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CROWDFUNDING OR FRAUDFUNDING? SOCIAL NETWORKS AND THE SECURITIES LAWS—WHY THE SPECIALLY TAILORED EXEMPTION MUST BE CONDITIONED ON MEANINGFUL DISCLOSURE*

THOMAS LEE HAZEN**

Social networks have been used as a medium for financing films and other performing arts, as well as for charitable solicitations. Crowdfunding can also be used to finance small business enterprises, which, in contrast to other crowdfunding efforts, is a highly regulated activity by virtue of the securities laws. Securities laws are designed to provide investor protection. This Article provides an overview of the applicable securities laws and evaluates the various proposals and the recently enacted JOBS Act which purportedly provides a workable exemption for crowdfunding that would not unduly compromise investor protection. The Article examines the proposals and ensuing legislation and concludes that the only appropriate exemption for crowdfunding is one conditioned on meaningful disclosures about the company and the terms of the offering.

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INTRODUCTION

Social networks have been used as a medium for financing films¹ and other forms of art, as well as for charitable solicitations.² These and similar fundraising endeavors are known as crowdfunding. Crowdfunding is the fundraising analog to crowdsourcing, which refers to mass collaboration efforts through large numbers of people, generally using social media or the Internet.³ Social networks have the potential for using crowdfunding to reach large numbers of

1. See Daniel M. Satorius & Stu Pollard, *Crowd Funding: What Independent Producers Should Know About the Legal Pitfalls*, 28 ENT. & SPORTS LAW., Summer 2010, at 15, 15 (discussing the use of crowdfunding in the film industry).

2. See, e.g., Matt Villano, *Small Donations in Large Numbers, with Online Help*, N.Y. TIMES, Mar. 18, 2010, at F31 (discussing websites such as Kickstarter.com, ChipIn.com, and CreateaFund.com).

3. See, e.g., Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) (“The concept of crowdfunding finds its root in the broader concept of crowdsourcing, which uses the ‘crowd’ to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment; this is generally done by using social networks, in particular through the Internet (Twitter, Facebook, LinkedIn and different other specialized blogs). The crowd - funders (those who provide the money) can at times also participate in strategic decisions or even have voting right. In other words, instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the ‘crowd’), where each individual will provide a very small amount.” (quoting Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd 2* (Ctr. for Operations Research & Econometrics, Discussion Paper No. 2011/32, 2010) (internal citation omitted), available at <http://ssrn.com/abstract=1578175>); Jeff Howe, *The Rise of Crowdsourcing*, WIRED, June 2006, at 176, 178–83, available at <http://www.wired.com/wired/archive/14.06/crowds.html>.

people. Since crowdfunding is designed to reach a large number of people, limiting the fundraising request to a small amount from each donor can provide meaningful funding.⁴ The solicitation of funds as gifts or donations is a substantially unregulated activity. There are, however, charitable solicitation statutes that provide a minimal degree of consumer (or donor) protection.⁵ In instances of abuse, online solicitations may be subject to wire fraud statutes.⁶ The charitable solicitation and wire fraud statutes, which are beyond the scope of this Article, provide only minimal protection in comparison with investor protections of the federal securities laws. This Article examines various proposals for a special crowdfunding exemption from the securities laws and concludes that any new exemption for crowdfunding must be conditioned on meaningful disclosures to investors about the company and the offering. Only with meaningful disclosure to investors can an exemption strike the right balance to encourage small business financing without unduly sacrificing investor protection.

Crowdfunding can be used to finance small business enterprises and has been employed outside the United States.⁷ Unlike raising money for charities or other nonprofit ventures, a business seeking investors through crowdfunding implicates the securities laws which provide investor protection by requiring disclosure and, in many instances, registration of securities offered to the public. Investor protection becomes an issue when social networks are used for widespread solicitation of funds for business enterprises, regardless of the amount being sought from each investor. The federal securities laws' pattern is that the exemptions from the more burdensome securities law disclosures do not apply when there is a general solicitation⁸ of potential investors—as is the case with crowdfunding

4. See, e.g., Angus Loten, *Crowd-Fund Sites Eye Boom*, WALL ST. J., May 12, 2011, at B10 (discussing crowdfunding for raising capital).

5. See, e.g., 10 PA. STAT. ANN. §§ 162.5–162.17 (West 2011). For a summary of charitable solicitation laws, see Jamie Usry, *Charitable Solicitation Regulation for the Nonprofit Sector: Paving the Regulatory Landscape for Future Success*, POL'Y PERSP. (July 30, 2008), http://www.imakenews.com/cppa/e_article001162331.cfm.

6. The federal wire fraud statute is found in 18 U.S.C. § 1343 (2006).

7. See, e.g., Tania Kishore Jaleel, *Funding Ideas for Returns*, BUS. STANDARD (May 5, 2011), <http://www.business-standard.com/india/news/funding-ideas-for-returns/434488/> (discussing crowdfunding in India); CROWDCUBE, www.crowdcube.com (last visited May 5, 2012) (offering a capital-raising crowdfunding site in the United Kingdom).

8. A general solicitation occurs when, through advertising or otherwise, potential investors are contacted without regard to whether they meet specified sophistication or accreditation requirements. See, e.g., 17 C.F.R. § 230.502(c) (2011) (giving examples of a general solicitation); see also, e.g., 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF

efforts, which reach out to anyone accessing a crowdfunding website. A few exemptions from the Securities Act of 1933's ("1933 Act") registration requirements⁹ permit a general solicitation of potential investors, but those exemptions are conditioned on the use of an offering circular or other mandated disclosure to potential investors.¹⁰ Suggesting a departure from the current regulatory pattern, there was discussion in some circles to create a less onerous exemption from the securities laws to facilitate crowdfunding of business ventures.¹¹ In fact, there were a number of proposals to the Securities and Exchange Commission ("SEC") and Congress urging the adoption of an exemption for crowdfunding efforts.¹²

Policymakers continually face the challenge of effectively balancing the benefits of encouraging small business formation against the investor protection goals of the securities laws. Without the crowdfunding exemption that was recently enacted by Congress and signed into law,¹³ crowdfunding would not be a viable capital-raising method in light of the costs of complying with securities registration or even the more limited disclosure requirements available under the exemption set forth in SEC Regulation A.¹⁴

SECURITIES REGULATION § 4.25, at 579–80 (6th ed. 2009) (discussing offeree qualifications and their relationship to a general solicitation). In March 2012, the House and Senate agreed on legislation to permit a general solicitation in a private placement, provided that the solicitation pool is limited to potential investors who qualify as "accredited investors" under SEC rules. Jumpstart Our Business Startups Act ("JOBS Act"), H.R. 3606, 112th Cong. (2d Sess. 2012) (enacted at JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified at scattered sections of 15 U.S.C.)).

9. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77aa (2006)), amended by JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

10. See SEC Regulation A, 17 C.F.R. §§ 230.251–263 (2011); SEC Rule 504, 17 C.F.R. § 230.504; see also *infra* text accompanying notes 77–79, 179–83 (discussing Regulation A and Rule 504).

11. See, e.g., Tim Devaney, *Startups Seek New Form of Microfinance*, WASH. TIMES, Apr. 26, 2011, at A9, available at 2011 WLNR 8154844 (discussing entrepreneurs' lobbying of the SEC to create a new exemption).

12. See *infra* Part II.

13. JOBS Act § 302, 126 Stat. at 315 (to be codified at 15 U.S.C. § 77d); Maria Lokshin, *Obama Signs 'JOBS Act,' Says Law is 'Game Changer' for Small Companies*, 44 Sec. Reg. & L. Rep. (BNA) 700 (April 6, 2012); see Maria Lokshin, *House Votes for Senate-Amended 'JOBS Act'; Bill Headed to President's Desk for Signature*, 44 Sec. Reg. & L. Rep. (BNA) 643 (April 2, 2012) [hereinafter Lokshin, *House Votes*] (describing the final bill approved by both the House and Senate).

14. 17 C.F.R. §§ 230.25–.263. For additional discussion of Regulation A, see *infra* text accompanying notes 72, 179–82.

A number of observers proposed creating a new exemption from registration tailored to crowdfunding.¹⁵ This Article provides an overview of the applicable securities laws and evaluates the proposals that purportedly would provide a workable exemption without unduly compromising investor protection. This Article concludes, however, that many of those proposals did not adequately justify a new exemption. The proponents of an exemption for crowdfunding found support in those commentators who, as a general proposition, believe the existing exemptions should be expanded.¹⁶ This Article is limited to the advisability of an exemption tailored to crowdfunding efforts and thus does not engage in the debate as to whether other broader exemptions are justified to encourage small business financing generally.¹⁷

As discussed below, after weighing the various proposals and bills in the House and Senate, in March 2012, the House and Senate agreed on a crowdfunding exemption that was signed into law by President Obama.¹⁸ The statutory exemption mandates SEC action to implement a crowdfunding exemption according to the guidelines including required disclosures that are discussed later in this Article.¹⁹ This Article discusses the importance of disclosure in any crowdfunding exemption and concludes that with the new exemption, Congress has given the SEC the tools to implement a viable exemption without unduly sacrificing investor protection.

I. CROWDFUNDING AND THE SECURITIES LAWS

If a crowdfunding effort seeks donations without any express or implied possibility of a return to the donor, there is no offering of securities, and thus, the securities laws are not implicated.²⁰

15. See *infra* Part II.

16. See Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 81-82 (2006) (discussing the small issue exemptions generally and urging increased use of Regulation A). Some observers believe that the SEC has not been as accommodating to small business as it should. See, e.g., Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure To Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1 *passim* (2007).

17. The exemptions presently strike a reasonable balance. That is not to say that they might not be improved by tweaking the existing exemptions, but there is no reason to seek massive overhaul or major expansion of the existing exemptions.

18. JOBS Act § 302, 126 Stat. at 315-21.

19. See *infra* notes 118-21 and accompanying text.

20. The securities laws apply only to offers, sales, and purchases of securities. See, e.g., 15 U.S.C. § 77e (2006) (prohibiting offers and sales of securities without adequate disclosure); 17 C.F.R. § 240.10b-5 (2011) (prohibiting fraud and material misstatements and omissions in connection with a purchase or sale of securities). A gift does not involve

Discussion of fundraising efforts not offering the potential for benefits to the persons solicited is beyond the scope of this Article. The securities laws apply to offerings of traditional business investments such as stock, bonds, and certain partnership interests.²¹ The broad concept of an “investment contract” as a security²² means that crowdfunding for business ventures cannot bypass the securities laws by using something other than stock or other traditional investment vehicles. The statutory term “investment contract” is broadly construed and would clearly encompass any fundraising effort that expressly or impliedly offers investors a potential return on their investment.²³ Characterizing the crowdfunding contribution as a loan rather than an ownership interest likewise will not bypass the securities laws since notes and indebtedness also fall within the definition of security.²⁴

Classification of a fundraising scheme as a security means that absent an applicable exemption, promotion of those investments will be subject to the 1933 Act.²⁵ Once a company has engaged in a securities offering registered under the 1933 Act, it becomes subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (“1934 Act”).²⁶

the donor’s receiving a security. In addition, since no consideration is promised in return, it cannot properly be classified as a purchase or sale.

21. Section 2(a)(1) of the 1933 Act includes stock, notes, and investment contracts within the definition of security. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (“The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate”); see 1 HAZEN, *supra* note 8, § 1.6 (discussing the very inclusive definition of security). Limited partnership interests, limited liability company memberships, and even general partnership interests offered as a passive investment fall within the definition. See *id.* § 1.6[10]–[11].

22. 15 U.S.C. § 77b(a)(1) (expressly including “investment contract” as a security).

23. As explained by the Supreme Court, the term “investment contract” includes the solicitation of funds in a common enterprise with the expectation of a profit coming primarily from the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946); 1 HAZEN, *supra* note 8, § 1.6 (discussing the broadly interpreted definition of “security” under the federal securities laws and the various nontraditional investments that fall within the definition).

24. The definition of “security” expressly includes a note and other “evidence of indebtedness.” 15 U.S.C. § 77b(a)(1). See *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990) (stating that notes are presumed to be securities except for (1) notes delivered in connection with consumer financing, (2) a note secured by a home mortgage, (3) short-term notes to a small business secured by the business’s assets, and (4) bank character loans). See generally 1 HAZEN, *supra* note 8, § 1.6[14] (discussing the classification of a note as a security).

25. 15 U.S.C. § 77a–77aa (2006).

26. 15 U.S.C. § 78a–77nn (2006).

A. *Overview of the 1933 Act Registration and Disclosure Requirements and Ensuing 1934 Act's Periodic Reporting and Broker-Dealer Registration Requirements*

1. 1933 Act Registration and Disclosure Requirements

The first federal securities law followed in the wake of the stock market crash of 1929. The 1933 Act²⁷ was enacted as a “Truth in Securities” Act.²⁸ President Roosevelt described the 1933 Act as a vigorous consumer protection law.²⁹ The federal securities laws do not focus on the merits of investments but rather are based on disclosure to allow sufficiently informed investors to fend for themselves. The importance of disclosure was premised on Justice Brandeis’s adage that sunlight is the best disinfectant.³⁰

The regulatory pattern imposed by the 1933 Act consists of registration requiring a full disclosure document to investors with

27. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77aa (2006)). As explained in the next Section, even without a 1933 Act registration, a company becomes subject to the 1934 Act’s periodic reporting requirements when its securities are publicly traded in the secondary markets.

28. See Milton H. Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340, 1340–41 (1966). See generally FERDINAND PECORA, WALL STREET UNDER OATH (1939) (discussing the impact of the 1933 Act); William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933) (providing an overview of the 1933 Act as originally enacted); Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329 (1988) (setting forth the history of the 1933 Act and amendments thereto); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959) (providing the legislative history of the 1933 Act). For an additional perspective on the history of securities regulation, see generally John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015 (2001).

29. President Franklin Roosevelt observed that we were moving from a period of *caveat emptor* into one of *caveat vendor*. *Message to Congress from President Franklin Roosevelt* (Mar. 29, 1933), quoted in H.R. REP. NO. 73-85, at 2 (May 4, 1933) (“This proposal adds to the ancient rule of *caveat emptor*, the further doctrine, ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”).

30. This is the oft-cited phrase of Louis D. Brandeis. LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY 92 (1934) (“Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”). Felix Frankfurter was one of the most influential voices in the drafting of the securities laws. See Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1221–22 (1999) (“Soon after the Securities Act was passed, Frankfurter wrote an article in *Fortune* magazine about the anticipated social and financial effects of the Act. Frankfurter was quite explicit that the purpose of disclosure was to affect the behavior of corporate managers, bankers, and accountants.”); Felix Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 53, 53; see also JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 71 (3d ed. 2003) (discussing Frankfurter’s *Fortune* article).

respect to offerings and distributions of securities that end up in the hands of the investing public.³¹ Section 5 of the Act makes it unlawful to offer and sell securities without a registration statement and required disclosure document known as a prospectus.³² The prospectus disclosure requirements include detailed information about the company and audited financial statements.³³ The 1933 Act provides exemptions from registration, many of which are supplemented by or require rulemaking by the SEC.³⁴

Once a company offers securities under a 1933 Act registration statement, the company is subject to the periodic reporting requirements of the 1934 Act that are summarized briefly in the Section that follows.

2. 1934 Act Periodic Reporting Requirements

The 1934 Act's periodic reporting requirements impose quarterly and interim reporting obligations on publicly traded companies.³⁵ Registration under the 1933 Act is one of the events that can trigger the 1934 Act's periodic reporting requirements.³⁶ Irrespective of an offering registered under the 1933 Act, when a company's securities are widely traded in the secondary markets, the company becomes subject to the 1934 Act's registration requirements that impose a host of other requirements.³⁷ 1934 Act registration has two alternative triggers. Any company with securities listed on a

31. See 1 HAZEN, *supra* note 8, chs. 2–3. This includes not only primary distributions (sold by the issuer), but also secondary distributions wherein the securities are sold by individuals or institutions who did not acquire the securities in a public offering. See *id.* § 4.26, at 586–93; 2 *id.* §§ 4.27–28.

32. Section 5(a) prohibits sales unless a registration statement has been filed with the SEC and has become effective. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (2006). Section 5(c) prohibits offers prior to the filing of the registration statements. § 5(c), 15 U.S.C. § 77e(c). Section 5(b) prohibits written offers unless in the form of an SEC mandated prospectus and also requires a delivery of such a prospectus prior to sale. § 5(b), 15 U.S.C. § 77e(b).

33. For a discussion of the details of 1933 disclosure requirements, see 1 HAZEN, *supra* note 8, ch. 3.

34. The statutory exemptions are found in 15 U.S.C. § 77c–77d.

35. *Id.* § 78m. The periodic reporting requirements include the filing of quarterly reports including financial data and also interim reports between quarters for certain material events. The disclosure requirements are discussed in 2 HAZEN, *supra* note 8, §§ 9.0–6[5].

36. 15 U.S.C. § 78o(d).

37. The 1934 Act registration triggers are set forth in section 12 of the Act. Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l. Once registered under the 1934 Act, a company becomes subject to the federal proxy regulation, the insider trading reporting obligation, and many other requirements. See 2 HAZEN, *supra* note 8, §§ 9.0–6[5]; 3 *id.* ch. 10; 4 *id.* ch. 13; 5 *id.* §§ 13.3–6[2].

national securities exchange, such as the New York Stock Exchange or the Nasdaq Stock Market, must register under the 1934 Act.³⁸ For companies whose shares are not listed on a national securities exchange, the registration requirements were triggered if the company has more than \$10 million in assets and at least 500 shareholders of record.³⁹ After considering a number of proposals,⁴⁰ Congress raised the threshold for companies that are not exempt from the 1934 Act registration requirements. The JOBS Act amended section 12(g) to increase the threshold from 500 to 2,000 shareholders of record but retains the lower 500 record holder threshold with respect to investors who are not accredited investors.⁴¹ This means that without an exemption from 1934 Act registration, even if a crowdfunding effort can take advantage of an exemption from 1933 Act registration, trading in the secondary markets will be subject to periodic disclosure and other requirements if the company exceeds the 500 shareholder and \$10 million thresholds. However, the JOBS Act added section 12(g)(6) that directs the SEC to exempt from the shareholder calculation any securities acquired in an exempted crowdfunding offering.⁴² Instead of periodic reporting, companies relying on the crowdfunding exemption must make annual reports to the SEC and to their shareholders.⁴³

38. 15 U.S.C. § 78l(a).

39. *Id.* § 78l(g) (requiring registration for companies with more than \$1 million in assets and at least 500 shareholders of record); SEC Rule 12g-1, 17 C.F.R. § 240.12g-1 (2011) (raising the asset threshold to \$10 million). As part of the JOBS Act, the statutory threshold was raised to the same \$10 million threshold that the SEC had adopted in Rule 12g-1 *supra*. JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (to be codified at 15 U.S.C. 78l(g)(1)(A)).

40. *See, e.g.*, Letter from Darrell Issa, Chairman, House Comm. on Oversight & Gov't Reform, to Mary Schapiro, Chairman, SEC 6-10 (Mar. 22, 2011), *available at* <http://democrats.oversight.house.gov/images/stories/FULLCOM/510%20future%20of%20cap%20form/2011-03-22%20DEI%20to%20Schapiro-SEC%20-%20capital%20formation%20due%204-5.pdf> (presenting the issues created by limiting the number of shareholders that can own shares of a private issuer); Letter from Sarah A. Miller, Senior Vice President, Ctr. for Sec., Trust & Invs., Am. Bankers Ass'n, to John W. White, Dir., Div. of Corp. Fin. & James Overdahl, Chief Economist, SEC 3-4 (Nov. 12, 2008) *available at* <http://www.sec.gov/rules/petitions/4-483/4483-21.pdf> (raising the issue of increasing the 500 shareholder threshold); Letter from Mary Schapiro, Chairman, SEC, to Darrell E. Issa, Chairman, House Comm. on Oversight & Gov't Reform 17-22 (Apr. 6, 2011), *available at* <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf> (discussing the proposals to amend section 12(g)'s reporting standards).

41. JOBS Act, § 501, 126 Stat. at 325. Accredited investors are discussed *infra* note 79.

42. § 303(a), 126 Stat. at 321 (to be codified as 15 U.S.C. § 78l(g)(6)). The exemption can either be conditional or unconditional. *Id.*; *see infra* note 121.

43. § 302(b), 126 Stat. at 315-16 (to be codified as new section 4A of the Securities Act of 1933, 15 U.S.C. § 77d-1).

3. 1934 Act Broker-Dealer Registration Requirements

Concerns about crowdfunding sites extend beyond the disclosure and reporting requirements. For example, when a person or entity acts as an intermediary between sellers and purchasers of securities, especially in the context of a public offering of securities, the intermediary is likely to be subject to its own registration requirements.⁴⁴ Thus, if a crowdfunding site acts as an intermediary between a company and potential investors, the site may be subject to the 1934 Act requirement for registration of securities brokers and dealers.⁴⁵

*B. Existing Small Issue Exemptions from 1933 Act Registration*⁴⁶

The foregoing registration and disclosure requirements are consequences of financing a company through a public offering. There are a number of 1933 Act registration exemptions directed primarily at small business and small offerings. It is widely recognized that small businesses are an important part of the U.S. economy and that there is a value in encouraging small businesses to get started. A number of federal initiatives apart from the securities laws reflect this policy. The Small Business Administration (“SBA”) is but one example.⁴⁷ Registering securities under the 1933 Act is an expensive and otherwise burdensome process that presents barriers to small businesses’ access to the U.S. capital markets. Encouraging small business formation and capitalization thus clashes with the regulatory investor protection thrust of the securities laws. Mindful of these two potentially conflicting policies, the federal securities laws include some exemptions from registration as an incentive to small business financing.⁴⁸ Some barriers to small business financing have been lifted both through relaxed registration requirements⁴⁹ and special

44. 15 U.S.C. § 78o (2006 & Supp. IV 2010). This provision sets forth the broker-dealer registration requirements. *See also infra* Part IV (discussing crowdfunding sites as intermediaries).

45. *See* 15 U.S.C. § 78o.

46. Portions of this discussion are adapted from 1 HAZEN, *supra* note 8, §§ 4.15–17.

47. *See, e.g.*, U.S. SMALL BUS. ADMIN., <http://www.sba.gov/> (last visited May 5, 2012). The SBA offers a variety of business initiatives to small businesses including guidance, loans, and other financial and managerial assistance. *Id.*

48. *See, e.g.*, Campbell, *supra* note 16, at 79–81 (discussing the small issue exemptions generally and urging increased use of Regulation A); Cohn & Yadley, *supra* note 16, at 16–35 (discussing Rule 506 and private offerings exemptions).

49. For many years, the SEC provided relaxed disclosures in Regulation S-B that were tailored to small businesses. More recently, the SEC eliminated specialized

exemptions from registration for securities offerings by small businesses.⁵⁰

In addition to the streamlined registration forms for small business issuers, Congress and the SEC developed various exemptions for small issues.⁵¹ The small issue exemptions come from varied provisions of the 1933 Act. Section 4(2) sets forth an exemption for transactions not involving a public offering⁵² and applies to offerings to sophisticated investors.⁵³ SEC rules under section 3(b) provide exemptions for certain offerings not in excess of \$5 million.⁵⁴ Section 4(5) provides an exemption for offerings up to \$5 million that are made exclusively to accredited investors.⁵⁵ Exemptions under both section 4(2) and 4(5) are conditioned on the absence of a general solicitation of investors and thus are not suitable for crowdfunding offerings. Small issues that are *purely* local in nature may qualify for section 3(a)(11)'s intrastate exemption,⁵⁶ which is not dependent on the size of the offering but also would not be suitable for crowdfunding because it cannot be limited to the confines of a single state.

In 1982, the Commission adopted Regulation D⁵⁷ in an effort to simplify the overlapping rough edges of the most frequently relied

disclosure forms while at the same time retaining scaled or reduced disclosures for small businesses. 1 HAZEN, *supra* note 8, § 4.15[2].

50. See, e.g., Small Business Initiatives, 57 Fed. Reg. 36,442, 36,442 (Aug. 13, 1992) (codified in scattered parts of 17 C.F.R.) (marking the adoption of SEC Regulation D).

51. See, e.g., J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 §§ 7:196, 8:39–42 (2d ed. 2011) (discussing small business investment companies).

52. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2006); see 1 HAZEN, *supra* note 8, § 4.24. The section 4(2) exemption is not limited to small issues. It can be used, and frequently is used, for large nonpublic offerings. § 4(2), 15 U.S.C. § 77d(2). Offerings that are exempt under § 4(2) may nevertheless be subject to state registration and disclosure requirements, see *infra* notes 159–63 and accompanying text, unless the offering is exempt under Rule 506, 17 C.F.R. § 230.506 (2011). See 15 U.S.C. § 77r(b) (2006 & Supp. IV 2010) (preempting state securities laws for specified offerings).

53. See SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (noting that the section 4(1) exemption applies to offerings solely to investors who are able to “fend for themselves” and who can obtain sufficient information to make an informed investment decision); see also, e.g., Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 899–908 (5th Cir. 1977) (discussing the scope of the nonpublic offering exemption).

54. § 3(b), 15 U.S.C. § 77c(b). Unlike the other exemptions mentioned herein, section 3(b) is not self-implementing, but rather requires SEC rulemaking. See 1 HAZEN, *supra* note 8, §§ 4.16–17, 4.21–22.

55. § 4(5), 15 U.S.C. § 77d(5); see 1 HAZEN, *supra* note 8, § 4.23.

56. § 3(a)(11), 15 U.S.C. § 77c(a)(11); see 1 HAZEN, *supra* note 8, § 4.12.

57. 17 C.F.R. §§ 230.501–508; see 1 HAZEN, *supra* note 8, §§ 4.19–25. See generally Theodore Parnall, Bruce R. Kohl, & Curtis W. Huff, *Private and Limited Offerings After a Decade of Experimentation: The Evolution of Regulation D*, 12 N.M. L. REV. 633 (1982)

upon small issue exemptions. Regulation A⁵⁸ is another exemption for offerings by an issuer of up to \$5 million per year, of which no more than \$1.5 million can be attributed to a secondary offering by existing shareholders.⁵⁹ Unlike the other small issue exemptions, Regulation A is available for offerings using a general solicitation of investors but is conditioned upon dissemination of a disclosure document.⁶⁰ Regulation A thus is particularly well suited for crowdfunding efforts. In fact, Regulation A has been recognized as a convenient vehicle for direct offerings over the Internet.⁶¹ However, compliance costs limited Regulation A's utility for crowdfunding. In March 2012 Congress voted to amend the Securities Act of 1933 to mandate an SEC exemption for offerings up to \$50 million pursuant to a disclosure statement where the securities would be issued without restrictions on resales.⁶² This new exemption essentially is patterned

(outlining Regulation D's development); Marvin H. Mohny, Note, *Regulation D: Coherent Exemptions for Small Business Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121 (1982) (discussing Regulation D when it was first enacted, its relationship to other securities regulations, and the challenges it creates). Except for Rule 506 offerings, Regulation D offerings may be subject to state disclosure requirements. See 15 U.S.C. § 77r(b) (2006 & Supp. IV 2010) (preempting state securities laws for specified offerings).

58. 17 C.F.R. §§ 230.251–263; see 1 HAZEN, *supra* note 8, § 4.17; see 15 U.S.C. § 77r(b) (2006 & Supp. IV 2010) (preempting state securities laws for specified offerings). See generally Campbell, *supra* note 16 (discussing the small issue exemptions generally and urging increased use of Regulation A); Harvey Frank, *The Processing of Small Issues of Securities Under Regulation A*, 1962 DUKE L.J. 507 (discussing the operation of Regulation A when it was adopted). Regulation A offerings may be subject to state disclosure requirements as well.

59. See Small Business Initiatives, 57 Fed. Reg. 36,442, 36,443 (Aug. 13, 1992) (codified as amended in scattered parts of 17 C.F.R.); Small Business Initiatives, 57 Fed. Reg. 9768, 9770 (proposed Mar. 20, 1992). The exemption was limited to issues up to \$1.5 million prior to the 1992 amendment. Small Business Initiatives, 57 Fed. Reg. at 36,443.

60. Regulation A is the oldest and formerly the most widely used section 3(b) exemption. 1 HAZEN, *supra* note 8, § 4.17[1]. It is embodied in SEC Rules 251 through 263. 17 C.F.R. §§ 230.251–263. The Regulation A exemption is dependent upon the securities being offered through the use of an offering circular, in a manner similar to the use of a prospectus in a registered offering. *Id.* § 230.251(d)(ii)(c). The Regulation A exemption may not be used for more than an aggregate of \$5 million in any one year. *Id.* § 230.251(b).

61. See Mark Anthony Jefferis, Note, *Regulation A: Direct Public Offerings and the Internet*, 79 DENV. U. L. REV. 229, 240–43, 255–57 (2001) (discussing the use of Regulation A for online offerings). An offering exempt under Regulation A likely will have to be registered under state blue sky laws, which are discussed *infra* notes 159–63 and accompanying text.

62. JOBS Act, Pub. L. No. 112-116, § 302, 126 Stat. 306, 315 (2012) (to be codified as new section 4A of the Securities Act of 1933, 15 U.S.C. § 77d-1).

on Regulation A.⁶³ The new exemption for offerings up to \$50 million also will require the company to provide audited financial information as well as annual reports of operations.⁶⁴ Presumably, given the size of the offering, the disclosures will be more rigorous than those required by the dedicated crowdfunding exemption for offerings up to \$1 million.⁶⁵

Another section 3(b) exemption is SEC Rule 505, which permits offerings up to \$5 million but is conditioned on the absence of a public solicitation of investors.⁶⁶ However, the inability to engage in general solicitation by reaching out to the general public means that Rule 505 as currently in force is not readily adaptable to crowdfunding efforts.

As originally adopted, Rule 504 permitted unrestricted trading of securities issued under the exemption.⁶⁷ However, in the mid-1990s, many companies relied on Rule 504 for online offerings without registration or any disclosure even close to what would be provided in a registered offering.⁶⁸ Typically, companies would issue stock through the Internet and then provide a bulletin board or other online trading vehicle whereby initial purchasers could sell their shares to other investors.⁶⁹ Frequently, these online offerings would be accompanied by considerable hype concerning the newly issued securities. In large part as a response to these so-called “pump and dump” schemes, the SEC amended Rule 504 to prohibit not only a general solicitation but also to impose restrictions on resale unless the securities are registered under state law or issued under a state law

63. In addition, offerings under the exemption are subject to 1933 Act § 12(a)(2)'s cause of action for materially misleading offering materials and misstatements. Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006).

64. JOBS Act § 401, 126 Stat. at 323 (to be codified at 15 U.S.C. 77l(b)).

65. §§ 301–305, 126 Stat. at 315–23 (to be codified at scattered sections of 15 U.S.C.); see *infra* notes 171–88 and accompanying text.

66. 17 C.F.R. § 230.505 (2011); see 1 HAZEN, *supra* note 8, § 4.22.

67. As originally adopted, the exemption was limited to offerings or sales up to \$500,000. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,257–58 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239) (adopting Regulation D). Under the current version of the rule, any nonpublic company may take advantage of the \$1 million ceiling, but the offering cannot be made through a general solicitation of purchasers, and resales of securities are restricted unless the offering is registered under state law. 17 C.F.R. § 230.504(b)(2); see 1 HAZEN, *supra* note 8, § 4.21.

68. See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, 64 Fed. Reg. 11,090, 11,090–91 (Mar. 8, 1999) (codified at 17 C.F.R. pt. 230). This paragraph is adapted from 1 HAZEN, *supra* note 8, § 2.2[3][D].

69. See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, 64 Fed. Reg. at 11,090–91. This paragraph is adapted from 1 HAZEN, *supra* note 8, § 2.2[3][D].

exemption permitting a general solicitation.⁷⁰ The Internet can, of course, be used for legitimate exempt offerings so long as adequate steps are taken to assure that offers are made without a general solicitation and are limited to those persons who are qualified to receive offers under the exemption in question.⁷¹ Alternatively, raising capital via crowdfunding could be accomplished if effected in compliance with the disclosures required by the exemption in Regulation A. Regulation A permits offerings of up to \$5 million per year provided, among other things, that the company is not already publicly held and, further, that investors are provided with an offering circular setting forth certain mandated information about the company and the offering.⁷² As noted above, the JOBS Act of 2012 directs the SEC to create an exemption that essentially will expand Regulation A to cover offerings up to \$50 million during a twelve-month period.⁷³

The pattern that emerges from the existing exemptions from registration is quite clear. Any exemption that involves a general solicitation of investors will require an offering circular or other affirmative disclosure. As discussed above, Regulation A requires an offering circular,⁷⁴ whereas the intrastate exemption from federal registration does not.⁷⁵ However, state securities laws would likely require registration for purely intrastate offerings involving a general

70. Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, 64 Fed. Reg. at 11,090-91; 17 C.F.R. § 230.504(b)(1). While the Internet can still be used for exempt offerings of securities, the ability to create a public secondary market without registration has been severely limited, if not eliminated. *See* 17 C.F.R. § 230.502(c)(1).

71. *See, e.g.*, Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL 282988 (May 29, 1997) (use of Internet was permissible where, in order to obtain access to information available on the website, a potential investor was required to complete a questionnaire designed to allow the issuer to form a reasonable basis for determining that the potential investor qualified as an accredited investor); Iponet, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996) (use of the Internet to solicit indications of interest from accredited investors was not a general solicitation under Rule 502 so long as prescreening and the use of passwords assured that only accredited investors would receive information about the offering); *see also, e.g.*, Use of Electronic Media, 65 Fed. Reg. 25,843, 25,852 (May 4, 2000) (codified at 17 C.F.R. pts. 231, 241, 271) (describing instances in which prescreening methods satisfactorily distinguished accredited investors); *cf.* Net Roadshow, Inc., SEC No-Action Letter, 1998 WL 40252 (Jan. 30, 1998) (permitting use of Internet for road shows for Rule 144A offerings where prescreening assured that only qualified institutional buyers could access the information on the website).

72. 17 C.F.R. §§ 230.251-263; 1 HAZEN, *supra* note 8, § 4.17.

73. JOBS Act, Pub. L. No. 112-106, § 401(a), 126 Stat. 306, 323-25 (2012).

74. *See supra* text accompanying note 72.

75. *See supra* text accompanying note 72.

solicitation of investors.⁷⁶ Furthermore, limiting the offering pool to residents of a single state—as is required for a federally exempt intrastate offering—renders the exemption unusable for crowdfunding efforts given the interstate reach of the Internet. Rule 504 allows offerings of up to \$1 million but permits a general solicitation only if offered pursuant to state law mandatory disclosure.⁷⁷ Even in the absence of a general solicitation, the exemptions generally require that an offering circular, often called a private placement memorandum, be given to less sophisticated investors.⁷⁸ Except for a Rule 504 offering made without a general solicitation, exemptions are conditioned on mandatory disclosures unless the offering is made solely to accredited investors.⁷⁹

As can be seen from the foregoing discussion, prior to the JOBS Act, there were no exemptions from registration that could be used for crowdfunding capital raising without requiring that an offering circular be sent to potential investors prior to their being asked to make an investment decision. However, the SEC already had statutory authority to craft an exemption that could apply to crowdfunding.⁸⁰ As discussed in the next Section, there were a

76. For a discussion of state blue sky laws and their disclosure requirements, see 2 HAZEN, *supra* note 8, ch. 8.

77. See *supra* text accompanying notes 67–71.

78. SEC Rule 505, which allows offerings of up to \$5 million per year, does not permit a general solicitation and does not impose sophistication requirements on the purchasers. However, Rule 505 does limit the offering to thirty-five unaccredited purchasers, 17 C.F.R. § 230.505, each of whom is entitled to a disclosure document. See SEC Rule 502(b), 17 C.F.R. § 230.502(b) (2011) (detailing the disclosure required in Rule 505 and 506 offerings). Rule 506 permits offerings to sophisticated investors and does not impose a dollar limit. § 230.506. However, as is the case with Rule 505, each unaccredited investor (of which there can be no more than 35) must receive a disclosure document. § 230.502(b). In addition, Rule 506 is conditioned on the absence of a general solicitation. As pointed out *supra* note 8, Rule 506 will be amended to clarify that a general solicitation is permitted so long as all of the investors solicited are accredited investors.

79. The term “accredited investors” includes financial institutions and high net worth individuals. See SEC Rule 215, 17 C.F.R. § 230.215; see also 17 C.F.R. § 230.501(a) (providing a comprehensive definition of accredited investor). Accredited investors also include directors of the issuer. See § 230.215(d).

80. As noted above, the SEC has the authority under section 3(b) to create an exemption for offerings of \$5 million or less. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (2006). A rule could be adopted under section 3(b) to permit general solicitation of investors and would not have to be conditioned on the existence of an offering circular given to investors. The SEC also has broad rulemaking authority under section 28 of the 1933 Act that allows for exemptions when deemed in the public interest. § 28, 15 U.S.C. § 77z-3; see 2 HAZEN, *supra* note 8, § 4.35, at 70–71 (“The SEC now has a choice of working within the statutory limitations . . . or in expanding those parameters through rulemaking deemed to be in the public interest.”).

number of proposals to provide such an exemption, and these proposals led to the JOBS Act.

II. PROPOSALS FOR A NEW CROWDFUNDING EXEMPTION FROM THE SECURITIES LAWS; THE JOBS ACT

A. *The Crowdfunding Proposals*

A number of proposals for a crowdfunding exemption emerged, and there was increasing pressure on the SEC to consider a crowdfunding exemption.⁸¹ A bare-bones crowdfunding bill passed the House,⁸² and there were bills pending in the Senate.⁸³ The original House Bill failed to contain any meaningful investor protections. There were congressional hearings as well.⁸⁴ The Senate reached a compromise and approved an amended version of the original House Bill, which was in turn approved by the House as part of the JOBS Act.⁸⁵

The proposals took various forms. One approach was to allow extremely simplified and limited disclosures for crowdfunding efforts soliciting small amounts from each investor.⁸⁶ Another proposal would have exempted crowdfunding offerings of up to, \$250,000 provided no investor could invest more than \$250 or \$500 per year, along with a companion exemption from the Investment Advisers Act of 1940⁸⁷ for qualified crowdfunding websites.⁸⁸ Another proposal

81. See, e.g., Yin Wilczek, *SEC Under Pressure To Allow Crowdfunding; Agency To Consider Issue Soon, Official Says*, Sec. L. Daily (BNA) (Sept. 16, 2011), http://news.bna.com/sdln/SDLNWB/split_display.adp?fedfid=22850387&vname=sldbullallissues&wsn=500524000&searchid=17343810&doctypeid=1&type=date&mode=doc&split=0&scm=SDLNWB&pg=0 (noting concerns by some policy makers that crowdfunding could lead to an increase in fraudulent practices and that investor protection should not be compromised).

82. See Phil Mattingly, *U.S. House Approves Looser SEC Rules for Closely Held Firms*, BLOOMBERG BUS. WK. (Nov. 9, 2011, 3:37 PM), <http://www.businessweek.com/news/2011-11-09/u-s-house-approves-looser-sec-rules-for-closely-held-firms.html>.

83. See, e.g., Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. (introduced by Sen. Jeff Merkley Dec. 8, 2011); Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (introduced by Sen. Scott Brown Nov. 2, 2011).

84. See Andrew Ackerman, *Fizzled Beer Deal Prompts 'Crowd-Funding' Hearing*, WALL ST. J. (Sept. 14, 2011, 3:53 PM), <http://online.wsj.com/article/SB10001424053111903927204576570614068591324.html>.

85. JOBS Act, H.R. 3606, 112th Cong. (2d Sess. 2012).

86. See Heminway & Hoffman, *supra* note 3, at 955–60 (proposing that the SEC adopt “filing and other disclosure requirements [that are] minimal but substantive” and suggesting specific regulations).

87. The Investment Advisers Act is codified at 15 U.S.C. §§ 80b-1 to -21 (2006). The Investment Advisers Act imposes registration and disclosure requirements on individuals

would have provided an exemption for crowdfunding offerings up to \$250,000 provided an investor does not invest more than \$1,000 during a six-month period.⁸⁹ Yet another would have allowed financing by “regular investors” of up to \$10,000 per investor, or 10% of his adjusted gross income.⁹⁰ Accepting for argument’s sake that such a limitation would be supportable,⁹¹ if the exemption without mandated disclosure is conditioned on limiting amounts from each investor, who will monitor investors’ claims that they meet the exemption’s qualifications?

The SEC acknowledged the push in some circles for a crowdfunding exemption.⁹² Subsequently, President Obama announced his support for a crowdfunding exemption and increasing the maximum amount for a Regulation A offering from the current

and firms that provide securities related investment advice for compensation. *See* § 80b-3 (establishing registration procedures); § 80b-4 (prescribing reporting requirements).

88. *See* C. Stephen Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 *passim* (2012). The proposed Investment Advisers Act exemption would be available to crowdfunding websites that would “(1) be open to the general public; (2) provide public communication portals for investors and potential investors; (3) require investors to fulfill a simple education requirement before participating; (4) prohibit certain conflicts of interest; (5) not offer investment advice or recommendations; and (6) notify the SEC that they are hosting crowdfunding offerings.” *Id.* at 93.

89. *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, 1000–01 (2011).

90.

Startup Exemption is proposing a plan built around “micro-investors” that it thinks would minimize the risk of fraud. They want the SEC to allow small businesses—with fewer than 50 employees and less than \$5 million in annual gross sales—to raise up to \$1 million through crowd funding. Regular investors, defined as people who make less than \$200,000 a year and have a net worth below \$1 million, would be capped at \$10,000 or 10 percent of their adjusted gross income. But the average investor will only give about \$50 to \$500, they say, shielding them from large losses if fraud occurs.

Devaney, *supra* note 11.

91. For the suggestion that limiting investments to small amounts from each investor does little if anything to provide meaningful investor protection without either sophistication or disclosure requirements, see *infra* text accompanying notes 188–91.

92. The SEC considered proposals to amend Regulation D to enable crowdfunding efforts. *See, e.g.*, Jean Eaglesham & Jessica Holtzer, *SEC Boots Up for Internet Age*, WALL ST. J., Apr. 9, 2011, at B1 (describing SEC consideration of crowdfunding proposals). Previously, the SEC solicited comments on a proposer’s rulemaking petition. *See Comments on Rulemaking Petition: Request for Rulemaking To Exempt Securities Offerings up to \$100 from Registration Under Section 5 of the Securities Act of 1933*, U.S. SEC, <http://www.sec.gov/comments/4-605/4-605.shtml> (last visited May 5, 2012).

\$5 million per year to \$50 million per year.⁹³ The President's proposal for a specially tailored exemption applied to crowdfunding efforts seeking to raise less than \$1 million, provided that each investor's contribution would be limited to \$10,000 or 10% of each investor's annual income.⁹⁴ The President's proposal was not detailed, and at first it was unclear whether the exemption would be conditioned on providing investors with information about the company and the offering. The White House proposal included regulating crowdfunding platforms.⁹⁵

Some of the proposals in Congress would have preempted state securities laws⁹⁶ and have provided an exemption for offerings of up to \$5 million per year provided that each purchaser's investment is limited to the lesser of \$10,000 or 10% of the investor's annual income.⁹⁷ Originally, the proposals for a crowdfunding exemption received a mixed reception in Congress.⁹⁸ Nevertheless, the House Financial Services Committee transmitted the bill to the full House which passed it with overwhelming support.⁹⁹ The problem with the

93. See Press Release, White House, Fact Sheet and Overview (Sept. 8, 2011), available at http://www.whitehouse.gov/sites/default/files/american_jobs_act_factsheet.pdf.

94. *Id.*

95. See Maria Lokshin, *Obama Presses Congress To Sign Capital Formation Bills, Will Sign "Right Away,"* 44 Sec. Reg. & L. Rep. (BNA) 250 (Feb. 6, 2012) ("Under the proposal, the offerings would be regulated by the Securities and Exchange Commission and operate within a 'national framework,' conducted through 'regulated online platforms,' and require the platforms to 'meet the SEC's broker-dealer standards' if they engage in broker-dealer 'activities.'").

96. Not surprisingly, state securities administrators have voiced their opposition to any such preemption. See Letter from Jack Herstein, President, N. Am. Sec. Adm's Ass'n, to House Fin. Servs. Comm. Leadership (Oct. 21, 2011), available at http://www.nasaa.org/wp-content/uploads/2011/07/2930_Letter102111.pdf; *infra* text accompanying notes 159-69.

97. See Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (1st Sess. 2011). Although not explicitly limited to crowdfunding, the proposed bill describes its purpose as "[t]o amend the securities laws to provide for registration exemptions for certain crowd-funded securities, and for other purposes." *Id.*

98. See Maria Lokshin, *House Subcommittee OK's Crowdfunding, Other Bills Aimed at Boosting Capital Growth*, Sec. L. Daily (BNA) (Oct. 6, 2011), http://news.bna.com/sdln/SDLNWB/split_display.adp?fedfid=23091267&vname=sldbullissues&wsn=500032000&searchid=17343811&doctypeid=1&type=date&mode=doc&split=0&scm=SDLNWB&pg=0 ("Although the panel cleared the measure, lawmakers found little common ground on Rep. Patrick McHenry's (R-N.C.) bill, H.R. 2930, to exempt crowdfunding.").

99. See Maria Lokshin, *Committee Votes To Report Crowdfunding, Other Capital Formation Proposals to House*, Sec. L. Daily (BNA), http://news.bna.com/sdln/SDLNWB/split_display.adp?fedfid=23275683&vname=sldbullissues&wsn=499902500&searchid=17343814&doctypeid=1&type=date&mode=doc&split=0&scm=SDLNWB&pg=0 (Oct. 27, 2011) (noting that "subcommittee members found little consensus on several proposals, including Rep. Patrick McHenry's (R-N.C.) bill to carve out a regulatory exemption for crowdfunding," but ultimately moved a number of bills "aimed at easing capital formation

House bill was that like some of the other proposals, the exemption was not conditioned on meaningful disclosure. In contrast, the proposed crowdfunding exemption found in Senate Bill 1791¹⁰⁰ was conditioned on disclosure “to investors all rights of investors, including complete information about the risks, obligations, benefits, history, and costs of offering.”¹⁰¹ The proposed exemption was to allow a maximum of \$1,000 investment per investor and, further, would be conditioned on an offering of no more than \$1 million per year.¹⁰² This was clearly a step in the right direction, although it did not explicitly go quite far enough.

A viable crowdfunding exemption should include not only disclosure of the “risks, obligations, benefits, [and] history”¹⁰³ of the offering, but also meaningful disclosure of the nature of the business sufficient to enable investors to evaluate the merits of the securities being offered. This was the approach subsequently taken by proposed Senate Bill 1970 to permit crowdfunding offerings up to \$1 million per year with the SEC having the authority to adjust the ceiling.¹⁰⁴ Senate Bill 1970 placed a limit on each individual’s investment using a sliding scale based on the investor’s annual income.¹⁰⁵ The proposed bill limited the aggregate crowdfunding investments an investor could make in any year,¹⁰⁶ although this could be difficult to enforce if the investor uses multiple crowdfunding sites. Senate Bill 1970 also required that any website offering crowdfunding opportunities either be registered with the SEC as a broker-dealer or be registered under

for small businesses” to the full House); Mattingly, *supra* note 82; see also, e.g., Maria Lokshin, *Obama’s Jobs Council Endorses Crowdfunding, SOX Amendments*, Sec. L. Daily (BNA), http://news.bna.com/sdln/SDLNWB/split_display.adp?fedfid=23279612&vname=sldbulallissues&wsn=499895000&searchid=17343816&doctypeid=1&type=date&mode=doc&split=0&scm=SDLNWB&pg=0 (Oct. 28, 2011) (noting White House support for a crowdfunding exemption).

100. Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (introduced by Sen. Scott Brown Nov. 2, 2011).

101. *Id.* § (b)(1)(A).

102. *Id.* § (a)(3).

103. *Id.* § (b)(1)(A).

104. Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2(a) (introduced by Sen. Jeff Merkley Dec. 8, 2011).

105. Investors with an annual income of less than \$50,000 would be able to invest up to \$500; investors with an annual income between \$50,000 and \$100,000 would be able to invest 1% of their annual income in a crowdfunding offering; and investors with over \$100,000 annual income would be able to invest up to 2% of their annual income. *Id.* § 2(a).

106. *Id.* § 4A(a)(9).

a streamlined procedure as a “funding portal.”¹⁰⁷ Meaningful disclosure to potential investors needs to be part of any proposal striking a proper balance between investor protection and the desire to encourage small business financing. While Congress was considering the various proposals, the Small and Emerging Companies Advisory Committee established by the SEC declined to recommend a crowdfunding exemption, recognizing the need to give adequate deference to investor protection.¹⁰⁸

B. *The JOBS Act*

The Senate eventually agreed on a compromise version of the House Bill by adding a number of significant investor protection provisions that had been included in the earlier Senate proposals.¹⁰⁹ The compromise bill passed both the Senate and House by overwhelming margins, and President Obama signed the bill into law.¹¹⁰ As described in the discussion that follows, the resulting JOBS Act¹¹¹ requires disclosure to investors for offerings under the new

107. *Id.* § 4A(a)(1); *see also id.* § 4(a)(1) (“The Commission shall, by rule, as the Commission determines appropriate, exempt funding portals from the registration requirements of section 15(a)(1), conditionally or unconditionally, provided that such funding portals remain subject to such examination by the Commission and a national securities association and to such other requirements under this title as the Commission determines appropriate under such rule.”). President Obama’s proposal similarly included SEC regulation of crowdfunding sites. *See supra* note 95 and accompanying text.

108. *See* Maria Lokshin, *SEC Small Business Panel Recommends Raising 12(g) Reporting Trigger to 1,000*, 44 *Sec. Reg. & L. Rep. (BNA)* 265 (Feb. 6, 2012) (“The panel, however, tabled a draft recommendation that the commission ‘review and consider’ proposals to exempt crowdfunding from 1933 Securities Act registration. ‘In terms of crowdfunding, I’m not sure we’re in a position to make a meaningful recommendation,’ Graham said. ‘This whole area is fraught with danger.’ Maeder echoed the view. ‘I would suggest that the SEC be very cautious,’ he said. ‘I think this is a very hot potato and a dangerous one at that.’ Catherine Mott, founder and CEO of BlueTree Capital Group and BlueTree Allied Angels, said equity may not be the right type of ownership for crowdfunding. Companies seeking ‘follow-on funding’ will have a hard time getting it from sophisticated investors, she said. Along that vein, Graham said small companies, which would be most likely to issue crowdfunded securities, may not understand all the regulatory issues that follow the offering. ‘I don’t know how you provide a regulatory framework that protects people from their own ignorance,’ he said.”).

109. *See* Lokshin, *House Votes*, *supra* note 13 (describing the final bill approved by both the House and Senate).

110. *Id.*

111. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified at scattered sections of 15 U.S.C.). The Act also implements a number of other provisions, including raising the trigger for companies having to file periodic reports with the SEC, and creating a new category of “emerging growth company,” which is a company having less than \$1 billion in annual total gross revenues. *Id.* §§ 101–105, 126 Stat. at 307–11. This threshold

crowdfunding exemption that will be codified in sections 4(6) and 4A of the Securities Act of 1933.¹¹² The new exemption requires registration of crowdfunding portals¹¹³ and significant preemption of state law.¹¹⁴

The new crowdfunding exemption limits the amount of money that a company may raise from any investor. With respect to investors having annual income or net worth below \$100,000, a company may not sell securities exceeding the greater of \$2,000 or 5% of the investor's annual income or net worth within a 12 month period.¹¹⁵ For investors over the \$100,000 annual income or net worth threshold, the 12 month investment is capped at 10% of the investor's annual income or net worth but not to exceed \$100,000 over the 12 month period.¹¹⁶ In addition, the maximum amount a company can raise under the crowdfunding exemption is \$1 million every twelve months.¹¹⁷

The new crowdfunding exemption is conditioned on providing investors with certain disclosures that must also be filed with the SEC. The required disclosures include the offering's purpose, the targeted amount to be raised, the deadline for reaching such amount, and the offering price.¹¹⁸ Significantly, risks to investors also must be disclosed as well as any additional information as the SEC may prescribe. The Act also expressly requires information about the company, its officers, directors, and major shareholders in addition to a description of the company's business, business plan, capital structure, and financial condition.¹¹⁹ Audited financial statements are required for offerings over \$500,000 or other threshold that may be imposed by SEC rulemaking.¹²⁰ The only advertising permitted is advertising that directs interested investors to the registered funding portal or registered broker handling the offering. The company may not compensate promoters of the offering unless the compensation is disclosed. The Act also imposes reporting obligations beyond the offering. For companies not subject to the 1934 Act's periodic

will be adjusted every five years as appropriate in light of inflation. *Id.* § 101, 126 Stat. at 307–08.

112. *Id.* § 302, 126 Stat. at 315–21.

113. *Id.* § 304, 126 Stat. at 321–22.

114. *Id.* § 305, 126 Stat. at 322–23.

115. *Id.* § 302, 126 Stat. at 315–21.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

reporting requirements, crowdfunded companies must file annual reports and provide investors annually with reports on the results of operations and financial statements. The JOBS Act further directs the SEC to exempt, conditionally or unconditionally, securities acquired through the crowdfunding exemption from the 1934 Act's calculation of shareholders of record as a trigger for the registration and periodic reporting obligations.¹²¹

The intermediary for a crowdfunding offering must be registered with the SEC either as a broker-dealer or under the new registration category for a crowdfunding portal.¹²² In addition to SEC registration, the SEC is directed to adopt rules requiring the broker or funding portal to provide disclosures to investors relating to risks and investor education materials.¹²³ These rules will also require the broker or funding portal to take steps to ensure that investors review the disclosures, answer various questions, and affirm that they understand the risk of loss.¹²⁴ The broker or registered funding portal will also be required to investigate the background of regulatory compliance by the company's officers, directors, and major shareholders. The broker or funding portal must make certain information available to investors and the SEC at least twenty-one days in advance of the offering.¹²⁵ The broker or funding portal must also follow SEC rules designed to assure that purchasers have not exceeded the investment cap for all crowdfunding offerings by any issuer during a twelve-month period.¹²⁶ The Act further requires the broker or funding portal to be sure that the offering proceeds are turned over to the issuer only when the target offering amount is reached.¹²⁷

The JOBS Act also addresses the role of the states in crowdfunding regulation. State blue sky law registration requirements for public offerings are preempted unless the issuer of the securities has its principal place of business in the state or more than fifty

121. *Id.* § 303, 126 Stat. at 321 (to be codified as new section 12(g)(6) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l(g)) (“The Commission shall, by rule, exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under section 4(6) of the Securities Act of 1933 from the provisions of this subsection.”); *see supra* note 42.

122. JOBS Act § 304, 126 Stat. at 321–22.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* In addition, the broker or funding portal must protect investor privacy and not compensate promoters, finders, or others for providing potential investors' personal identifying information. The broker or funding portal nor its directors, officers, or partners may have any financial interest in a company using its crowdfunding services.

percent of the crowdfunding offering's proceeds are purchased by residents of the state.¹²⁸ Thus, it is possible that two states could impose their registration requirements if the company's principal place of business is in one state and more than half of the offering's proceeds are raised in the other state. In addition, preemption extends to regulation of funding portals except for the state of the crowdfunding portal's principal place of business.¹²⁹ The funding portal's principal place of business may regulate the portal but not by imposing requirements greater than those imposed by the SEC.¹³⁰

III. THE SECURITIES LAWS' ANTI-FRAUD PROVISIONS AND PRIVATE REMEDIES

While it is true that the securities laws' anti-fraud provisions¹³¹ apply to transactions that are exempt, the SEC's resources are limited, and the Commission cannot be expected to be effective in the crowdfunding arena—especially considering widely reported enforcement failures involving much larger economic stakes.¹³² Beyond SEC enforcement, the anti-fraud provisions offer some private remedies to injured investors. For example, SEC Rule 10b-5¹³³ provides a remedy to investors who can demonstrate a causal connection between a material misstatement or omission in connection with a securities transaction and resulting damages.¹³⁴ A significant limitation is that in addition to being able to prove loss causation,¹³⁵ the plaintiff must also prove that the defendant acted

128. *Id.* § 305, 126 Stat. at 322–23.

129. *Id.*

130. *Id.*

131. Section 17 of the 1933 Act prohibits fraud and misstatements in the offering and sale of securities. Securities Act of 1933 § 17, 15 U.S.C. § 77q (2006). Section 10(b) and Rule 10b-5 of the 1934 Act prohibit fraud and misstatements in connection with the purchase or sale of securities. § 10(b), 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2011). 1934 Act Rule 10b-5, unlike 1933 Act § 17(a), provides an implied private remedy to injured investors. *See* 2 HAZEN, *supra* note 8, § 7.11[2][C]; 3 *id.* § 12.2[2], at 514–15.

132. *See* Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Across Borders*, N.Y. TIMES, Dec. 19, 2008, at A1 (discussing the growth and collapse of Bernard Madoff's Ponzi scheme); *see also* Kara Scannell, *Madoff Chasers Dug for Years, to No Avail*, WALL ST. J., Jan. 5, 2009, at C1 (discussing the SEC and other regulators' examination of Madoff and their inability to uncover the scheme).

133. 17 C.F.R. § 240.10b-5.

134. For discussion of the remedy available under SEC Rule 10b-5, *see generally* 3 HAZEN, *supra* note 8, § 12.3.

135. *See, e.g., Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345–46 (2005) (holding that the plaintiff in a Rule 10b-5 action bears the heavy burden of establishing a causal connection between the fraudulent transaction and provable damages). *But cf.* *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2186–87 (2011) (holding that loss

with scienter, which means he had the intent to deceive or acted with a highly reckless disregard for the truth.¹³⁶ While it is true that a class action involving securities that are not widely publicly traded may not be subject to the heightened pleading standards of the Private Securities Litigation Reform Act,¹³⁷ the Federal Rules of Civil Procedure require fraud claims to be pled with heightened specificity.¹³⁸ Furthermore, for more than thirty-five years, the Supreme Court has given narrow scope to implied private remedies generally and to Rule 10b-5 in particular. For example, it is not sufficient to establish that the defendant created the material misstatement or omission, he must have actually made the statement.¹³⁹

In contrast to Rule 10b-5, the Securities Act of 1933 includes two express remedies available to investors injured as a result of material misstatements or omissions in connection with the offering of securities. Section 11 of that Act provides a relatively robust remedy which does not require scienter and can be brought against a number of defendants who did not actually *make* the statement at issue.¹⁴⁰ However, the section 11 remedy is limited to misstatements and omissions made in a registration statement filed pursuant to a full-fledged registered public offering.¹⁴¹ As such, it would not be available to crowdfunding investors where the offering takes place under the aegis of an exemption from registration. The second 1933 Act remedy is found in section 12(a)(2), which allows private actions

causation need not be established as a precondition to certification of a class action but must be established prior to an award of damages).

136. *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (stating that scienter is a prerequisite to finding a violation of Rule 10b-5); *see also* *Aaron v. SEC*, 446 U.S. 680, 685 (1980) (finding that scienter is not limited to private suits and thus is an element of an SEC suit based on Rule 10b-5); *cf.* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319–25 (2007) (discussing pleading standards under Rule 10b-5).

137. Pub. L. No. 104-67, § 101, 109 Stat. 737, 738 (to be codified as new section 27(a)(2)(A) of the Securities Act of 1933, 15 U.S.C. § 77z-1); *id.* § 101, 109 Stat. 737, 743 (to be codified as new section 21D(a)(2)(A) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4).

138. FED. R. CIV. P. 9(b).

139. *Janus Capital Grp. Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2301 (2011). In addition, private actions cannot be brought on the basis of aiding and abetting liability. *See* *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994); *see also* *Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc.*, 552 U.S. 148, 158 (2008) (discussing primary liability and the necessity of establishing that the plaintiff had a basis for relying on the defendant's participation in the misstatement or omission).

140. 15 U.S.C. § 77k (2006). For a discussion of the scope of the remedy, *see* 2 HAZEN *supra* note 8, §§ 7.3–5, at 109–65.

141. 15 U.S.C. § 77k (explicitly limiting the remedy to misstatements and omissions in a registration statement).

against *sellers*¹⁴² of securities who make material misstatements or omissions in the offer or sale.¹⁴³ Although not expressly limited to registered or public offerings, the Supreme Court has limited the section 12(a)(2) remedy to offerings made by use of a prospectus or similar offering circular.¹⁴⁴ This limitation on the section 12(a)(2) remedy highlights the need for an offering circular requirement in any offering using a general solicitation as is the case with crowdfunding. The JOBS Act amends section 12 of the 1933 Act to expressly include a remedy for misstatements and omissions made in connection with an offering under the new crowdfunding exemption.¹⁴⁵

The foregoing provides an overview of the relatively limited remedies for material misstatements or omissions made in connection with securities offerings that are exempt from SEC registration. These remedies are not sufficient to protect investors in crowdfunding offerings without registration or an exemption that is conditioned on the use of an offering circular. Even with an exemption mandating the use of an offering circular, the impact of the private remedies must be tempered by the fact that a relatively small crowdfunding effort will result in relatively modest potential damages, thus raising questions regarding the economics of bringing such a claim and the adequacy of the economic incentives to plaintiff's law firms to bring suit on a contingent fee basis.

IV. CROWDFUNDING AND SOCIAL NETWORK SITES AS INTERMEDIARIES

The registration and disclosure provisions expressly apply to *any person* who offers or sells a security.¹⁴⁶ Traditionally, brokerage firms acting as underwriters distribute securities as part of a public offering. Acting as an intermediary for a securities offering likely entails offering securities for sale. This includes social networking sites that connect their viewers with crowdfunding offerings. In addition, dedicated crowdfunding sites run the risk of running afoul of the law

142. The defendant must have been the seller of the securities and also must have been in privity with the plaintiff. *See Pinter v. Dahl*, 486 U.S. 622, 641–55 (1988) (discussing the narrow definition of seller in section 12).

143. 15 U.S.C. § 77l(a)(2). For a discussion of the scope of the remedy, see 2 HAZEN, *supra* note 31, §§ 7.6–8.

144. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 578–84 (1995).

145. JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 316–21 (2012) (to be codified as new section 4A of the Securities Act of 1933, 15 U.S.C. § 77d-1).

146. *See, e.g.*, 15 U.S.C. § 77e (2006) (prohibiting offers and sales by “any person”); 17 C.F.R. § 240.10b-5 (2011) (prohibiting fraud and material misstatements by “any person”).

applicable to securities brokers and dealers.¹⁴⁷ It does not matter whether the site acting as an intermediary in a securities transaction receives specific compensation for its efforts.

Acting as an intermediary in a securities offering will classify that person as an “underwriter”¹⁴⁸ even if the intermediary is not a traditional securities professional.¹⁴⁹ For example, a nonprofit organization was an underwriter because it was a conduit from an offshore issuer to investors in the United States.¹⁵⁰ A website acting as a conduit for securities sales similarly would be an underwriter even if not compensated.¹⁵¹ A social network that provides links to crowdfunding efforts would likely receive underwriter status and be subject to consequences under the 1933 Act.¹⁵² Dedicated crowdfunding sites¹⁵³ would clearly qualify as underwriters of any offering efforts. Further, their activities could expose them to the 1934 Act’s registration requirements for securities brokers since acting as an underwriter can by itself be sufficient to require registration as a broker-dealer.¹⁵⁴

Section 15(a)(1) of the 1934 Act requires securities brokers and dealers to register in order to conduct their business unless they operate solely intrastate or are otherwise exempted from registration.¹⁵⁵ Registration subjects the broker-dealer to many

147. See 15 U.S.C. § 78o(a)(1). For additional discussion of the broker-dealer implications for crowdfunding sites, see Bradford, *supra* note 88, at 33–43.

148. 15 U.S.C. § 77b(a)(11) (“The term ‘underwriter’ means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . .”).

149. See generally 2 HAZEN, *supra* note 8, § 4.27, at 5–24 (discussing the expansive definition of “underwriter”).

150. See, e.g., SEC v. Chinese Consol. Benevolent Ass’n, 120 F.2d 738, 739–41 (2d Cir. 1941), *cert. denied*, 314 U.S. 618 (1941) (finding that a benevolent association helping China distribute bonds was an underwriter and violated the securities laws since the offering was not registered).

151. The court issued an injunction against Chinese Consolidated Benevolent Association for proceeding without registration even though the conduit was acting for benevolent purposes and was not compensated. *Id.* at 740.

152. See *id.*; see also 15 U.S.C. § 77h-1 (2006 & Supp. IV 2010) (listing the possible penalties imposed for violations of the 1933 Act).

153. For examples of dedicated crowdfunding sites, see *supra* note 2.

154. See, e.g., Paul A. Barrios, Securities Act Release Nos. 33-7810, 34-42531, 71 SEC Docket 2070, 2070, 2000 WL 279232 (Mar. 15, 2000) (ordering a cease-and-desist proceeding against the defendant for his participation in unregistered offerings); SEC v. Milan Capital Grp., Inc., Litigation Release No. 16405, 71 SEC Docket 1080, 1080, 2000 WL 12467 (Jan. 10, 2000).

155. Securities Exchange Act of 1934 § 15(a)(1), 15 U.S.C. § 78o(a)(1) (2006).

reporting requirements and also impacts its daily operation and organizational structure.¹⁵⁶ The need to register is triggered by acting as a broker or dealer in securities. “Broker” is defined in the 1934 Act to include any person engaging in the business of buying and selling securities for others.¹⁵⁷ Websites facilitating crowdfunding efforts could easily qualify as a broker or, as noted above, as underwriters. Either way, registration would be required absent an exemption. As noted above, the new crowdfunding exemption is conditioned on using a registered broker dealer or a registered funding portal.¹⁵⁸

V. IMPACT OF STATE SECURITIES LAWS

Even before Congress introduced the 1933 Act, state securities regulation had existed for more than twenty years.¹⁵⁹ Typically, state securities laws require registration and disclosures for securities offerings made within the state.¹⁶⁰

Absent registration or an applicable exemption, offerings to investors are likely to violate state securities law. For example, the Massachusetts Supreme Judicial Court recently rejected a First Amendment challenge to the Massachusetts Secretary of State’s cease and desist order against a website offering securities without registration under state law.¹⁶¹

Prior to 1996, registration of public offerings was required in each state in which the securities were offered for sale.¹⁶² However, as a result of the National Securities Markets Improvement Act of 1996¹⁶³ (“NSMIA”), state registration and disclosure requirements are preempted for offerings registered under the 1933 Act and

156. Section 15(b) and SEC rules promulgated thereunder set forth the registration requirements. § 15(b), 15 U.S.C. § 78o(b). The information to be supplied in the registration materials includes a detailed description of the broker-dealer’s assets and financial condition, including a showing of compliance with the Commission’s net capital rule, which imposes minimum solvency requirements on broker-dealer firms. *See* 5 HAZEN, *supra* note 8, § 14.5[1].

157. 15 U.S.C. § 78c(a)(4)(A) (“The term ‘broker’ means any person engaged in the business of effecting transactions in securities for the account of others.”).

158. H.R. 3606, 112 Cong. § 304 (2d Sess. 2012).

159. In 1911, Kansas enacted the first state securities act and other states followed suit by enacting state securities laws that are commonly referred to as blue sky laws. *See* 2 HAZEN, *supra* note 8, § 8.1[1][A] at 420; *supra* note 76 and accompanying text.

160. *See* 2 HAZEN, *supra* note 8, ch. 8.

161. *Bulldog Investors v. Sec’y of Commonwealth*, 953 N.E.2d 691, 718 (Mass. 2011) (upholding state’s ability to pursue website under Massachusetts law).

162. *See* 2 HAZEN, *supra* note 8, § 8.1[3].

163. National Securities Market Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

offerings exempt under a few specified 1933 Act exemptions. Section 18(b) of the 1933 Act sets forth the scope of NSMIA preemption.¹⁶⁴ For example, certain private placements conditioned on the absence of a general solicitation¹⁶⁵ and offerings made within a single state¹⁶⁶ are not covered by NSMIA preemption. NSMIA does not preempt the states from imposing their registration and disclosure requirements for offerings that involve a general solicitation across state lines. For example, Regulation A, which, at least in theory, could be used for crowdfunding, does not preclude state law from mandating its own registration and disclosure. Any new exemption that would cover crowdfunding efforts similarly would not be within NSMIA's preemption without legislative action. Accordingly, to be effective in reducing registration costs, Congress needed to amend section 18(b) of the 1933 Act to expand NSMIA's preemption.¹⁶⁷

Prior to the JOBS Act, there was little the SEC could do to change the securities regulation landscape for crowdfunding without congressional action. In opposition to the proposals to preempt state law,¹⁶⁸ the North American Securities Administrators Association indicated that it may be crafting rules for crowdfunding and other small business financing techniques.¹⁶⁹ Preemption of state laws without a meaningful disclosure requirement for a federal crowdfunding exemption would unduly limit the states' ability to prevent fraud in small offerings. As previously noted, the JOBS Act

164. Securities Act of 1933 § 18(b), 15 U.S.C. § 77r(b) (2006 & Supp. IV 2010).

165. Section 18(b) preempts state registration and disclosure mandates for private placements that are exempt from registration by virtue of a rule implementing section 4(2)'s exemption for transactions not involving a public offering. To date, SEC Rule 506 is the only rule that qualifies for NSMIA preemption for private placements. *See* 17 C.F.R. § 230.506 (2011).

166. Section 3(a)(11) exempts offerings where securities are offered and sold only to residents of a single state. 15 U.S.C. § 77c(a)(11).

167. *See* Pope, *supra* note 89, at 1001 (proposing that Congress amend section 18(b) to enable preemption of state securities laws for crowdfunding offerings); *see also* Bradford, *supra* note 88, at 4–5 (proposing to preempt state regulation of crowdfunding for federally exempt offerings). Of course, such an expansion of preemption would not be necessary if it is determined that the existing exemptive scheme is appropriate.

168. *See* Letter from Jack Herstein, President, N. Am. Sec. Adm'rs Ass'n, to House Fin. Servs. Comm. Leadership, *supra* note 96.

169. News Release, N. Am. Sec. Adm'rs Ass'n, State Securities Regulators To Explore Steps To Help Small and New Businesses Raise Investment Capital (Oct. 24, 2011), available at <http://www.nasaa.org/7187/state-securities-regulators-to-explore-steps-to-help-small-and-new-businesses-raise-investment-capital/>. Even without rulemaking, state securities administrators can shut down crowdfunding efforts that are neither registered under nor exempt from state blue sky registration requirements. *See* ProFounder Fin., Inc. (Cal. Dept. of Corps. Aug. 21, 2011) (consent order to cease crowdfunding activities), available at http://www.corp.ca.gov/ENF/pdf/2011/ProFounder_CO.pdf.

preempts state law in most respects while also mandating disclosure to investors.¹⁷⁰

VI. INVESTOR PROTECTION WOULD BE UNDULY SACRIFICED BY AN OVERLY PERMISSIVE EXEMPTION FOR CROWDFUNDING

As noted above, there are many who proposed that the merits of encouraging crowdfunding efforts limiting the amount any one investor can commit justify a new exemption from 1933 Act registration without requiring meaningful disclosure to investors. The SEC has been consistent in conditioning offerings to the general public on mandatory disclosures.¹⁷¹ The benefits of crowdfunding do not justify a departure from this pattern. In order to give proper deference to investor protection, any exemption applicable to crowdfunding should be conditioned on mandatory disclosures, perhaps a bit less rigorous than those currently required in Regulation A offerings.¹⁷²

Many of the proponents of a new or special crowdfunding exemption from 1933 Act registration forgot the telling history of Rule 504's exemption for offerings of \$1 million or less. As originally adopted, Rule 504 provided an exemption for nonpublic companies to permit offerings of \$500,000 or less and had no specific disclosure requirements, although it did not permit a general solicitation of investors unless the offering was made in compliance with state law disclosure requirements.¹⁷³ Securities issued under Rule 504 were not subject to resale restrictions and thus could be traded freely among investors.¹⁷⁴ However, as the Internet became more popular and widely used, online securities offerings took off and many less scrupulous promoters used the Rule 504 exemption for bogus or fraudulent offerings.¹⁷⁵ Accordingly, the SEC responded by amending Rule 504, for which the ceiling had already been raised to \$1 million, to its current form. Rule 504 no longer allows exempt offerings under the rule to be made through a general solicitation, nor does it allow

170. See *supra* notes 128–30 and accompanying text.

171. See *supra* note 10 and accompanying text.

172. Even Rule 505's exemption, which does not permit offerings using a general solicitation, mandates disclosure to unaccredited investors. 17 C.F.R. § 230.505 (2011).

173. See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251, 11,257–58 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239) (adopting Regulation D).

174. *Id.* at 11,252.

175. See, e.g., Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Securities Act Release No. 33-7644, 64 Fed. Reg. 11,090, 11,091 (Mar. 8, 1999) (codified at 17 C.F.R. pt. 230).

unrestricted aftermarket trading unless the issuer of the securities has complied with applicable disclosure requirements under the law of at least one state.¹⁷⁶

No doubt, there is a public policy that favors encouraging small business capital raising efforts. In fact, Congress and the SEC recognized this with their small business initiatives.¹⁷⁷ For example, smaller companies may take advantage of scaled disclosure that is less onerous than the disclosure requirements applicable to most public companies.¹⁷⁸ Encouraging small business financing is the primary thrust of SEC Regulation A, which permits what are in essence public offerings of less than \$5 million per year with an even more significantly scaled back disclosure document.¹⁷⁹ As noted above, many of the existing small issue exemptions are conditioned on the absence of general solicitations to potential investors.¹⁸⁰ Others are conditioned on investors' sophistication or ability to fend for themselves.¹⁸¹ The small issue exemptions that permit general solicitations mandate the use of an offering circular to provide information about the company and the investment opportunity being offered.¹⁸² In addition, by relying on Rule 504 for offerings up to \$1 million,¹⁸³ small businesses can target unsophisticated investors, evading the disclosure requirements so long as the investors are not strangers and therefore are not the result of a general solicitation.

The current exemption landscape allows small businesses to seek private financing from sophisticated and accredited investors without mandated disclosures since those investors can fend for themselves.¹⁸⁴ There is good reason for these limitations, and the burden of justifying a deviation from the current pattern should fall on the

176. 17 C.F.R. § 230.504. In addition, securities offered under the Rule 504 exemption may not be freely resold absent state disclosure compliance.

177. See, e.g., Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C.); Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251, 11,251 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230 & 239) (adopting Regulation D).

178. SEC Regulation S-K sets forth the disclosure requirements, including the scaled disclosure for smaller companies. 17 C.F.R. §§ 229.10–100 (2011).

179. 17 C.F.R. §§ 230.251–263; see *supra* text accompanying note 14.

180. See *supra* notes 10, 77–79 and accompanying text.

181. See *supra* note 53.

182. E.g., Regulation A, 17 C.F.R. §§ 230.251–263.

183. 17 C.F.R. § 230.504.

184. Such offerings could take place under section 4(2)'s non-public offering exemption or under Regulation D's Rules 505 or 506. 15 U.S.C. § 77d(2) (2006 & Supp. IV 2010); 17 C.F.R. §§ 230.505–506.

proponents of a crowdfunding exemption. The original House version of the JOBS Act did not meet this burden with respect to an exemption that would not have contained an affirmative disclosure requirement about the company and the offering sufficient to enable potential investors to make an informed investment decision. The exemption proposed in Senate Bill 1791¹⁸⁵ was a step in the right direction. The JOBS Act conditions the crowdfunding exemption on disclosure to investors¹⁸⁶ which quite properly preserves the proper balance by encouraging small business financings while also giving appropriate consideration to investor protection. Only time will tell whether the express disclosure requirements in new section 4(6) of the 1933 Act will be sufficient to provide meaningful investor protection.¹⁸⁷ If not, the SEC can correct the situation. As noted earlier, the crowdfunding exemption expressly authorizes the SEC to impose additional requirements.¹⁸⁸

It is naïve to assume that limiting offerings to small amounts per investor will deter scammers from taking advantage of investors via crowdfunding. Even limiting the exemption to relatively small amounts such as \$250 or \$500 does not mean that there is an insufficient investor-protection stake such that scrutiny is not warranted.¹⁸⁹ Why does a small amount of money from many investors present less of an investor-protection threat than more significant amounts of money from fewer investors? While the argument that the limited risk exposure per investor warrants less regulation may have some surface appeal, a deeper analysis does not support this as the primary basis for a specially tailored exemption, unless the exemption is conditioned on meaningful disclosures to investors. Also, although it is often said that good things come in small packages, fraud can come in small packages, too.¹⁹⁰ Fraud in small packages can be just as effective and damaging to the victims,

185. Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (introduced by Sen. Scott Brown Nov. 2, 2011); *see supra* note 168 and accompanying text.

186. *See supra* notes 128–30 and accompanying text.

187. JOBS Act, Pub L. No. 112-106, § 302, 126 Stat. 306, 315–21 (2012) (to be codified as new section 4A of the Securities Act of 1933, 15 U.S.C. § 77d-1).

188. *Id.*; *see supra* note 119 and accompanying text.

189. Some of the proposals would have allowed larger contributions by each investor. *See supra* notes 86–102 and accompanying text.

190. In fact, Charles Ponzi, who created the Ponzi scheme perpetrated his fraud by raising relatively small amounts of money from a large number of people. *See infra* note 199.

many of whom may be least able to bear the risk of even a small investment in a speculative business.¹⁹¹

Investors in crowdfunding offerings are likely to be strangers to the company and, as such, would have no information about the company except that provided by the company or the website where the securities are offered for sale. If anything, the impersonal nature of the Internet would seem to call for more, rather than less, investor protection. Also, the solicitation of small investors is likely to attract more unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws. It also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.¹⁹² Furthermore, if an overly permissive crowdfunding exemption were recognized, what is to prevent scammers from repeatedly going to the same investors for purportedly different investments? Even putting aside scammers who are trying to bilk the public, crowdfunding offers the potential for raising large amounts of money, warranting the mandatory disclosure that is required by the federal securities laws.¹⁹³

Depending on the aggregate amount of money being raised, there are plenty of existing exemptions, although as noted above, many of them preclude offering by general solicitation.¹⁹⁴ Under

191. If, as the proposals suggest, the limited dollar exposure of each investor is a precondition of the exemption, who will monitor this? Will crowdfunding operations have to do their due diligence to assure that investors in fact qualify? If not, what is to prevent an investor from making multiple investments that are not in compliance with the exemption's limitations?

192. It has been suggested that people who cannot afford the risk are lured to gambling as a chance to hit it big in order to exit from their dire economic circumstances. *See, e.g.,* ANN FABIAN, *CARD SHARPS, DREAM BOOKS & BUCKET SHOPS: GAMBLING IN 19TH-CENTURY AMERICA* 11 (Cornell Univ. Press 1990); Thomas Lee Hazen, *Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1002 (1992) ("One of the factors that has motivated people to become gamblers and speculators is that 'hitting it big' offers them the opportunity to cross economic barriers that could not otherwise be transcended by rational investment strategies.") (citing VICKI ABT, JAMES F. SMITH & EUGENE MARTIN CHRISTIANSEN, *THE BUSINESS OF RISK: COMMERCIAL GAMBLING IN MAINSTREAM AMERICA passim* (1985)).

193. In the SEC's first publicized enforcement action, it exacted a settlement with respect to successful crowdfunding efforts. The agency in question was seeking \$300 million and had already received \$200 million in pledges. Migliozi, *Securities Act Release No. 33-9216*, 2011 WL 2246317 (June 8, 2011) (resulting in a consent cease and desist order regarding crowdfunding efforts without registration), as described in SEC News Release 2011-122 (June 8, 2011), available at <http://www.sec.gov/news/press/2011/2011-122.htm>. The offering that was eventually shut down before any actual funds changed hands was an attempt to find a purchaser for Pabst Brewing Company.

194. *See supra* notes 51–66 and accompanying text.

existing law, general solicitation offerings require affirmative disclosure.¹⁹⁵ Many of the proposals did not meet the burden of establishing that a new exemption to encourage crowdfunding would be consistent with investor protection. Regardless of the amount of money to be raised, any exemption for crowdfunding should include some affirmative disclosure requirements. Those disclosures could be less burdensome than those currently required under Regulation A, but they should still be sufficiently detailed to provide investors with sufficient information to enable them to make an informed investment decision. The JOBS Act has set the stage for the SEC to strike the appropriate balance when it implements the crowdfunding exemption through rulemaking.

It is one thing to argue, as some have, that the exemptions are too burdensome regardless of the forum for seeking financing.¹⁹⁶ If those arguments are persuasive, then a more massive overhaul of the exemptions was warranted, rather than a specific focus on crowdfunding as a launching pad for a new exemption. It therefore was appropriate that the JOBS Act took exactly that approach.

Exposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals to the perceived need to lower the disclosure barriers for small businesses and crowdfunding techniques. The Internet and social networking offer fertile ground for scammers. Scammers and securities fraudsters have for nearly a century found ways to adapt their scams to new technologies.¹⁹⁷ Consider, for example, high-pressure boiler room sales operations¹⁹⁸ or the promotion of fictitious or worthless securities to build Ponzi schemes.¹⁹⁹ The Internet has also proven to

195. See *supra* notes 51–66 and accompanying text.

196. See, e.g., Campbell, *supra* note 16, at 81; Cohn & Yadley, *supra* note 16, at 87; see also 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) (proposing an unconditional exemption for small offerings).

197. See, e.g., John Rothchild, *Protecting the Digital Consumer: The Limits of Cyberspace Utopianism*, 74 IND. L.J. 893, 898 (1999) (describing consumer vulnerability in a changing commercial market, and in particular, abuse of the “pay-per-call” system in the 1980s); see *infra* note 202.

198. Boiler rooms are high pressure sales operations that have existed since the early twentieth century. See, e.g., Philip A. Loomis, Jr., *Enforcement Problems Under the Federal Securities Laws*, 14 BUS. LAW. 665, 672–73 (1959) (describing the rising of the boiler room scheme). The movie *Boiler Room* (New Line Cinema 2000) accurately depicted many of the tactics used in the perpetration of securities brokers’ high-pressure sale frauds.

199. As one court explained:

be fertile ground for pump and dump schemes.²⁰⁰ Boiler room tactics have adapted to new technologies. For example, telephonic cold calling has been supplemented or superseded by spam emails.²⁰¹ In other words, the benefits of technology necessarily offer scammers new opportunities. The Internet as a forum for crowdfunding thus does not by itself warrant a special exemption. It is to be expected that absent compliance with the crowdfunding exemption, the SEC will vigorously pursue crowdfunding efforts without 1933 Act registration.²⁰²

The term “Ponzi Scheme” arises out of the remarkable criminal financial career of Charles Ponzi. In December 1919, with \$150, he began the business of borrowing money on his promissory notes. He did not profess to receive money for investment for account of the lender. He borrowed the money on his credit only. He spread the false tale that, on his own account, he was engaged in buying international postal coupons in foreign countries and selling them in other countries at one hundred percent profit, and that this was made possible by the excessive differences in the rates of exchange following the war. Ponzi induced thousands to lend to him by promising in ninety days to pay them \$150 for every \$100 loaned. Within eight months he took in \$9,582,000, for which he issued notes for \$14,374,000. He paid his agents a commission of ten percent. He was always insolvent, and made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes. By the time his scheme collapsed, Ponzi was taking in about \$1,000,000 a week.

State v. Hurd, Nos. 96APA03-326 to -328, 1999 WL 281305, at *4 n.1 (Ohio Ct. App. May 4, 1999) (citing *Cunningham v. Brown*, 265 U.S. 1, 44 (1924)).

200. Pump and dump operations often involve high pressure recommendations, withholding securities from the market, and other manipulative actions designed to inflate a security's price before the manipulator dumps those shares on the market. *See, e.g.*, *Catton v. Def. Tech. Sys., Inc.*, 457 F. Supp. 2d 374, 383 (S.D.N.Y. 2006) (finding sufficient allegations of pump and dump scheme); *SEC v. Wolfson*, No. 2:02 CV 1086 TC, 2006 WL 1214994, at *10–11 (D. Utah May 5, 2006) (awarding summary judgment in SEC's favor against perpetrators of pump and dump scheme); *Scacci*, Exchange Act Release No. 34-41873, 70 SEC Docket 1290, 1999 WL 710848 (Sept. 14, 1999) (labeling the scheme at issue a “classic” pump and dump manipulation); *see also, e.g.*, *SEC v. Cavanagh*, 445 F.3d 105, 107 (2d Cir. 2006) (determining that shareholders were affiliates and thus 1933 Act § 4(1) was unavailable to shield 1933 Act § 5 violations in connection with pump and dump scheme); *Internet Firm, Officials, Face Charges in Alleged \$100M ‘Pump and Dump’ Scheme*, 33 Sec. Reg. & L. Rep. (BNA) 957, 1323 (2001) (reporting that Internet firm M&A West Inc. and its officers charged in connection with \$100 million pump and dump scheme).

201. Various boiler room techniques and legal consequences are discussed in 5 HAZEN, *supra* note 8, § 14.18.

202. *See, e.g.*, *Migliozzi*, Securities Act Release No. 33-9216, 2011 WL 2246317, at *2–3 (June 8, 2011) (resulting in a consent cease and desist order regarding crowdfunding efforts without registration). *Migliozzi* involved a crowdfunding effort to raise money for Pabst Blue Ribbon Beer. Participants were to receive crowdsourced ownership certificates plus a quantity of beer valued at the amount of the participant's contribution. It is interesting to compare this unsuccessful effort to bypass the 1933 Act's registration requirements to a previous beer sales promotion offering shares as a “gift” with each case

CONCLUSION

Congress adopted a new exemption that is tailored to crowdfunding efforts. As noted above, Senate Bill 1791²⁰³ was a step in the right direction. Senate Bill 1970²⁰⁴ struck a much better balance of removing barriers while still imposing a reasonable degree of investor protection. A crowdfunding exemption conditioned on meaningful disclosure represents the appropriate compromise between the desire to encourage small business financing while at the same time giving due attention to investor protection.

The new crowdfunding exemption is conditioned on mandated disclosures that gives investors the opportunity to evaluate the merits of the investment. As noted earlier, these disclosures are required in the form of an offering circular that is sufficient to trigger a section 12(a)(2) claim should the disclosures be materially deficient.²⁰⁵ Anything short of this would permit a general solicitation of investors regardless of sophistication and would trigger the types of abuses that led to the 1999 revision of the Rule 504 exemption.²⁰⁶ If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud. As such, it makes no sense to sacrifice investor protection simply because there are dollar limits on the investments solicited via crowdfunding. Hopefully, the new crowdfunding exemption as implemented by the SEC will provide sufficiently meaningful disclosure so that investors receive the protection they both need and deserve.

of beer. See Am. Brewing Co., SEC No-Action Letter, 1999 WL 38280 (Jan. 27, 1999) (finding that a stock “give away” was really a sale of securities); Vanderkam & Sanders, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 96 (Jan. 27, 1999) (noting that stock give-away program giving “free” stock for visiting Internet site would be a sale of stock in violation of section 5 of the 1933 Act).

203. See *supra* note 100 and accompanying text.

204. See *supra* notes 104–07 and accompanying text.

205. See *supra* text accompanying notes 142–44.

206. See *supra* text accompanying note 173–76.

