

# FALSE START: CARVING A NICHE FOR ESTABLISHED SMALL BUSINESS PARTICIPATION IN REGULATION CROWDFUNDING RULES DESIGNED FOR STARTUPS

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## INTRODUCTION

Regulation Crowdfunding has been called an “assault on investor protection” by some and “ill-conceived and burdensome” by others.<sup>1</sup> Title III of the Jumpstart Our Business Startups Act<sup>2</sup> was meant to help speed up the sluggish post-recession economic recovery by creating a new method for businesses to access capital: Regulation Crowdfunding.<sup>3</sup> Title III created a mechanism for entrepreneurs to sell stocks and bonds in their companies via specialized crowdfunding platforms similar to Kickstarter or GoFundMe.<sup>4</sup> Without this legal mechanism, crowdfunding the sale of stock would have violated federal securities law, which strictly limits public transactions that involve the expectation of a financial return.<sup>5</sup>

Importantly, this was the first time since the Great Depression all Americans,

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1. John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 599 (2013) (quoting statements of Sen. Carl Levin and Rep. James Himes).

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 §§ 301-05, 126 Stat. 306, 315-23 (2012) [hereinafter JOBS Act]. There were seven total titles in the JOBS Act, but only Title III is relevant to this Note. *Id.* § 2.

3. Graham Rogers, *Much Ado About Nothing: Why the Equity Crowdfunding Exemption Will Only Be Useful to a Few, and What to Do About It*, 35 REV. BANKING & FIN. L. 335, 338-40 (2015). The SEC uses the term “regulation crowdfunding” to describe the sale of securities through crowdfunding. Press Release, SEC, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), available at <https://www.sec.gov/news/pressrelease/2015-249.html> [<https://perma.cc/5GTB-VU25>].

4. JOBS Act § 302. The JOBS Act uses the word intermediaries. *Id.* These intermediaries are required to register with the SEC as a broker or a funding portal. *Id.* A funding portal is defined as “any person acting as an intermediary in a transaction . . . solely pursuant to . . . (15 U.S.C. 77d(6)).” 15 U.S.C. § 78c(a)(80) (2012) (under the definition of “funding portal”); see also KICKSTARTER, <https://www.kickstarter.com> [<https://perma.cc/48TQ-TM64>] (last visited Dec. 3, 2017); GOFUNDME, <https://www.gofundme.com> [<https://perma.cc/M7QM-P8MN>] (last visited Dec. 3, 2017).

5. Crowdfunding, 80 Fed. Reg. 71,388, 71,389 (Nov. 16, 2015).

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regardless of economic background, were given the opportunity to invest in securities offered by non-public companies.<sup>6</sup> After Congress completed the statutory framework for crowdfunding in the JOBS Act, the Securities and Exchange Commission (SEC) was required to develop a final set of regulations and standards that would fill in some gaps in the law.<sup>7</sup> The SEC adopted these final rules in October 2015,<sup>8</sup> but the debate about the efficacy of this law continues.<sup>9</sup>

Some critics have suggested that the crowdfunding mechanism isn't useful because the regulatory compliance is burdensome and costly compared to other available capital options.<sup>10</sup> They argue that these burdens need to be reduced to make the law work or businesses will simply look elsewhere.<sup>11</sup> The other side argues that allowing amateur investors to buy into newly formed companies is too risky.<sup>12</sup> This faction wants additional investor protections to prevent disaster.<sup>13</sup> Unfortunately, it is a double-sided coin; reducing the amount of disclosures might save businesses some money, but it would burden investors with more risk by taking away important information they need to make informed decisions.<sup>14</sup>

Is there a better way to approach this problem? Many in Congress seemed to have startup businesses specifically in mind when enacting this bill.<sup>15</sup> Indeed, the acronym of the JOBS Act itself contains the word "startups."<sup>16</sup> Unsurprisingly, much of the existing critical commentary has focused on Regulation Crowdfunding as a fundraising mechanism for startup businesses.<sup>17</sup> Conversely,

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6. Max E. Isaacson, *The So-Called Democratization of Capital Markets: Why Title III of the JOBS Act Fails to Fulfill the Promise of Crowdfunding*, 20 N.C. BANKING INST. 439, 453 (Mar. 2016).

7. See generally JOBS Act §§ 301-05.

8. Press Release, SEC, *supra* note 3.

9. See *infra* Part III.

10. See, e.g., Joseph Hogan, Note, *Like Oil and Water: Equity Crowdfunding and Securities Regulation*, 18 LEWIS & CLARK L. REV. 1091 (2014); Rogers, *supra* note 3.

11. Hogan, *supra* note 10.

12. See, e.g., Sharon Yamen & Yoel Goldfeder, *Equity Crowdfunding—A Wolf in Sheep's Clothing: The Implications of Crowdfunding Legislation Under the JOBS Act*, 11 BYU INT'L L. & MGMT. REV. 41 (2015); Wroldsen, *supra* note 1.

13. Wroldsen, *supra* note 1, at 632-35.

14. Federal securities law uses disclosures as a proxy for direct investor protection; by requiring businesses to disclose information, the risks posed by the investment are on display for a potential investor to consider. See Wroldsen, *supra* note 1, at 606-07; Hogan, *supra* note 10, at 1095-96.

15. See, e.g., 158 CONG. REC. S1782-83 (daily ed. Mar. 19, 2012) (statement of Sen. Snowe) (using the words "startup," "entrepreneurs," and "high-growth companies"); 158 CONG. REC. S1830 (daily ed. Mar. 20, 2012) (statement of Sen. Coons) ("I am glad this Chamber is focused on job creation, on access to capital, on ways we can help strengthen the speed and growth of high promise, startup companies.").

16. JOBS Act, Pub. L. No. 112-106 § 1, 126 Stat. 306, 306 (2012).

17. See, e.g., Wroldsen, *supra* note 1.

relatively little attention has been paid to the effect of Regulation Crowdfunding on more established businesses.<sup>18</sup>

Such enterprises are free to participate under the existing rules,<sup>19</sup> but these established businesses are inherently different from startups and do not warrant the same regulatory burdens.<sup>20</sup>

Startups have poor survival rates and otherwise pose additional risks to investors like equity dilution.<sup>21</sup> On the other hand, businesses that have been in operation for three years or longer pose significantly less risk.<sup>22</sup> Like startups, existing small business owners are looking for small amounts of capital, which can be used to expand or improve their enterprise.<sup>23</sup> The traditional market for small business lending stagnated after the Great Recession as big banks looked for more profitable loans.<sup>24</sup> Although alternative sources of funding exist, some of them seem to “caus[e] more harm than good.”<sup>25</sup> Regulation Crowdfunding can create an avenue for small businesses to raise flexible funding while continuing to build rapport with an engaged client base.<sup>26</sup> There is also evidence that suggests the successful completion of a crowdfunding campaign can open the door to traditional capital sources down the road by serving as a “proof-of-concept.”<sup>27</sup> Existing businesses are also an enormous part of the economy and have the potential to create millions of jobs.<sup>28</sup>

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18. Many articles have referenced small businesses generally in addition to startups, but throughout the research process, this author could not find any article devoted to existing business participation specifically.

19. *See generally*, JOBS Act §§ 301-05. Aside from using the word “startups” in the title, the law itself does not specify that a business must be a startup. *Id.* § 1-701.

20. *See infra* Part IV.

21. *See infra* Part IV. Dilution refers to the watering down of the value of equity caused by the release of additional shares in subsequent rounds of funding. *See infra* note 162 and accompanying text.

22. *See infra* Part IV.

23. Youngro Lee, *A Personal Perspective on Title III Investment Crowdfunding*, CROWDFUND INSIDER (Sept. 9, 2016, 12:30 PM), <https://www.crowdfundinsider.com/2016/09/89965-personal-perspective-title-iii-investment-crowdfunding> [<http://perma.cc/72Z3-YXYL>].

24. *Id.*

25. *Id.*

26. *Id.*

27. VENKAT KUPPUSWAMMY & KATHY ROTH, RESEARCH ON THE CURRENT STATE OF CROWDFUNDING: THE EFFECT OF CROWDFUNDING PERFORMANCE AND OUTSIDE CAPITAL, No. 433, U.S. SMALL BUS. ADMIN. OFFICE OF ADVOCACY 1, 3 (2016), *available at* [https://www.sba.gov/sites/default/files/rs433-Crowdfunding\\_RS\\_CLEARANCE5-5-16cx.pdf](https://www.sba.gov/sites/default/files/rs433-Crowdfunding_RS_CLEARANCE5-5-16cx.pdf) [<https://perma.cc/2Z7X-TXDX>].

28. J.D. Harrison, *Who actually creates jobs: start-ups, small businesses or big corporations?*, WASH. POST: ON SMALL BUS. (Apr. 25, 2013), [https://www.washingtonpost.com/business/on-small-business/who-actually-creates-jobs-start-ups-small-businesses-or-big-corporations/2013/04/24/d373ef08-ac2b-11e2-a8b9-2a63d75b5459\\_story.html](https://www.washingtonpost.com/business/on-small-business/who-actually-creates-jobs-start-ups-small-businesses-or-big-corporations/2013/04/24/d373ef08-ac2b-11e2-a8b9-2a63d75b5459_story.html) [<https://perma.cc/RL9G-65Y2>].

Should established small businesses be regulated as strictly as startups or could Congress create a separate category within the JOBS Act to reflect these advantages? If existing businesses are less risky than startups, a reduction in regulation on the business would not put investors more at risk. There is an analogy for making such a distinction within existing securities law.<sup>29</sup> Certain publicly traded companies that have already issued a substantial amount of investor held securities, called “well-known seasoned issuers” (WKSIs), are granted more “communications and registration flexibilities” than a brand-new issuer.<sup>30</sup> Although this category is not based on business age, it reflects the policy that a WKSI may be a safer investment because of its previous participation in the market and wide following among investors.<sup>31</sup>

This Note argues that Congress should modify the relevant portions of the JOBS Act to create a distinction between startups and “seasoned small businesses.”<sup>32</sup> Creating this category will not resolve the debate about the utility or safety of Regulation Crowdfunding in the context of startups. It is not the intention of this Note to argue that startups should not be able to participate in crowdfunding or is it the intention to argue that the rules as they apply to startups do not need modification. This Note argues that a new set of rules for seasoned small businesses will help to assuage the concerns of both sides, provide new capital for a large sector of the economy, and allow investors to see some financial gain. Part I discusses the historical background of crowdfunding. Part II discusses securities regulation and how the JOBS Act fits into existing law. Part III discusses the debate between commentators on the utility of the law as it stands. Part IV argues that there are compelling policy reasons for encouraging seasoned small business participation as a compromise position. Finally, Part V suggests specific changes to the JOBS Act.

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29. See generally Securities Offering Reform, 70 Fed. Reg. 44,722, 44,726-31 (Aug. 3, 2005).

30. *Id.* at 44,727. An issuer is “every person who issues or proposes to issue any security[.]” 15 U.S.C. § 77b(a)(4) (2012).

31. Securities Offering Reform, 70 Fed. Reg. at 44,726-27.

32. For consistency, the new category should adopt the “seasoned” nomenclature the SEC already adopted in other applications. As becomes apparent in Part IV, a “seasoned small business” should mean a small business that has been in continuous operation for at least three years. For the purposes of this Note, a “startup” will refer to a business that has been in operation for less than three years. Likewise, a “small business” will mean the Small Business Administration (SBA) general standard for loans that refers to either 1) businesses with 500 employees or less engaged in manufacturing or mining, or 2) \$7.5 million in average annual receipts or less for most non-manufacturing settings. The SBA bases small business size on an industry by industry basis, but these two benchmarks should serve as a rough approximation. *Summary of Size Standards by Industry Sector*, SBA (Oct. 1, 2017), <https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards/summary-size-standards-industry-sector> [<https://perma.cc/LVA5-6T5D>].

## I. THE DEVELOPMENT OF CROWDFUNDING

In spite of the relatively recent development of the word “crowdfunding,”<sup>33</sup> the concept has a long historical track record.<sup>34</sup> For example in the eighteenth and nineteenth century, “loan funds” in Ireland provided much needed credit to impoverished Irish citizens by soliciting monetary donations from the more financially secure that were then redistributed as microloans to the poor.<sup>35</sup> It can even be said that the Statue of Liberty was completed thanks to a crowdfunding campaign that began in the United States via newspaper in 1885 and raised \$100,000, mostly from donations under one dollar.<sup>36</sup>

In the modern context, crowdfunding typically refers to a method of raising funds from the Internet at-large through specialized websites.<sup>37</sup> Crowdfunding has been used to raise money for feature films, to cover expenses incurred during litigation, and even to give one man the chance to make \$55,000 worth of potato salad.<sup>38</sup>

Internet crowdfunding can be categorized into five basic forms: donation based, pre-purchase based, rewards based, debt based, and equity based.<sup>39</sup> Donation based crowdfunding campaigns solicit donations from the crowd and are typically used by non-profits or individuals raising money for a specific cause.<sup>40</sup> Pre-purchase refers to campaigns that offer investors the opportunity to receive a new product that is funded by the contributions of participants.<sup>41</sup> Rewards based campaigns offer investors a tangible reward for their contribution such as a t-shirt.<sup>42</sup> Contributors to these three types of campaigns do not expect

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33. Wil Schroter, *The Politics of Crowdfunding*, FORBES (May 13, 2014, 10:02 AM), <https://www.forbes.com/sites/wilschroter/2014/05/13/the-politics-of-crowdfunding/#4a7b5caf4961> [<https://perma.cc/JQ7H-M4R4>] (noting the first recorded use of the word was in 2006).

34. Jake Hobbs et al., *Success in the Management of Crowdfunding Projects in the Creative Industries*, 26 INTERNET RES. 146, 147 (2016).

35. Aidan Hollis & Arthur Sweetman, *Microcredit in Prefamine Ireland*, 35 EXPLORATIONS ECON. HIST., 347, 347-49, 352-53 (1998).

36. Chris Gaylord, *How crowdfunding brought the Statue of Liberty to America*, CHRISTIAN SCI. MONITOR, (June 17, 2015), <http://www.csmonitor.com/Technology/2015/0617/How-crowdfunding-brought-the-Statue-of-Liberty-to-America> [<https://perma.cc/S2PS-S2Z2>].

37. *Crowdfunding*, OXFORDDICTIONARIES.COM, <https://en.oxforddictionaries.com/definition/crowdfunding> [<https://perma.cc/V4WD-ADVP>] (last visited Dec. 3, 2017).

38. Jason Krause, *Crowdfunding Can Be a Great Way to Finance Your Case—or Destroy It*, 101 A.B.A. J. 32, 32 (Sept. 2015).

39. Wroldsen, *supra* note 1, at 588.

40. Jason Futko, *Equity vs. Debt Crowdfunding*, CROWDFUND INSIDER (Sept. 24, 2014, 9:49 AM), <http://www.crowdfundinsider.com/2014/09/50628-equity-vs-debt-crowdfunding> [<https://perma.cc/QQ3C-EGB3>].

41. Wroldsen, *supra* note 1, at 588.

42. *Id.*

or receive any profit from their investment.<sup>43</sup> Therefore, crowdfunding campaigns operating under these three models have not been subject to regulation as securities transactions.<sup>44</sup>

Equity crowdfunding allows users to invest in companies by purchasing stocks through regulated securities transactions.<sup>45</sup> Equity crowdfunding was slower to develop in the United States because a legal mechanism needed to be in place to allow companies to sell ownership interests in this manner.<sup>46</sup> All securities transactions in the United States must be registered with the SEC or fit within a statutory exemption.<sup>47</sup> Thus, equity crowdfunding was not legal in the United States, at least in interstate securities transactions, until the passage of the JOBS act.<sup>48</sup>

Debt crowdfunding is like equity crowdfunding but allows users to buy debt, such as a bond, issued by the offering company.<sup>49</sup> Debt crowdfunding differs from equity crowdfunding in that it can be structured as either a securities transaction or an unregulated transaction.<sup>50</sup> For example, if the company sells a bond that will be paid back with interest, it is considered a securities transaction because the investor expects to profit from the investment.<sup>51</sup> Conversely, some websites have created a market for crowdfunded microloans that do not generate interest for the website or the funders and are therefore not considered securities.<sup>52</sup>

Across all types of crowdfunding worldwide, more than \$16 billion was funded in 2014.<sup>53</sup> Equity based crowdfunding grew worldwide by more than 180% in 2014,<sup>54</sup> and if equity crowdfunding follows the growth patterns of other types of crowdfunding, it could become a \$36 billion industry by 2020.<sup>55</sup>

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43. *Id.*

44. Crowdfunding, 80 Fed. Reg. 71,388, 71,389 (Nov. 16, 2015).

45. Rob Marvin, *Are You Ready for the Next Age of Crowdfunding?*, PC MAG. (May 19, 2016, 7:00 AM), <http://www.pcmag.com/article/344545/are-you-ready-for-the-next-age-of-crowdfunding> [<https://perma.cc/D2BH-LHEH>].

46. Wroldsen, *supra* note 1, at 589.

47. Theodore Weitz & Thomas D. Halket, *Funding Innovation Symposium: State Crowdfunding and the Intrastate Exemption Under Federal Securities Laws—Less than Meets the Eye?*, 34 REV. BANKING & FIN. L. 521, 530 (2015).

48. *Id.* at 522-23.

49. Futko, *supra* note 40.

50. Wroldsen, *supra* note 1, at 589.

51. *Id.* at 588-89.

52. *See, e.g.*, KIVA, <http://www.kiva.org/about/how> [<https://perma.cc/Z4KM-CDKU>] (last visited Mar. 16, 2017).

53. Crowdfunding, 80 Fed. Reg. 71,388, 71,488 (Nov. 16, 2015).

54. *Id.*

55. Chance Barnett, *Trends Show Crowdfunding to Surpass VC In 2016*, FORBES (June 9, 2015, 5:33 PM), <http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/3/#2206f4006078> [<https://perma.cc/93S7-R7NY>].

## II. SECURITIES REGULATION GENERALLY

In the late nineteenth and early twentieth century, investing by the general public in companies, particularly infrastructure companies like railroads and oil, became popular.<sup>56</sup> Beginning in 1911, states started enacting what came to be known as “blue sky” laws that provided regulations and investor protections in these securities transactions.<sup>57</sup> For almost twenty years, the states were largely in charge of regulating securities until two significant developments in the economy began to challenge this arrangement.<sup>58</sup>

As the twentieth century progressed, interstate transactions were becoming more and more common as businesses, investors, and technologies became more sophisticated — but the jurisdiction of the so-called “blue sky laws” ended at the state line.<sup>59</sup> The stock market crash of 1929 and the subsequent Great Depression helped push the federal government into action.<sup>60</sup> It was from this climate that the SEC was created and given a mandate to facilitate growth while maintaining meaningful investor protections.<sup>61</sup>

Congress passed two pivotal laws in back to back years: the Securities Act of 1933<sup>62</sup> and the Securities Exchange Act of 1934, which, among other things, created the SEC.<sup>63</sup> The underlying principle of federal securities regulations is that investors are entitled to accurate information about any potential investment.<sup>64</sup> This disclosure-based philosophy rejected the merit-based approach adopted by many of the “blue sky laws.”<sup>65</sup> Under the merit-based system, regulators engage in a “qualitative assessment of the offering” prior to approval; under the disclosure-based approach, regulators require issuers to disclose comprehensive information that allows the market to determine the investment’s soundness.<sup>66</sup> The 1933 Act created the general rule that all offers to sell securities

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56. Christopher H. Pierce-Wright, *State Equity Crowdfunding and Investor Protection*, 91 WASH. L. REV. 847, 854-55 (2016).

57. *Id.* at 853-55. The term “blue sky law” refers to “speculative schemes which have no more basis than so many feet of ‘blue sky.’” Wroldsen, *supra* note 1, at 607 n.124 (quoting *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917)).

58. Pierce-Wright, *supra* note 56, at 855.

59. *Id.* at 854, 859; Hogan, *supra* note 10, at 1095.

60. Paige M. Lager, *The Route to Capitalization: The Transcendent Registration Exemptions for Securities Offerings as a Means to Small Business Capital Formation*, 94 TEX. L. REV. 567, 568 (2016).

61. 15 U.S.C. §§ 77b(b), 78d (2012).

62. Securities Act of 1933, ch. 38, Title I, 48 Stat. 74 (codified as 15 U.S.C. §§ 77a to 77z, 77aa (2012)) [hereinafter 1933 Act].

63. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as 15 U.S.C. §§ 77b to 77e, 77j, 77k, 77m, 77o, 77s, 78a to 78o, 78o-3, 78p to 78z, 78aa to 78hh, 78kk, 78ll (2012)).

64. Weitz & Halket, *supra* note 47, at 527-29.

65. Wroldsen, *supra* note 1, at 606-08.

66. *Id.*

in the United States must be registered with the SEC.<sup>67</sup> A broad definition of what constitutes a security was codified, including “investment contract[s].”<sup>68</sup> Investment contracts themselves were defined in the 1946 Supreme Court decision *SEC v. W.J. Howey Co.*<sup>69</sup>

The *Howey* test asks whether the instrument being offered for sale involves an investment of money in a common enterprise with an expectation of profits “to come solely from the efforts of others.”<sup>70</sup> If so, the instrument is an investment contract.<sup>71</sup> An investment contract is defined by the statute as a security, and the statute requires offers and sales of securities to be registered with the SEC unless an exemption is available.<sup>72</sup> Registering these offers of securities is a costly and time-consuming undertaking rife with regulations.<sup>73</sup> Because of the complexity of this process, the 1933 Act has always authorized certain exemptions, which have been expanded over time, that do not require the companies selling their securities (called “issuer[s]”) to register an offer for securities.<sup>74</sup> So long as the issuer satisfies the requirements of the specific exemption, the offer does not need to be registered with the SEC.<sup>75</sup> This is where Regulation Crowdfunding fits into the regulatory scheme.<sup>76</sup>

Interestingly, while the SEC was deliberating over the final crowdfunding rules, many states took advantage of a different exemption to enact their own crowdfunding laws.<sup>77</sup> The intrastate exemption allows issuers to offer securities if the offer and all sales are solely confined to one state.<sup>78</sup> This provision covers the very narrow situation where a company incorporated in one state makes an offer only to residents of the same state.<sup>79</sup> In this rule, geographic proximity between the issuer and investor was seen as a form of protection.<sup>80</sup> The offer must only comply with state securities regulation and requires no involvement from the SEC unless the exemption is lost.<sup>81</sup> This rule is deceptively simple, but if the offer crosses state lines at all, the issuer is no longer protected under the exemption.<sup>82</sup> To date, at least thirty-six states, including Indiana, have enacted some form of

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67. 15 U.S.C. § 77f (2012).

68. *Id.* § 77b(a)(1).

69. 328 U.S. 293 (1946).

70. *Id.* at 301.

71. *Id.* at 298-99.

72. 15 U.S.C. §§ 77b(a)(1), 77d-77f.

73. Yamen & Goldfeder, *supra* note 12, at 48-50; *see also* 15 U.S.C. §§ 77f, 77g.

74. 15 U.S.C. §§ 77c, 77d.

75. *Id.* §§ 77c(a), 77d(a).

76. *Id.* §§ 77d(a)(6)(D), 77d-1.

77. Michael Vignone, *Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Businesses*, 91 CHI. KENT L. REV. 803, 810-11 (2016).

78. 15 U.S.C. § 77c(a)(11).

79. *Id.*

80. Pierce-Wright, *supra* note 56, at 862.

81. *Id.*

82. Vignone, *supra* note 77, at 811.

state-based Regulation Crowdfunding under this exemption.<sup>83</sup>

In addition to this intrastate exemption, another exemption relevant to startups and small businesses prior to the JOBS Act allowed offers to investors who met certain sophistication requirements.<sup>84</sup> The 1933 Act created an exemption for transactions “not involving any public offering” called “private placements.”<sup>85</sup> Because exempted transactions were generally created for situations “where there is no practical need for [the 1933 Act’s] application,” the Supreme Court held that the private placement exemption should only apply to “those who are shown to be able to fend for themselves . . . .”<sup>86</sup> The theory is that sophisticated investors would have either 1) enough money to handle losses or 2) enough expertise in the market to make informed investment decisions.<sup>87</sup> Because of this sophistication, investors needed less protection and so the issuers were subject to less regulation.<sup>88</sup> Regulation D, promulgated by the SEC as a safe harbor for compliance with the private placement exemption requires a more specific type of sophisticated investor called an “accredited investor.”<sup>89</sup> These exemptions are where securities-based startup funding has typically originated in the past, but because of the strict sophistication requirements that an investor must meet to participate, only about 7% of all households qualify.<sup>90</sup>

Title III of the JOBS Act created investment opportunities for investors through a new statutory exemption, regardless of whether they meet the sophistication requirements of the prior regulations.<sup>91</sup> Now sophisticated and unsophisticated investors alike can participate.<sup>92</sup> Some have called this a “democratization of capital,”<sup>93</sup> while others view it as exposing the unwary to tremendous financial risk.<sup>94</sup>

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83. Anthony Zeoli, *State of the States – List of Current Active and Proposed Intrastate Crowdfunding Exemptions (Updated)*, CROWDFUNDINGLEGALHUB.COM (Aug. 28, 2017), <https://crowdfundinglegalhub.com/2017/08/28/2017-state-of-the-states-list-of-current-active-and-proposed-intrastate-crowdfunding-exemptions-updated/> [https://perma.cc/ZM4T-UKB2].

84. Isaacson, *supra* note 6, at 445.

85. 15 U.S.C. § 77d(a)(2) (2012); Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 167 n.100 (2010).

86. SEC v. Ralston Purina Co., 346 U.S. 119, 122-25 (1953).

87. Hogan, *supra* note 10, at 1097.

88. *Id.*

89. Johnson, *supra* note 85, at 169; *see generally* 17 C.F.R. § 230.501 (2017). An accredited investor can be an organization or an individual. *Id.* An example of an organization would be a bank, and an individual would be a person with a net worth more than \$1,000,000 or annual income in excess of \$200,000. *Id.*

90. Isaacson, *supra* note 6, at 445; Hogan, *supra* note 10, at 1111.

91. Isaacson, *supra* note 6, at 453.

92. *Id.*

93. *Id.* at 441.

94. Yamen & Goldfeder, *supra* note 12, at 58-59.

### III. WHAT DOES TITLE III OF THE JOBS ACT DO?

When the final JOBS Act was signed into law by President Obama in April 2012, he called it a “game changer” for startups and small businesses because it would create investing opportunities for “ordinary Americans” while simultaneously protecting them through “rigorous oversight.”<sup>95</sup> Simply put, Title III created a statutory framework within which the SEC was required to develop standards and final rules for Regulation Crowdfunding.<sup>96</sup> The statute itself provides for the new exemption under the 1933 Act, and sets up the general requirements for investors, issuers, and crowdfunding portals.<sup>97</sup>

Statutory and regulatory requirements placed on individual investors provide one layer of investor protection.<sup>98</sup> For example, the aggregate amount any individual investor can contribute toward Regulation Crowdfunding campaigns is capped.<sup>99</sup> For investors with an annual income or net worth less than \$100,000, the limit is \$2,000 or 5% of the lesser of annual income or net worth during any twelve-month period.<sup>100</sup> If income or net worth is greater than or equal to \$100,000, the limit is 10% of the lesser of income or net worth, not to exceed \$100,000 in any twelve-month period.<sup>101</sup> Congress also required the SEC to develop mandatory investor education standards, which must be completed by potential investors before any investment is made.<sup>102</sup> The SEC gave the individual platforms some freedom in developing the educational component, but essentially the platform must inform the investor about the risks generally involved with this kind of investing.<sup>103</sup>

The JOBS Act also creates a private right of action for investors against issuers if the issuer by “any means of any written or oral communication . . . makes an untrue statement of a material fact or omits to state a material fact required to be stated . . . .”<sup>104</sup> In such an action, the issuer has the burden of proof to show that it both did not and could not know about the omission or falsity of the statement.<sup>105</sup>

Issuers are also subject to statutory requirements.<sup>106</sup> For example, issuers are

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95. Press Release, White House, President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012, 2:36 PM), *available at* <https://obamawhitehouse.archives.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing> [<https://perma.cc/M25D-SCME>].

96. *See generally* JOBS Act, Pub. L. No. 112-106 §§ 301-05, 126 Stat. 306, 315-23 (2012).

97. *See generally id.*

98. Crowdfunding, 80 Fed. Reg. 71,388, 71,394 (Nov. 16, 2015).

99. 15 U.S.C. § 77d(a)(6)(B) (2012).

100. Crowdfunding, 80 Fed. Reg. at 71,390.

101. *Id.*

102. *Id.* at 71,439-41.

103. *Id.* at 71,438-40.

104. JOBS Act, Pub. L. No. 112-106 § 302, 126 Stat. 306, 318-19 (2012).

105. *Id.*

106. 15 U.S.C. § 77d-1(b) (2012).

subject to various mandatory disclosures, as summarized by Table 1, *infra*,<sup>107</sup> and must file the new Form C with the SEC at various times before, during, and after the offering is available to investors, as summarized by Table 2, *infra*.<sup>108</sup> Moreover, issuers can only raise a maximum of \$1,000,000 during any twelve-month period.<sup>109</sup> This cap is inclusive of any costs associated with making the offer, including fees charged by the crowdfunding website; so a company must take this into account when determining its offering amount.<sup>110</sup> Although estimates of the final compliance costs vary, they could be quite substantial.<sup>111</sup>

**Table 1**<sup>112</sup>

**Summary of Issuer Disclosure Requirements under Regulation Crowdfunding**

<b>Business Information</b>	<b>Offering Information</b>	<b>Financial Information</b>
Information about all officers, directors, and individuals who own 20% or more of the issuer.	Description of the intended use of all proceeds.	Description of the issuer's financial condition.
Description of the business including a business plan.	Information on the price of the offering, target amount to be raised, and whether investments beyond the original offering will be accepted.	Financial statements that may need to be reviewed or audited by an accountant based on the amount of the offering.

107. *See infra* Table 1.

108. *See infra* Table 2.

109. Crowdfunding, 80 Fed. Reg. 71,388, 71,390 (Nov. 16, 2015).

110. *Id.* at 71,391.

111. *See infra* Part IV.

112. Crowdfunding, 80 Fed. Reg. at 71,390.

Table 2<sup>113</sup>

## Required Forms to Comply with Regulation Crowdfunding

Which box on Form C	Offering Statement (Form C)	Amendment (Form C/A)	Progress Update (Form C-U)	Annual Report (Form C-AR)	Termination of Reporting (Form C-TR)
<b>When to file</b>	When making the offering	As needed	<p>Within five days of reaching intervals (such as 50% of target) if the platform does not make this information available to investors</p> <p>AND</p> <p>within five days of reaching the target amount or after the offering deadline.</p>	<p>No later than 120 days after the end of fiscal year covered by report.</p> <p>Filed annually if securities are outstanding or until issuer can file Form C-TR.</p>	Within five days of becoming eligible to terminate annual reporting.
<b>What it must contain</b>	<p>Financial statements, type determined by amount of offering</p> <p>Basic company information and financial situation of company.</p> <p>Information on offering amount, etc.</p>	Any material change from Offering Statement	The total amount of securities sold.	<p>Financial statements certified by officer of the company</p> <p>Company information and financial situation of company as required on offering statement.</p>	Explanation of eligibility to terminate

113. See generally *id.* at 71,397-424.

Regulation Crowdfunding places limits on how an issuer can promote its offering.<sup>114</sup> Although a post on social media or the issuer's website is allowed, it must direct potential investors to the crowdfunding platform and contain no more than the following information:

(1) A statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the investor to the intermediary's platform; (2) the terms of the offering; and (3) factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and Web site of the issuer, the email address of a representative of the issuer and a brief description of the business of the issuer.<sup>115</sup>

When the SEC proposed these requirements, it received comments about whether they would interfere with the ability of an issuer to utilize social media to its full effect.<sup>116</sup> Ultimately, the SEC decided that the rules would not hinder social media usage because an issuer does not have to include all the information cited above—it just cannot include any more.<sup>117</sup> Two-way communications with potential investors are more limited and can only be accomplished through a mechanism created by the platform, such as a comment feature.<sup>118</sup>

#### IV. THE DEBATE

Controversy has surrounded Regulation Crowdfunding from the beginning.<sup>119</sup> The very first piece of federal legislation that tried to legalize securities based crowdfunding earned the dubious nickname the “Boiler Room Legalization Act” because it contained so few investor protections and almost no mandatory disclosures for the business.<sup>120</sup> The Bill, called the Entrepreneur Access to Capital Act,<sup>121</sup> still passed the House by a margin of 407-17.<sup>122</sup> After this House Bill was widely criticized, a Senate version, unimaginatively called the CROWDFUND Act,<sup>123</sup> eventually became Title III of the JOBS Act after being drafted to contain

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114. *Id.* at 71,425.

115. *Id.*

116. *Id.*

117. *Id.*

118. Isaacson, *supra* note 6, at 460.

119. Wroldsen, *supra* note 1, at 598-99.

120. *Id.* at 598. Boiler rooms refer to operations where groups of stock promoters cold call investors to encourage participation in questionable or outright fraudulent schemes. *Id.*

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

122. Christine E. McKillip, *Keeping Current: Crowd Funding Bills Stall in Congress*, BUS. L. TODAY 1 (Feb. 2012).

123. Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. (2011).

more investor protections and winning both chambers with bipartisan support.<sup>124</sup> Even with the wide support for the new changes, one progressive Senator called the final bill “the most sweeping deregulatory effort and assault on investor protection in decades”<sup>125</sup> while a conservative Representative called the modifications “ill-conceived and burdensome.”<sup>126</sup>

Nearly three years after the Bill became law, the final rules were released and several SEC commissioners expressed similar reservations.<sup>127</sup> In a dissenting statement to the final rules, SEC Commissioner Michael Piowar concluded that, as written, the rules contain “many traps for the unwary . . . [and] creat[e] potential nightmares for small business owners” because of the “complex web of provisions and requirements for compliance.”<sup>128</sup> Another SEC Commissioner, Kara Stein, was pleased with the final rules overall, but indicated with some caution that crowdfunding was an “experiment” and the Commission would need to keep a watchful eye on how the new market develops.<sup>129</sup>

Commentators have similarly factionalized into two camps: those who believe the regulations are too burdensome<sup>130</sup> and those who believe the risk to amateur investors is too great.<sup>131</sup>

#### *A. Too Much Regulation*

The concerns in the deregulation camp focus largely on the following: compliance costs for issuers, relatively low monetary cap on offering amounts, and relatively arbitrary restrictions on investor contribution.<sup>132</sup> For example, crowdfund issuers will face fees from the crowdfunding platform itself, preparation and filing costs associated with the mandatory disclosure forms, and accounting fees for reviewed or audited financials if necessary.<sup>133</sup>

For issuers seeking \$100,000 or less, the SEC estimates fees charged by the platform could range between 5% and 15% of the value of the offering.<sup>134</sup>

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124. Wroldsen, *supra* note 1, at 598-99. The bill passed the Senate 73-26 and the House 380-41. *Id.*

125. *Id.* at 599 (quoting Sen. Carl Levin).

126. *Id.* (quoting statement of Rep. James Himes).

127. Kara M. Stein, SEC Commissioner, *Statement on the Adoption of Regulation Crowdfunding*, SEC.GOV (Oct. 30, 2015), <https://www.sec.gov/news/statement/statement-on-adoption-of-regulation-crowdfunding-stein.html> [<https://perma.cc/M3R6-8C88>]; Michael S. Piowar, SEC Commissioner, *Dissenting Statement at Open Meeting on Crowdfunding and Small Business Capital Formation*, SEC.GOV (Oct. 30, 2015), <https://www.sec.gov/news/statement/piowar-regulation-crowdfunding-147-504.html> [<https://perma.cc/45DH-GWWA>].

128. Piowar, *supra* note 127.

129. Stein, *supra* note 127.

130. *See, e.g.*, Isaacson, *supra* note 6, at 453.

131. *See, e.g.*, Yamen & Goldfeder, *supra* note 12.

132. *See, e.g.*, Rogers, *supra* note 3, at 370-73.

133. Crowdfunding, 80 Fed. Reg. 71,388, 71,497 (Nov. 16, 2015).

134. *Id.*

Compliance costs for preparing and filing Form C will be approximately \$2,500.<sup>135</sup> These costs will be incurred even if the crowdfunding effort is unsuccessful.<sup>136</sup> The cost of filing Form C-AR will be approximately \$1,650 annually as long as there are outstanding securities.<sup>137</sup> Thus, a \$100,000 offering of securities that are owned by investors for three years could cost the issuer as much as \$22,000.<sup>138</sup> For smaller offerings, the percentage of cost to benefit increases dramatically; a \$50,000 offering could cost as much as \$14,000, and a \$25,000 offering could cost as much as \$11,000.<sup>139</sup>

For issuers seeking \$100,000 to \$500,000, the estimated platform fees could range between 5% and 10%.<sup>140</sup> Compliance costs for preparing and filing Form C for these slightly larger offers will be approximately \$2,500 to \$5,000.<sup>141</sup> The SEC estimates the cost of filing Form C-AR will be approximately two thirds of the cost of filing Form C.<sup>142</sup> Finally, the required reviewed financial statements for offerings of this size are estimated to cost between \$1,500 and \$18,000.<sup>143</sup>

In the highest existing tier, issuers seeking between \$500,000 and \$1,000,000, the SEC estimates platform fees could range between 5% and 7.5%.<sup>144</sup> Compliance costs for preparing and filing Form C will be approximately \$6,000 to \$20,000.<sup>145</sup> The cost of filing Form C-AR will once again be approximately two thirds of the cost of filing Form C.<sup>146</sup> If reviewed financial statements are sufficient for the issuer, the cost likely will be within the same range as the middle tier.<sup>147</sup> If audited financials are required, the estimated cost ranges between \$2,500 to \$30,000.<sup>148</sup>

These estimates may vary significantly based on market conditions, and some businesses may be able to complete the filings without outside assistance.<sup>149</sup> Some have accused the SEC's cost estimates of being "egregiously low."<sup>150</sup>

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135. *Id.* at 71,498.

136. *Id.*

137. *Id.*

138. This calculation is based on the SEC estimates discussed in the immediately preceding sentences. An intermediary fee of 15% on \$100,000 equals \$15,000. Plus \$2,500 for filing Form C. Plus filing the annual report, Form C-AR for three years at \$1,650 per year (\$4,950). This totals \$22,450.

139. These calculations follow the same methodology as in *supra* note 138.  $(.15 \times \$50,000) + (\$2,500) + (\$1,650 \times 3) = \$14,950$ ;  $(.15 \times \$25,000) + (\$2,500) + (\$1,650 \times 3) = \$11,200$ .

140. Crowdfunding, 80 Fed. Reg. at 71,497.

141. *Id.* at 71,498.

142. *Id.*

143. *Id.* at 71,499.

144. *Id.* at 71,497.

145. *Id.* at 71,498.

146. *Id.*

147. *Id.* at 71,500.

148. *Id.* at 71,499.

149. *Id.* at 71,498.

150. Isaacson, *supra* note 6, at 457.

Crowdfunding will only be a viable alternative to businesses if it is more attractive or at least as attractive as other options.<sup>151</sup> These cost estimates challenge the viability of Regulation Crowdfunding especially when they are considered in tandem with the relatively low offering limit.<sup>152</sup>

In the world of startup funding, \$1 million is not a lot.<sup>153</sup> It does not seem like much at all when compared to the potential investment from a venture capitalist or angel investor.<sup>154</sup> Startups are usually seeking liquid capital because they currently do not have enough—or any.<sup>155</sup> Business owners who do the math will find a large portion of that capital is already spoken for by compliance costs and may become deterred.<sup>156</sup>

### *B. Not Enough Investor Protection*

In its release of the final rules, the SEC cited several studies regarding the survival rates of startups and small businesses backed by venture capital specifically.<sup>157</sup> One study suggested that nearly 75% of companies receiving \$1 million in venture funding went on to fail.<sup>158</sup> The SEC expects a higher failure rate than even these studies show due to the early stage of business development of expected participants in Regulation Crowdfunding.<sup>159</sup>

One of the most significant risks to crowdfunding investors is dilution of the value of their shares in the issuer.<sup>160</sup> Startups that successfully crowdfund initially will likely need to seek future funding from more traditional sources such as venture capitalists and angel investors.<sup>161</sup> When new shares are subsequently sold to venture capitalists, the original crowdfunding investors' relative percentage of ownership in the company could decrease dramatically.<sup>162</sup>

Venture capitalists typically seek contractual protections against dilution.<sup>163</sup> The final rules adopted by the SEC do not contain any automatic protection against dilution.<sup>164</sup> The low investment limits imposed by the rules as well as the

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151. Hogan, *supra* note 10, at 1114.

152. Rogers, *supra* note 3, at 370-71.

153. *Id.* at 371.

154. Wroldsen, *supra* note 1, at 615-16. A venture capitalist may invest \$2,000,000 to \$10,000,000 in a typical funding round. *Id.*

155. Rogers, *supra* note 3, at 370.

156. *Id.*

157. Crowdfunding, 80 Fed. Reg. 71,388, 71,489 (Nov. 16, 2015).

158. *Id.*

159. *Id.*

160. *See generally* Wroldsen, *supra* note 1, at 613-20.

161. *Id.* at 615-16.

162. *Id.* at 616. Wroldsen uses the example of early Facebook investor Eduardo Saverin whose stock was diluted from a 30% ownership share to .03% after twenty four million shares were issued in a subsequent round. *Id.* at 585, 614.

163. *Id.* at 614.

164. Crowdfunding, 80 Fed. Reg. 71,388, 71,493.

likely lack of sophistication and bargaining power in the investor or even a mechanism to negotiate such protections makes this risk potentially substantial.<sup>165</sup>

#### V. PROMOTING SEASONED SMALL BUSINESS AS A COMPROMISE

Investor risk can be reduced in two ways: by increasing the amount of regulation on the issuer (or the investor) or by decreasing the risk presented to the investor in the first place.<sup>166</sup> Startups are inherently risky.<sup>167</sup> Seasoned businesses are less risky.<sup>168</sup> The end goal of increased capital could be achieved with regulations tailored to the risk level presented by the business itself.<sup>169</sup>

Small businesses account for approximately 99% of all employer firms in the United States.<sup>170</sup> Nearly 50% of all workers run or work for a small business.<sup>171</sup> According to its 2016 Mid-Year Economic Report, the National Small Business Association found that 70% of small businesses expected growth in the next twelve months or were already growing.<sup>172</sup> Conversely, 31% of small businesses were unable to find adequate financing, and nearly 41% of businesses said a lack of capital was hindering the ability to hire workers or expand operations.<sup>173</sup> The National Small Business Association's data going back to the 1990s shows a "clear correlation" between a small business's access to financing and ability to hire.<sup>174</sup> Although this report does not break down the data by a business's age,<sup>175</sup> at least 37% of the sample size had six or more employees, which would indicate that they likely were not startups.<sup>176</sup>

#### A. *The Impact of Seasoned Small Businesses on the Economy*

There is a debate among economists over whether startups or existing businesses add more jobs to the economy.<sup>177</sup> Both startups and existing businesses can obviously create jobs, but determining what proportion each adds is problematic.<sup>178</sup> Some studies indicate that startups are responsible for almost all

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165. *Id.*; Wroldsen, *supra* note 1, at 614.

166. Hogan, *supra* note 10, at 1096.

167. *See infra* Part V.C.

168. *Id.*

169. *See infra* Part VI.

170. NAT'L SMALL BUS. ASS'N, 2016 MID-YEAR ECONOMIC REPORT 14 (2016), available at <http://www.nsba.biz/wp-content/uploads/2016/09/Mid-Year-Economic-Report-2016.pdf> [<https://perma.cc/542X-ZZGS>].

171. *Id.*

172. *Id.* at 6.

173. *Id.* at 9.

174. *Id.*

175. *See generally id.*

176. *Id.* at 3.

177. Harrison, *supra* note 28.

178. *See id.*; SBA Office of Advocacy, *Small Business Facts: Where are the jobs created? New or existing businesses?*, SBA.GOV (May 2012), <https://www.sba.gov/sites/default/>

of the net job growth each year.<sup>179</sup> Startups may also be more reliable job creators because hiring among new firms remains fairly constant regardless of economic conditions.<sup>180</sup> The Small Business Administration (SBA) argues that existing businesses are actually better job creators.<sup>181</sup> Part of the problem in the data, the SBA contends, is that startup jobs are more volatile and thus need to be controlled based on whether the firm ultimately fails or succeeds.<sup>182</sup> This argument hinges on the fact that “[l]ess than half of the jobs created by startups exist after five years.”<sup>183</sup> When controlled, existing businesses added approximately 60% of all new small business jobs whereas startups created about 40% over the past two decades.<sup>184</sup>

As SBA Administrator Karen Mills wrote in 2013, “[w]hile startups receive a great deal of attention, there is another segment of businesses that can fuel economic growth—existing establishments.”<sup>185</sup> Although most existing businesses do not expand beyond a certain size, those that do can have a significant impact.<sup>186</sup> Between 2011 and 2012, for example, existing business growth added 8.7 million jobs to the economy.<sup>187</sup> Existing business employment tends to rise and fall with economic conditions more so than startup hiring, but existing businesses also tend to rehire workers that were previously laid off when economic conditions later improve—something that a failed startup cannot do.<sup>188</sup> Additionally, startup jobs on average only pay about 70% of those created by existing firms.<sup>189</sup>

Regardless, 33% of all small businesses expect to hire more employees within the next twelve months compared to only 8% that expect to reduce employment.<sup>190</sup> Additionally, 51% of small businesses expect to increase employee compensation over the next twelve months.<sup>191</sup> Small businesses are growing,<sup>192</sup> and a less burdensome method of crowdfunding could help supply

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files/Job\_Creation.pdf [https://perma.cc/C8MP-H6JL].

179. Harrison, *supra* note 28.

180. *Id.*

181. SBA Office of Advocacy, *supra* note 178.

182. *Id.*

183. *Id.*

184. *Id.*

185. Karen Mills, *SBA's Karen Mills: Revving America's jobs engine with the help of existing businesses*, WASH. POST: ON SMALL BUS. (April 22, 2013), [https://www.washingtonpost.com/business/on-small-business/sbas-karen-mills-revving-americas-jobs-engine-with-the-help-of-existing-businesses/2013/04/22/da784e10-a691-11e2-8302-3c7e0ea97057\\_story.html](https://www.washingtonpost.com/business/on-small-business/sbas-karen-mills-revving-americas-jobs-engine-with-the-help-of-existing-businesses/2013/04/22/da784e10-a691-11e2-8302-3c7e0ea97057_story.html) [https://perma.cc/S6BH-FQ94].

186. Harrison, *supra* note 28.

187. *Id.*

188. *Id.*

189. *Id.*

190. NAT'L SMALL BUS. ASS'N, *supra* note 170, at 8.

191. *Id.*

192. *Id.*

capital to fuel this growth.

### *B. Problems with Traditional Lending*

Equity or debt-based crowdfunding could be extremely helpful to seasoned businesses because small business loans originated by banks are still not as available as they were prior to the Great Recession; lending fell by more than \$100 billion from 2008 to 2011.<sup>193</sup> Small businesses were especially hard hit as lending standards kept tightening for small businesses even as they loosened for large companies.<sup>194</sup> Even when loans are available, many small companies cannot obtain them for several reasons. First, in 2013, 90% of small business loans were collateralized.<sup>195</sup> Small business owners may be struggling to meet collateral requirements—about 25% used home equity as collateral.<sup>196</sup> Second, banks typically examine the credit history of both the business itself as well as the principal within the company applying for the loan.<sup>197</sup> A principal may have issues with personal credit history or issues that otherwise preclude personally guaranteeing the loan, a condition for most small business loans.<sup>198</sup> Finally, even if a business can meet credit, collateral, and other requirements, otherwise worthy borrowers may be denied because the loan they need is simply too small for the bank to consider.<sup>199</sup>

Consequently, alternative lenders have emerged following the dearth in small business lending.<sup>200</sup> It is possible for a small business owner to now apply for loans online and have access to capital within minutes—albeit for a price.<sup>201</sup> Interest rates on these loans can be considerably higher with less favorable payment plans than bank originated loans.<sup>202</sup> For example, one such lender, Lending Club, has interest rates available as low as 8%, which may be competitive with traditional lenders, but it may also charge small businesses an

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193. Crowdfunding, 80 Fed. Reg. 71,388, 71,485 (Nov. 16, 2015).

194. Ann Marie Wiersch & Scott Shane, *Why Small Business Lending Isn't What It Used to Be*, FED. RES. BANK OF CLEV. (Aug. 14, 2013), <https://clevelandfed.org/newsroom-and-events/publications/economic-commentary/2013-economic-commentaries/ec-201310-why-small-business-lending-isnt-what-it-used-to-be.aspx> [<https://perma.cc/2HUC-GWZR>].

195. *Id.*

196. *Id.*

197. Natale Goriel, *6 Step Guide – How to Get a Business Loan*, SBA.GOV BLOGS-FIN. (Sept. 4, 2013), <https://www.sba.gov/blogs/6-step-guide-how-get-business-loan> [<https://perma.cc/7VX3-LK9T>].

198. *Id.*

199. *Id.*

200. Julapa Jagtiani & Catharine Lemieux, *Small Business Lending After the Financial Crisis: A New Competitive Landscape for Community Banks*, 40 ECON. PERSP. (FED. RES. BANK CHI.), no. 3, 2016, at 11-13.

201. *Id.* at 13-14.

202. *Id.* at 14.

annualized percentage rate as high as 32%.<sup>203</sup>

The SBA also has a variety of loan programs that meet the needs of many borrowers, but they are not always a perfect fit.<sup>204</sup> The SBA does not issue loans, but it guarantees the loans of another lender under specific government programs.<sup>205</sup> Typical SBA Advantage Loans, for example, can be used for working capital and equipment purchases.<sup>206</sup> To be eligible, business owners with at least a 20% stake in the company cannot have been previously indicted for a felony or have caused the government to lose money on a previous business loan.<sup>207</sup> Businesses may also be denied for not having sufficiently invested equity, or failing to first use alternative financial resources such as personal assets.<sup>208</sup>

### *C. Existing Businesses Are Less Risky for Investors*

Figure 1, *infra*, demonstrates that the survival rate of new businesses varies dramatically over the first few years of the company's life: 78.5% of all businesses survive for at least one year before failing, but by the tenth year, only 33.5% remain in operation.<sup>209</sup> The first two years are the most volatile, but by year three, the rate of failure begins to decrease noticeably.<sup>210</sup> At the three-year mark, around 40% of all businesses will have failed, but only an additional 26% will fail within the next seven years.<sup>211</sup> The mean failure rate of businesses is approximately 13.5% per year during the first three years, but only 3.7% per year for the next seven.<sup>212</sup> Thus, a seasoned business, that has operated for three years or longer, is less likely to fail subsequently than a startup in its first or second year of operation.<sup>213</sup>

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203. *Id.* at 21.

204. *7(a) Loan Program Eligibility*, SBA.GOV, <https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a/7a-loan-program-eligibility> [<https://perma.cc/W32W-4T2F>] (last visited Oct. 21, 2016).

205. *What SBA Offers to Help Small Businesses Grow*, SBA.GOV, <https://www.sba.gov/loans-grants/see-what-sba-offers/what-sba-offers-help-small-businesses-grow> [<https://perma.cc/2BBP-7BKL>] (last visited Feb. 8, 2017).

206. *Use of Loan Proceeds*, SBA.GOV, <https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/small-business-loans-sba-advantage-loans-7a/use-loan-proceeds> [<https://perma.cc/5CXT-SUYD>] (last visited Feb. 8, 2017).

207. *7(a) Loan Program Eligibility*, *supra* note 204.

208. *Id.*

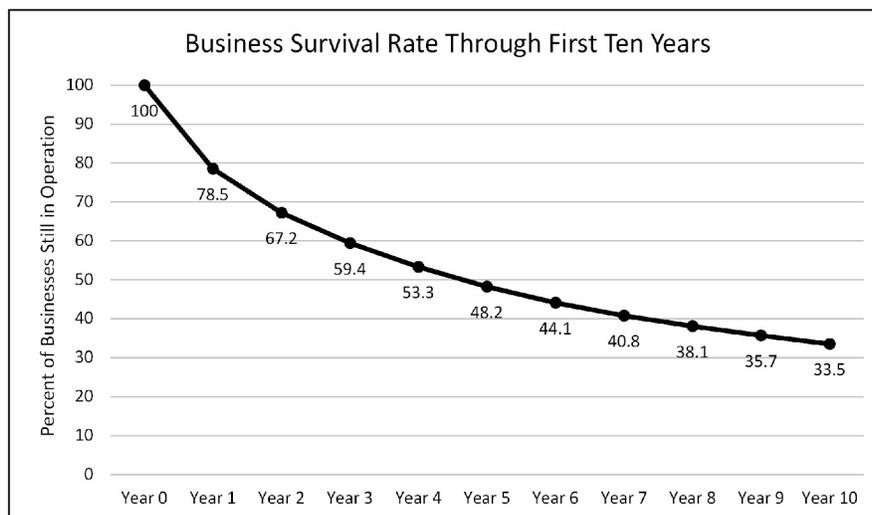
209. *See infra* Figure 1.

210. *Id.*

211. *Id.*

212. *Id.*

213. SBA Office of Advocacy, *Survival Rates and Firm Age*, SBA.GOV, [https://www.sba.gov/sites/default/files/SurvivalRatesAndFirmAge\\_ADA\\_0\\_0.pdf](https://www.sba.gov/sites/default/files/SurvivalRatesAndFirmAge_ADA_0_0.pdf) [<https://perma.cc/8QPK-G6QR>] (last visited Dec. 4, 2017).

Figure 1<sup>214</sup>

Investors in seasoned businesses may also be less likely to be harmed by stock dilution. Venture capitalists typically focus on young, high-growth companies.<sup>215</sup> They also prefer businesses that have already secured at least one other form of financing and are likely to go public after only a few years of investment.<sup>216</sup> Venture capitalists also typically demand “significant control rights over such companies”<sup>217</sup> and push startups through multiple rounds of funding.<sup>218</sup> Startups that successfully crowdfund an initial round of capital are likely to need subsequent rounds of funding, making them prime targets for venture capitalists to come in with an offer of \$2,000,000 to \$10,000,000.<sup>219</sup> Although seasoned businesses may seek out additional financing sources down the road that could include some type of venture capital, the problem of dilution is a greater risk to investors in startups because more startups will fit the model of the high-growth-potential investment venture capitalists are seeking.<sup>220</sup>

Investors may also be protected because seasoned small businesses may

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214. *Id.*

215. Rogers, *supra* note 3, at 368-69.

216. *Id.* at 369.

217. *Id.*

218. *Id.*

219. Wroldsen, *supra* note 1, at 615-16. A typical investment from a venture capitalist is \$2,000,000 - \$10,000,000. *Id.*

220. *Id.* at 611.

prefer debt-based Regulation Crowdfunding because of the flexibility it offers.<sup>221</sup> Because debt must be repaid, it theoretically represents a less speculative investment than equity, which may never yield a return.<sup>222</sup> Startups may face cashflow problems that prevent paying back debt, may be forced into offering an extremely high interest rate to attract investors, or may be unable to attract investors who only want the potential high-reward-equity could offer.<sup>223</sup> Small businesses are already accustomed to debt financing; in 2016, 34% of small businesses used some kind of loan for capital compared to only 3% who utilized venture capital or angel investors.<sup>224</sup> Debt-based crowdfunding may also be easier for businesses and investors because many of the more complicated issues with equity such as dilution, voting rights, and shareholder resolutions will not be present.<sup>225</sup> An entrepreneur with a seasoned business may also not be willing to give up an ownership stake because of the resultant loss of control.<sup>226</sup>

## VI. PROPOSED SOLUTIONS

Crafting an exemption for seasoned small businesses is a fairly simple exercise because much of the structure of the existing law could be copied into a new statutory section after making the relevant changes.<sup>227</sup> These proposed changes will generally be a matter of line-drawing rather than a complete rewrite but for clarity should be codified in a new U.S. Code section adjacent to the existing statute, perhaps section 77d-2.<sup>228</sup> The creation of this new category of seasoned businesses probably must originate with Congress as many of the requirements on issuers and investors are explicitly spelled out in the JOBS Act.<sup>229</sup> Nothing within the text itself gives the SEC broad authority to rewrite the rules completely though it does have the authority to create additional requirements on issuers for investor protection or in the public interest.<sup>230</sup> After passing the new statute, Congress would likely defer to the SEC for final rulemaking as it did with the original JOBS Act.<sup>231</sup>

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221. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1482-90 (2013).

222. *Id.* at 1488.

223. *Id.*; Rogers, *supra* note 3, at 368-69.

224. NAT'L SMALL BUS. ASS'N, *supra* note 170, at 9.

225. Schwartz, *supra* note 221, at 1483-87.

226. *Id.* at 1489-90.

227. See generally JOBS Act, Pub. L. No. 112-106 §§ 301-05, 126 Stat. 306 (2012). The bulk of proposed changes will require adjusting number values or adding new subsections.

228. Most of the specific provisions for regulation crowdfunding are codified in 15 U.S.C. § 77d-1 (2012). Adding a section d-2 will keep the two sections together. Some of the proposed changes in this section will also require modification to other statutes such as 15 U.S.C. § 77d.

229. JOBS Act §§ 301-305.

230. *Id.* at § 302.

231. *Id.*

### *A. Key Sections to Retain*

The JOBS Act and the SEC's subsequent final rules created several important investor protection and anti-fraud provisions that should be retained.<sup>232</sup> First, an investor has a private right of action against an issuer that “makes an untrue statement of a material fact or omits to state a material fact required to be stated” and “does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.”<sup>233</sup> This provision has been criticized as exposing issuers to more liability than they might face under other exemptions, but it is reasonable to require a seasoned business to draft their disclosures with reasonable care.<sup>234</sup> Additionally, under the SEC's final rules the issuer does not lose the ability to use the exemption if it makes a “good faith and reasonable attempt” to comply with the rules and any failure was “insignificant with respect to the offering as a whole[.]”<sup>235</sup> Second, various kinds of bad-actors, including those who have been convicted of felonies “in connection with the purchase or sale of any security[.]” are disqualified from utilizing the crowdfunding exemption.<sup>236</sup>

### *B. Key Sections to Change*

To begin with, Congress should address the actual utility of the law. Seasoned businesses should be allowed to offer more than startups because of the decreased risk.<sup>237</sup> Instead of the current ceiling of \$1,000,000 per calendar year, Congress should set a higher upper bound for seasoned businesses.<sup>238</sup> To find an appropriate amount, Congress could look to small business loans as a proxy measurement since commercial loans are largely unavailable to startups and, therefore, are indicative of capital demand among seasoned small businesses.<sup>239</sup>

The average loan backed by the SBA in 2015 was \$371,628.<sup>240</sup> This is not helpful in determining the ceiling, but it may indicate the lower tiers that will be more commonly used by seasoned small businesses.<sup>241</sup> In 2010, Congress passed a different JOBS Act called the Small Business Jobs Act of 2010.<sup>242</sup> In Sec. 1112

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232. Crowdfunding, 80 Fed. Reg. 71,388, 71,480 (Nov. 16, 2015); 15 U.S.C. § 77d-1(c).

233. 15 U.S.C. § 77d-1(c)(2).

234. Rogers, *supra* note 3, at 372-73.

235. 17 C.F.R. § 227.502 (2017).

236. Crowdfunding 80 Fed. Reg. at 71,549.

237. *See supra* Part V.

238. *See, e.g.,* Vignone *supra* note 77, at 828-29.

239. Patrick Archambault, *How the SEC's Crowdfunding Rules for Funding Portals Save the Two-Headed Snake: Drawing the Proper Balance Between Integrity and Cost*, 49 SUFFOLK U. L. REV. 61, 62 (2016).

240. *Loan Amounts, Fees & Interest Rates*, SBA.GOV, <https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/small-business-loans-sba-advantage-loans-7a/loan-amounts-fees-interest-rates> [https://perma.cc/RR7L-X3H8] (last visited Feb. 8, 2017).

241. *Id.*

242. Pub. L. No. 111-240, 124 Stat. 2504 (2010).

of this bill, Congress increased the ceiling for most kinds of SBA-backed loans to \$5,000,000.<sup>243</sup> SBA loans are issued by commercial lenders, partially guaranteed by the federal government, and typically require collateral, giving lenders a certain amount of security that crowdfunding investors would not have.<sup>244</sup> Thus, \$5,000,000 may be too risky.<sup>245</sup> Conversely, in economic analysis, nonfarm, nonresidential loans of \$1,000,000 or less are often used as a proxy measurement for small business lending in general.<sup>246</sup> Some critics have already suggested \$1,000,000 is too low.<sup>247</sup> Several states have set their crowdfunding offering limits to \$2,000,000 under the intrastate exemption.<sup>248</sup> This seems to be an appropriate increase that reflects the reduced risk presented by seasoned businesses while recognizing the risk still posed to amateur investors.<sup>249</sup>

After Congress increases the offering limit, it should adjust the tiered disclosure requirements.<sup>250</sup> Two million would now be the top tier, which will continue to require the most disclosure.<sup>251</sup> The question then becomes how to adjust the lower tiers. Critics have pointed to financial statements as a source of cost, so reducing the requirements in the lower tiers would help assuage those concerns.<sup>252</sup> The suggested model, as indicated in Table 3, simply requires repositioning the disclosures already required by the law.<sup>253</sup> The significant changes are 1) only requiring relevant tax information and internally certified financial statements up to \$500,000 and 2) only requiring reviewed financials for offers of up to \$1,000,000.<sup>254</sup>

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243. *Id.* § 1112.

244. *What SBA Offers to Help Small Businesses Grow*, *supra* note 205.

245. *Id.*

246. Wiersch & Shane, *supra* note 194.

247. *See, e.g.*, Vignone, *supra* note 77, at 828.

248. Pierce-Wright, *supra* note 56, at 878.

249. *See supra* Part V.

250. *See, e.g.*, Isaacson, *supra* note 6, at 456-57.

251. *See generally* Crowdfunding 80 Fed. Reg. 71,388, 71,397-424 (Nov. 16, 2015) (final rule to be codified at 17 C.F.R. parts 200, 227, 232, 239, 240, 249, 269, and 274).

252. *See, e.g.*, Vignone, *supra* note 77, at 828.

253. *See* Crowdfunding 80 Fed. Reg. at 71,411-17.

254. *See infra*, Table 3.

Table 3

Amount of Offer:	≤ \$100,000	≤ \$500,000	≤ \$1,000,000	≤ \$2,000,000
Financial Disclosure Required:	Internally certified financial statements and most recent tax information.	Internally certified financial statements and most recent tax information.	Independently reviewed financial statements.	Independently audited financial statements.

Reducing the amount of financial disclosure required in the bottom tiers while increasing the offering limit in the top tier should help to alleviate some concerns about costs.<sup>255</sup> Producing, reviewing, or auditing financial statements will always present some cost to an issuer, but by adjusting when they kick in, Congress can ease the burden on issuers utilizing the lower tiers.<sup>256</sup> For example, a seasoned small business, because it will have been in operation for at least three years, likely will have tax information available already that will present no additional cost to the issuer.<sup>257</sup> As an added protection measure, Congress could adopt (or the SEC could apply) the language in the current final rules that mandate audited financials to be used if they are already available, regardless of offering tier.<sup>258</sup>

The SEC should strongly consider creating a more simplified form for seasoned small business offerings as another method of decreasing compliance costs.<sup>259</sup> The form in its current arrangement is time-consuming and burdensome to complete.<sup>260</sup> Looking to state crowdfunding regulations may be helpful in drafting a new form.<sup>261</sup> Intrastate offerings are estimated to cost less than \$5,000 in total compliance fees, including lawyers and accountants.<sup>262</sup> An additional compromise measure might be to make the simplified form only available for offering amounts of up to \$500,000 to reduce risk.<sup>263</sup> This would help encourage participation in what will likely be the most often used tiers for seasoned small

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255. See Hogan, *supra* note 10, at 1110.

256. See Isaacson, *supra* note 6, at 457, 462.

257. See Crowdfunding 80 Fed. Reg. at 71,408.

258. 17 C.F.R. § 227.201 (2017).

259. Lager, *supra* note 60, at 596-97.

260. Isaacson, *supra* note 6, at 456-57.

261. Vignone, *supra* note 77, at 813-14.

262. *Id.*

263. See Crowdfunding 80 Fed. Reg. 71,388, 71,423 (Nov. 16, 2015) (noting that the use of one form will be more efficient, but approving a modified format for completing the form that is “less burdensome for small issuers while still providing . . . the required information”).

businesses.<sup>264</sup> It will also leave existing disclosures in place for businesses choosing to offer more, thus retaining investor protection for the higher tiers.<sup>265</sup>

The SEC discussed the substantial risk of business failure as a justification for retaining strict investment limits.<sup>266</sup> It received comments expressing fears investors would sustain “unaffordable losses,” and it found the argument “persuasive.”<sup>267</sup> Seasoned businesses do not pose this kind of systemic risk, even if they pose some.<sup>268</sup>

First, in the lower tier, the somewhat complicated “greater of” formula should be abandoned.<sup>269</sup> It should simply be a fixed amount based on annual income. This should also simplify compliance for the portal and may lead to additional reduced costs.<sup>270</sup> As a starting point for discussion, \$4,000 seems like a reasonable limitation for investors making up to \$100,000 each year.<sup>271</sup> Second, for investors who earn more than \$100,000 per year, the new statute should retain the 10% of annual income figure, but once again lose the net worth provision for simplicity.<sup>272</sup>

Congress should also add a new tier to the investor limitations for accredited investors.<sup>273</sup> Accredited investors can invest tremendous amounts of money in other registration exemptions, so why not here?<sup>274</sup> So long as there is a mechanism built in the platform to verify the investor meets the requirements, it seems logical that the most sophisticated investors should be able to bear more risk if they choose to do so.<sup>275</sup> Although accredited investors make up only about 7% of households, they control 70% of the available investment capital.<sup>276</sup> The SEC received numerous comments about creating a different limit for accredited investors, but in its discussion of the final rules, it stated that the language of the JOBS Act did not grant them the authority to create such a rule.<sup>277</sup> Therefore, this

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264. *Loan Amounts, Fees & Interest Rates*, *supra* note 240.

265. *See generally* Crowdfunding 80 Fed. Reg. at 71,398-416.

266. *Id.* at 71,394.

267. *Id.*

268. *See supra* Part V.

269. Crowdfunding 80 Fed. Reg. at 71,394.

270. *See Lager*, *supra* note 60, at 588-90 (arguing that costs incurred by the platform will ultimately be passed on to the issuer).

271. *See, e.g., Pierce-Wright*, *supra* note 56, at 873 (noting that Indiana allows \$5,000 per unaccredited investor per year).

272. *See* Crowdfunding 80 Fed. Reg. at 71,394.

273. *See id.* at 71,394-95.

274. For example, accredited investors can invest unlimited amounts of money in Regulation A offerings, another kind of exempted transaction. *See Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)*, 80 Fed. Reg. 21,806, 21,816 (Apr. 20, 2015).

275. *See id.* at 21,816 (“[I]nvestors that qualify as accredited under our rules satisfy certain criteria that suggest they are capable of protecting themselves . . .”).

276. Hogan, *supra* note 10, at 1111.

277. Crowdfunding 80 Fed. Reg. at 71,394-95.

type of reform was already in the contemplation of the SEC, but will require further congressional action.<sup>278</sup>

Finally, Congress and the SEC should relax the rules on general advertising to allow a broader use of social media in promoting crowdfunding offers.<sup>279</sup> The most successful traditional crowdfunding campaigns highly utilize social media to achieve success.<sup>280</sup> At least initially, contributions to crowdfunding campaigns tend to stem from the campaigner's family and friends.<sup>281</sup> After this initial, quick flow of investment largely based on trust or personal connection to the campaigner, larger crowdfunding projects must then seek to bring in people with no original connection to the campaign.<sup>282</sup>

Quantifiable data exists to illustrate the connection between strong social media campaigns and crowdfunding success. For example, one study of crowdfunded film projects found several social media trends that separate successful campaigns (those that were fully funded) and failed campaigns (those that did not meet their funding goal).<sup>283</sup> The average number of Facebook friends for the person launching the project was 529 for successful campaigns and 381 for unsuccessful campaigns.<sup>284</sup> The direct network size, defined as the "connections to the campaigners and any campaign related pages on Facebook and Twitter," was 37,760 for successful campaigns and only 2,627 for unsuccessful campaigns.<sup>285</sup> Finally, the average number of Facebook shares for the duration of a campaign was 655 for successful projects and only 146 for unsuccessful campaigns.<sup>286</sup> This is only a small sample, but it reinforces the conventional wisdom of crowdfunding experts that social media is a key component of success and that "[c]rowds cannot simply be expected to pick up on good ideas on their own."<sup>287</sup>

Although issuers are allowed to advertise on social media under the Regulation Crowdfunding rules, they are not currently permitted to use the full range of social media tools available.<sup>288</sup> Because they can only contact potential investors individually through channels created by the crowdfunding platform, issuers will be unable to respond to direct interactions with potential investors on social media (or even e-mail) regarding the offering.<sup>289</sup> Traditional crowdfunding

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278. *Id.*

279. *See* Rogers, *supra* note 3, at 372.

280. John Boitnott, *5 Secrets of Successful Crowdfunding Campaigns*, INC.COM, (Mar. 5, 2015), <http://www.inc.com/john-boitnott/5-secrets-of-successful-crowdfunding-campaigns.html> [<https://perma.cc/4AS4-EL9X>].

281. Hobbs et al., *supra* note 34, at 148.

282. *Id.* at 148-49.

283. *Id.* at 155-56.

284. *Id.* at 154.

285. *Id.* at 153-54.

286. *Id.* at 154.

287. *Id.* at 150.

288. Crowdfunding, 80 Fed. Reg. 71,388, 71,425 (Nov. 16, 2015).

289. Isaacson, *supra* note 6, at 453 (referring to crowdfunding platforms).

projects that reach 25% of their funding goal in the first week, typically from friends and family, are five times more likely to be fully funded.<sup>290</sup>

#### CONCLUSION

There are legitimate complaints about the existing rules for Regulation Crowdfunding.<sup>291</sup> Neither side is necessarily wrong; the deregulation and investor protection arguments both have merit; it is sometimes too costly, and there may not be enough investor protections in all cases.<sup>292</sup> Guided by eighty years of precedent, securities regulations in the United States are a balancing act between investor protections and the capital needs of businesses.<sup>293</sup>

Creating a new regulation for seasoned businesses will attempt to address some of the more prominent issues with the law while maintaining this balance.<sup>294</sup> It will not eliminate every concern, nor will it stop all people from losing money,<sup>295</sup> but it might allow the crowdfunding exemption to be used more frequently and with more success.<sup>296</sup> The SEC adopted rules for Regulation Crowdfunding while acknowledging the likelihood of an extremely high failure rate and little promise for large rewards.<sup>297</sup> Funding seasoned businesses may not present many high yield investment opportunities, but it might create an influx of capital to a large sector of the economy while providing modest financial returns for many investors.<sup>298</sup>

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290. Robb Mandelbaum, *Here Comes Everybody*, INC., May 2014, at 114, available at <https://www.inc.com/magazine/201405/robb-mandelbaum/jobs-act-crowdfunding-problems.html> [<https://perma.cc/A3FF-VXUG>].

291. *See supra* Part IV.

292. *See id.*

293. 15 U.S.C. §§ 77b(b), 78d (2012).

294. *See supra* Part VI.

295. *See id.*

296. *See* Rogers, *supra* note 3, at 377.

297. Crowdfunding, 80 Fed. Reg. 71,388, 71,489 (Nov. 16, 2015).

298. *See supra* Part V.C.