; a site that develops a reputation for losing investments will suffer a loss of customers as investors move to more reputable sites.”).

207. *Crowdfunding Hearing*, *supra* note 2, at 98 (statement of Jeff Lynn, Seedrs Founder)).

208. *Id.*

209. *Id.*

210. Heminway & Hoffman, *supra* note 74, at 936.

211. *Id.* at 936-37.

consequences. Even “economics sage” Alan Greenspan admitted that he put too much faith in such self-correcting power, and that the theory was flawed.²¹² Millions of people could lose their money through crowdfunding before the market has time to self-correct and weed out the poorly regulated websites. We should learn from Greenspan’s mistake and not rely on the self-correcting power of crowdfunding markets.

VI. FLAWS WITH THE RECENT CROWDFUNDING LEGISLATION, H.R. 2930

With pressure building on Washington politicians to jumpstart the economy, legislators introduced an act exempting crowdfunded securities from the registration requirements of the ‘33 Act. This act is called the “Entrepreneur Access to Capital Act” (“H.R. 2930”), and the House of Representatives passed it on November 3, 2011.²¹³ H.R. 2930 proposes a new exemption that would fall under section 4 of the ‘33 Act,²¹⁴ which covers exempted transactions.²¹⁵ The proposal is still being evaluated in the Senate, which has also introduced its own versions of a crowdfunding exemption.²¹⁶ Since H.R. 2930 has progressed the furthest of any exemption proposal, it is worth examining its language and numerous flaws. H.R. 2930 is riddled with ambiguous language and loopholes, so this Note will limit the discussion to the four most egregious flaws: (1) the preemption of state registration laws; (2) high caps on the amount individuals can invest; (3) the self-certification of an investor’s income; and (4) only requiring intermediaries to take “reasonable” measures to reduce the risk of fraud.

A. *Preempts State Regulation*

H.R. 2930 contains provisions that would exempt crowdfunding securities offerings from the states’ registration requirements, thereby severely weakening investor protections. The language calls for an

212. See Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1 (“[A] humbled Mr. Greenspan admitted that he had put too much faith in the self-correcting power of free markets and had failed to anticipate the self-destructive power of wanton mortgage lending.”).

213. See Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011).

214. *Id.* at § 4.

215. 15 U.S.C. § 77d (2006).

216. See Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (2011) (introduced by Senator Scott Brown and has not been voted on); see also Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. (2011) (introduced by Sen. Jeff Merkley and has not been voted on).

amendment to section 18(b)(4) of the '33 Act,²¹⁷ which sets forth a list of securities that are exempt from state registration.²¹⁸ As discussed in Part IV(A)(2), preemption of the state registration requirements takes away most, if not all, of the meaningful investor protections under the securities laws. The exemption would eliminate federal and state registration requirements, leaving investors with simply the anti-fraud laws for protection.²¹⁹ Alone, the anti-fraud laws are wholly inadequate to protect investors from fraud, because the laws put regulators in a permanent state of reaction trying to clean up the fraud after it happens.²²⁰ This is problematic because: (1) it is difficult to find fraudulent actors that have fled with investor money; (2) it eliminates any warning signals to investors of possible fraud; and (3) it is economically inefficient to prosecute wrongdoers.²²¹ As such, preemption of the states' registration laws is a major flaw with H.R. 2930.

B. High Individual Investment Caps

The investment cap on individual investors is too high, thereby exposing the average American to unbearable amounts of investment risk. H.R. 2930 states that the aggregate amount sold to any investor in reliance on this exemption within the previous twelve-month period must not exceed the lesser of \$10,000 and 10 percent of an investor's annual income.²²² Again, such an investment cap relies on the flawed assumption that the average American can afford to lose \$10,000 or 10% of their annual income.²²³ This assumption is flawed because it does not reflect the reality that most individuals save very little of their income.²²⁴ As such, a \$10,000 or 10% loss could wipe out most people's savings and then some, leaving them unable to afford basic living expenses.²²⁵ Thus, as written, the investment caps are too high to adequately protect a large portion of our population.

Another flaw with the proposed cap is that the percentage is based off of an individual's *annual* income, as opposed to

217. See H.R. 2930 § 4.

218. See 15 U.S.C. § 77r(b)(4) (2006).

219. See *supra* Part IV(A)(2).

220. See *id.*

221. See *id.*

222. See H.R. 2930 § 2.

223. See *supra* Part V(C).

224. See *supra* notes 203-206 and accompanying text (noting that the average American saves \$1,319.15 of their \$37,690 disposable income).

225. See *supra* Part V(C).

discretionary income.²²⁶ Annual income is the amount of money a person earns in a year before taxes and expenses.²²⁷ A person's annual income is not a good baseline because it does not accurately reflect how much money that person can afford to lose.²²⁸ A better baseline measurement would be discretionary income, which is "[t]he amount of an individual's income that is left for spending, investing or saving after taxes and personal necessities (such as food, shelter, and clothing) have been paid."²²⁹ Discretionary income is more reflective of what an individual can afford to lose on speculative crowdfunding securities. As such, if discretionary income was used as the baseline for the 10% cap, it may be adequate to protect investors from a catastrophic loss. However, such changes need to be made before the exemption is passed into law.

C. Self-Certification of Income

As part of the investment cap scheme discussed in the preceding section, individuals must report their annual income levels; the problem is that there is no verification of the person's truthfulness and accuracy. H.R. 2930 states, "[A]n issuer or intermediary may rely on certifications as to annual income provided by the person to whom the securities are sold to verify the investor's income."²³⁰ Relying on potential investors to accurately report their annual income without verification is preposterous. People will surely abuse the system; they will inflate their annual income to invest more money in crowdfunding.

The same type of abuse was seen during the housing bubble through the pervasive use of "liar's loans."²³¹ Such loans got their name because they were based on a borrower's *stated* income, not

226. See H.R. 2930 § 2.

227. See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 1-2 (Foundation Press 11th ed. 2009) (explaining gross income, which equals "all income from whatever source derived," must be reduced by all deductions to find taxable income; tax rates are then applied to the taxable income to find an individual's tax liability).

228. See *id.* at 1 (stating annual income is a figure that has not been reduced by an individuals mandatory expenditures, like food, shelter, etc; thus, it is not reflective of how much someone has left over to spend non-necessity items).

229. *Discretionary Income*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/discretionaryincome.asp#axzz1ov6zCkru> (last visited Mar. 5, 2012).

230. See H.R. 2930 § 4A.

231. See Bill Black, *Why Aren't Honest Bankers Demanding Prosecutions of Their Dishonest Rivals?*, BUS.INSIDER (Apr. 11, 2011), http://articles.businessinsider.com/2011-04-11/wall_street/29986099_1_white-collar-criminals-white-collar-crime-professor-john-s-baker/3.

actual income.²³² Lenders never verified the borrower's stated income, so people inflated their income to receive a larger loan.²³³ Once the housing bubble burst, borrowers were stuck in mortgages they could not afford, so many defaulted on their payments.²³⁴

The same result will occur under H.R. 2930—an investor will come across a convincing business plan and he will inflate his reported income in order to invest more money in the security. Since most startup businesses fail, the investor faces a significant risk that he will lose his investment. The unfortunate part is that he is worse off than if he had been capped at 10% of his actual income. By not verifying investors' annual income, the effectiveness of the individual cap is severely reduced and it invites abuse of the system.

D. Merely Requiring a "Reasonable" Effort to Reduce Fraud

The proposed exemption does not impose enough of a burden on crowdfunding websites to prevent fraud. H.R. 2930 merely states that intermediaries involved in the issuance of crowdfunded securities must "take[] reasonable measures to reduce the risk of fraud with respect to such transaction[s]."²³⁵ The word "reasonable" is extremely vague, and it is useless to describe the type of care a crowdfunding site must take. Reasonable care is "the degree of care that a prudent and competent person engaged in the same line of business or endeavor would exercise under similar circumstances."²³⁶ This standard is useless for equity crowdfunding because it requires comparison to something that does not exist yet. Since "there are now no major,

232. See *Mortgage Fraud Overview*, FANNIE MAE (May 2007), <https://www.efanniemae.com/utility/legal/pdf/mtgfraudoverview.pdf> (discussing the "stated income/stated asset abuse").

233. See U.S. Atty's Office, *Sherman Oaks Woman Faces Charges in Mortgage Fraud Case for Inflating Income in "Liar Loan" Applications*, FED. BUREAU OF INVESTIGATION (Nov. 23, 2010), <http://www.fbi.gov/losangeles/press-releases/2010/la112310b.htm> (discussing a woman being charged for her role in a mortgage fraud scheme in which she falsely inflated her and her husband's income, claiming they earned nearly \$50,000 per month).

234. See Michael LaCour-Little & Jing Yang, *Taking the Lie Out of Liar Loans*, CAL. STATE UNIV. 4 (Aug. 30, 2009), http://www.fhfa.gov/webfiles/15048/website_lacour.pdf ("Without full-documentation, especially when stated-income or stated-assets programs are used, we find the default rate is significantly higher, even after controlling for other risk factors . . .").

235. See H.R. 2930 § 4A.

236. BLACK'S LAW DICTIONARY 240 (Bryan A. Garner, West Publishing Co. 3d. pocket ed. 2006).

publicly accessible equity crowdfunding sites in the United States,”²³⁷ what is the baseline to determine if a site is taking reasonable measures to reduce the risk of fraud? Theoretically, the first crowdfunding websites could take minimal efforts to reduce fraud, thereby establishing the bare minimum as reasonable for future comparisons. If passed as is, it will take years of litigation to determine what fraud reduction efforts are reasonable. In the meantime, investors will be left hoping that they picked the site that does more than the bare minimum to reduce fraud. The Senate should eliminate the vague reasonableness standard and insert specific actions that intermediaries must take to reduce fraud.

VII. CONCLUSION

Internet-based crowdfunding is on the cutting edge of raising money for small businesses. Crowdfunding websites allow entrepreneurs to reach millions of potential investors and pitch their business ideas.²³⁸ The non-equity models of crowdfunding have grown exponentially over the past few years, and many think that crowdfunding will revolutionize small business financing. However, crowdfunding proponents want to take it a step further and allow businesses to issue securities through crowdfunding websites. The equity model of crowdfunding directly conflicts with the registration requirements under the ‘33 Act and its applicable exemptions.²³⁹ As such, many are pushing for a crowdfunding exemption, and the House of Representatives has already approved one version.²⁴⁰

Unfortunately, legislators and crowdfunding supporters fail to see the catastrophic consequences of creating an equity crowdfunding exemption. Allowing businesses to issue crowdfunded securities will open the door for massive fraud to enter the securities market. History has already shown that securities fraud runs rampant over the Internet, and a crowdfunding exemption would take America down the same destructive path. Further, an exemption would eliminate all meaningful protection for the average investor, leaving him exposed to unscrupulous actors without any warning signs of fraud. The exemption will leave investors praying that the SEC will clean up the fraud after it occurs; however, such action by the SEC will be

237. See Bradford, *supra* note 3, at 25 (introducing why there is a need for a crowdfunding exemption under the securities laws).

238. See Bradford, *supra* note 3, at 10 (describing the concept of crowdfunding).

239. See *id.* at 25 (introducing why there is a need for a crowdfunding exemption under the securities laws).

240. See Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011).

limited because it is ill equipped to handle the influx of crowdfunding fraud.

The proposed exemption under H.R. 2930 is riddled with flaws and it exposes the average American to unbearable risks without the counterbalancing protections of the securities laws. H.R. 2930 makes it easier for issuers to target middle to lower class investors, yet it fails to properly protect such individuals who need it the most. As such, the exemption makes it easier for financially unsophisticated investors to gamble their life savings on highly speculative securities, thereby undermining eighty years of securities doctrine. I realize our economy desperately needs a boost, but an exemption for equity crowdfunding is not the answer; rather, it is a political knee-jerk reaction that will wreak havoc on the securities industry and the economy as a whole. Congress still has time to reconsider its actions; but if it goes forward with the exemption, get ready to watch the fleecing of the American masses and the next securities blooper of the 21st century.