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Rules Are Meant to Be Amended: How Regulation Crowdfunding's Final Rules Impact the Lives of Startups and Small Businesses

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Rules Are Meant to Be Amended

HOW REGULATION CROWDFUNDING'S FINAL RULES IMPACT THE LIVES OF STARTUPS AND SMALL BUSINESSES

INTRODUCTION

Before 2012, U.S. retail investors had very little access to the most exciting investment opportunities. Today, the American people—not just the wealthy—are able to invest in the potential of thousands of startups that may just be the next big thing. These are changes that have flowed from the Jumpstart Our Business Startups Act (JOBS Act).[1] As President Barack Obama stated at the bill's signing:

> This bill is a potential game changer . . . [b]ecause of this bill, start-ups and small businesses will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in the entrepreneurs that they believe in.[2]

In response to the difficulties of accessing traditional methods of funding, entrepreneurs revolutionized the approach to capital financing.[3] Traditional financing, such as bank loans, venture capital investing, or investments based on retained earnings are not as easily accessible to small businesses.[4] But with the inception of crowdfunding on platforms like Kickstarter,[5]

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[1] Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C. (2012)).

[2] Thomas Kalil & Doug Rand, *The Promise of Crowdfunding and American Innovation*, WHITE HOUSE BLOG (June 8, 2016, 9:49 AM), https://www.whitehouse.gov/blog/2016/06/08/promise-crowdfunding-and-american-innovation [https://perma.cc/ZD5Y-5FYN] (quoting President Barack Obama at JOBS Act Bill Signing).

[3] *See generally* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 (2012).

[4] Bradford, *supra* note 3, at 5; *Kickstarter vs. Equity Crowdfunding*, SEEDINVEST (Sept. 6, 2016), https://www.seedinvest.com/blog/crowdfunding/this-is-not-kickstarter [https://perma.cc/AZ3K-4PGS].

[5] KICKSTARTER, https://www.kickstarter.com [https://perma.cc/C3VZ-2GSC].

startups and small businesses have increasingly used innovative practices to raise capital.[6]

Crowdfunding is a form of capital financing that uses the Internet to raise capital through small investments from a large group of people—the "crowd."[7] There are several distinctive types of crowdfunding, including: rewards-based, donation-based, and equity-based crowdfunding.[8] In the rewards- and donation-based models, entrepreneurs propose business ventures to the general public predominantly through Web-based services such as Kickstarter[9] and IndieGoGo, with the opportunity for donors to get free a T-shirt or movie credit, for example, as a reward for their contribution.[10] The equity crowdfunding model is different and presents an issue of applying federal securities laws because it constitutes the offer and sale of a security.[11] Companies that might otherwise struggle to attract wealthy individuals and institutional investors, however, now have an alternative avenue to finance their venture via retail investors and web-based platforms.

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[6] *See* Bradford, *supra* note 3, at 5; *Kickstarter vs. Equity Crowdfunding*, *supra* note 4.

[7] *See* Bradford, *supra* note 3, at 1; Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1736 (2012); Roberta S. Karmel, *Disclosure Reform—the SEC Is Riding Off in Two Directions at Once*, 71 BUS. LAW. 781, 820 (2016) ("Crowdfunding uses the Internet to raise capital for a wide range of projects, typically seeking small contributions from a large number of individuals.").

[8] Anthony Zeoli, *The 4 Types of Crowdfunding*, CROWDFUNDING LEGAL HUB (Apr. 27, 2014), https://crowdfundinglegalhub.com/2014/04/27/test-3 [https://perma.cc/6UP9-NYNT].

[9] KICKSTARTER, *supra* note 5.

[10] INDIEGOGO, https://www.indiegogo.com/ [https://perma.cc/GPK9-B72P].

[11] Under Section 2(a) of the Securities Act of 1933, a security is defined as:

> [A]ny note, stock, treasury stock, security future, security-based swap, 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, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(a),15 U.S.C. § 77b(a)(1). Rules for Crowdfunding Regulation, Securities Act Release No. 9974, 80 Fed. Reg. 71,387, 71,388 (Oct. 30, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249) (adopting rules to implement Title III of the JOBS Act) [hereinafter Crowdfunding]; *see also* 15 U.S.C. § 77b(3) (2012) (definition of offers and sales of securities).

To address the issue of equity-based crowdfunding, Congress passed the JOBS Act in 2012 to establish a regulatory structure for startups and small businesses to raise capital through securities offerings using Internet crowdfunding.[12] The Securities and Exchange Commission (the Commission) drafted Title III and Title IV to provide early-stage businesses the option to offer and sell securities without overly expensive transaction costs, thereby easing their means to raise capital.[13] Title III, commonly known as Regulation CF (Reg CF) exempts certain crowdfunding activities.[14] Title IV, commonly known as Regulation A+ (Reg A+), exempts certain offerings done via public solicitation for early stage companies as an alternative to an initial public offering (IPO).[15] Specifically, the exemptions relieve small businesses and emerging growth companies from registration under the Securities Act of 1933 (Securities Act), and the Exchange Act of 1934 (Exchange Act) when engaging in capital raising activities.[16] Therefore, companies seeking to avail

[12] Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306, § 302 (2012) (codified as amended at 15 U.S.C. § 77d(6) (2012)) (adding a crowdfunding exemption to Section 4 of the Securities Act of 1933); *see* Sherief Morsy, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, 79 BROOK. L. REV. 1373, 1374 (2014) ("The JOBS Act exempts crowdfunding issuers and investors from SEC reporting requirements so long as the transactions fall within statutory boundaries."). The JOBS Act was enacted to increase American job creation and economic growth. Jumpstart Our Business Startups Act § 101 (codified as amended at 15 U.S.C. §§ 77b(a), 78c(a)) (adding definition of "Emerging Growth Company" to Section 2(a) of the Securities Act of 1933 and Section 3(a) to the Securities Exchange Act of 1934); *see also* Kalil & Rand, *supra* note 2.

[13] Jumpstart Our Business Startups Act tit. III, IV; Crowdfunding, 80 Fed. Reg. at 71,388.

[14] Jumpstart Our Business Startups Act tit. III, IV; *see Regulation Crowdfunding Rules*, SEEDINVEST (Sept. 21, 2016), https://www.seedinvest.com/blog/crowdfunding/regulation-crowdfunding-rules [https://perma.cc/B6MH-B338]. On May 16, 2016, the Commission adopted the final rules of Reg CF, causing polarizing reactions from issuers, intermediaries, and investors, fearing the unpredictable future of equity crowdfunding. *See Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm [https://perma.cc/EB5G-FMQB]. The final rules address issues of protecting investors from risk of fraudulent activity. Crowdfunding, 80 Fed. Reg. at 71,400.

[15] Jumpstart Our Business Startups Act tit. IV; *see Regulation A+ (Reg A+)*, NYSE, https://www.nyse.com/regulation-a [https://perma.cc/YF7M-FYMR] ("Regulation A+ (Reg A+) is an alternative to a traditional IPO . . . . Through Reg A+ a . . . company is afforded the opportunity to[ ] [r]aise up to $50 million in a 12 month period using a 'public solicitation' of its shares.").

[16] Jumpstart Our Business Startups Act §§ 101–04, 302; (crowdfunding exemption from registration requirements); Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 77*l* (requiring securities to be registered prior to being offered on an exchange); Securities Act of 1933 § 5, 15 U.S.C. § 77e (requiring securities to be registered prior to any capital raising activity); *see* Roberta S. Karmel, *Crowdfunding: Narrative and Financial Disclosures*, N.Y. L.J. (Online) (Dec. 17, 2015), http://www.newyorklawjournal.com/id=1202745015252/Crowdfunding-Narrative-and-Financial-Disclosures [https://perma.cc/AG9X-MSWW]. Prior to the JOBS Act, businesses would have to rely on other exemptions from registration, such as Rule 506. 17 C.F.R. § 230.506 (2017); *see Fast Answers: Rule*

themselves of the JOBS Act must contemplate which equity-based financing strategy would be more effective for their business: Reg CF or Reg A+.

This note focuses on comparing the Reg CF and Reg A+ financing schemes by analyzing their costs and relative benefits, submitting that the Commission has harshly burdened issuers from adequately raising capital under Reg CF because of its draconian restrictions on investment and strict investment limitations. Given its current state, Reg A+'s offering scheme more likely increases investors' potential gains while mitigating the risk of fraudulent issuers. The note ultimately prescribes a suggested adjustment to the final rules of Reg CF to improve the capital raising model without eliminating the basic framework of the exemption. Specifically, to protect investors while implementing an efficient method for capital raising, the Commission must alter the final rules of Reg CF, increase the investment cap, and reevaluate the disclosure requirements to further promote emerging business development.

I. AN OVERVIEW OF EQUITY CROWDFUNDING: A WORLD FULL OF EAGER INVESTORS

Fundamentally, equity crowdfunding is done via a combination of crowdsourcing and microfinancing.[17] Professor C. Steven Bradford defines crowdfunding as "funding from the crowd—raising small amounts of money from a large number of investors."[18] Entrepreneurs and small businesses seek out individual investors from the general public, or "the crowd," to obtain initial capital and create an opportunity for growth.[19] Through Internet platforms like WeFunder, entrepreneurs connect with a multitude of prospective investors to hopefully inspire them and give them the availability to invest in a business at a company's inception.[20]

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506 of Regulation D, SEC, https://www.sec.gov/fast-answers/answers-rule506htm.html [https://perma.cc/LZV5-HHKT] (allowing a company to "sell its securities to an unlimited number of 'accredited investors' and up to [thirty-five] purchasers," as long as they refrain from general solicitations or advertisements). The definition of what is technically a security has been construed widely, and therefore when not relying on an explicit exemption, companies can easily run afoul of the securities laws. *See* 15 U.S.C. § 77b(1) (definition of security); *see also* Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293 (1946) (seminal case regarding the definition of an "investment contract" as a security, finding that investments in orange groves were securities, and should have therefore been registered).

17 *See* Bradford, *supra* note 3, at 10.

18 *Id.* at 5.

19 *Id.*

20 *Id.*; *Kickstarter vs. Equity Crowdfunding*, *supra* note 4.

Since Congress enacted the JOBS Act, equity-based crowdfunding has become an attractive method of capital raising for startup companies because of the limited starting capital needed. In 2017, the global amount raised from equity crowdfunding offerings was $2.5 billion.[21] Under an equity-based crowdfunding model, "individual investors receive some sort of financial return in exchange for their monetary contributions."[22] Equity crowdfunding offers startups access to all investors[23] by combining "virtual technologies with traditional investing principles."[24] Crowdfunding "reopen[s] American capital markets to emerging growth companies,"[25] by providing an efficient financing method to reach the necessary capital, and while allowing businesses to raise capital without undergoing the costly process of an IPO.[26] Equity crowdfunding neither requires collateral to receive funds, nor does it increase an issuer's chances of experiencing bankruptcy, because there are no initial debts.[27] Instead, "payback is ongoing as a share of future revenues."[28]

The JOBS Act opens necessary capital markets for businesses that would otherwise have limited avenues to finance their companies, if any at all. Specifically, Title III gives startups

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21 *See Crowdfunding Statistics [Updated for 2017]*, FUNDLY, https://blog.fundly.com/crowdfunding-statistics [https://perma.cc/N3PG-N57A]; *see also* Jason Best & Sherwood Neiss, *The 2017 State of Regulation Crowdfunding: US Securities-based Crowdfunding under Title III of the JOBS Act*, CROWDFUND INSIDER (Jan. 15, 2018, 4:39 PM), https://www.crowdfundinsider.com/2018/01/127112-2017-state-regulation-crowdfunding-us-securities-based-crowdfunding-title-iii-jobs-act [https://perma.cc/AHX8-SKTC] (In 2017, the total proceeds from all Reg CF offerings was $76.8 million.).

22 David Groshoff et al., *Crowdfunding 6.0: Does the SEC's Fintech Law Failure Reveal the Agency's True Mission to Protect Solely Accredited Investors?*, 9 OHIO ST. ENTREPRENEURIAL BUS. L.J. 277, 283 (2015).

23 An "unaccredited investor" is an investor who is not qualified as an accredited investor, failing to meet the income or net worth requirements set out by the Securities and Exchange Commission. An accredited investor is any person who meets the requirements stipulated in Regulation D. *See* 17 C.F.R. § 230.501(a) (2017). In the crowdfunding sense, an unaccredited investor is someone whose individual net worth or joint net worth with their spouse does not exceed $1,000,000. *Id.*

24 Michael Vignone, *Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Businesses*, 91 CHI.-KENT L. REV. 803, 804 (2016).

25 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, 445 (2016) (quoting Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 2, 126 Stat. 306 (2012)).

26 *See generally Considering an IPO to Fuel Your Company's Future?: Insight Into the Costs of Going Public and Being Public*, PWC (Nov. 2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf [https://perma.cc/Y52E-JRUH] [hereinafter PWC] (summarizing the costs of an IPO).

27 *See* RYAN TAYLOR, SMALL BUS. ADMIN. OFF. OF ADVOC., ISSUE BREIF NO. 5, EQUITY-BASED CROWDFUNDING: POTENTIAL IMPLICATIONS FOR SMALL BUSINESS CAPITAL 3 (2015), https://www.sba.gov/sites/default/files/advocacy/Issue-Brief-5-Equity-Based-Crowdfunding_2.pdf [https://perma.cc/C7RS-RZNK].

28 *Id.* This is an equity-based financing model. No debt is included to eliminate companies from turning to bankruptcy as a way out. *Id.*

and entrepreneurs a cost-efficient exemption to registration that "may increase both capital formation and the efficiency of capital allocation among small issuers by expanding the range of methods of external financing available to small businesses and the pool of investors willing to finance such types of businesses."[29] Title III was designed to alleviate expenses for startups and small businesses, promote crowdfunding investments, and "increase[] economic growth and job creation."[30]

Title III is the crowdfunding exemption to the registration requirements associated with an IPO, otherwise mandated by Section 5 of the Securities Act.[31] Under the Securities Act, the offer or sale of any security must be registered with the Commission pursuant to Section 5, unless qualifying for an exemption.[32] Title III added Section 4(a)(6), which exempts crowdfunding transactions from registration.[33] Section 4(a)(6) allows issuers to raise a maximum of $1.07 million, and avoid the registration requirements under Section 5.[34] The aggregate amount sold to an investor during a twelve month period cannot exceed the greater of $2,200 or five percent of the lesser of the investor's annual income or net worth if either is less than $107,000.[35]

Congress designated Title III and Title IV of the JOBS Act to facilitate small business growth by expanding registration

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[29] Crowdfunding, 80 Fed. Reg. 71,387, 71,492 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 227). *See* Jumpstart Our Business Startups Act tit. III (codified as amended in scattered sections of 15 U.S.C.) (amending Securities Act of 1933 and Securities Exchange Act of 1934). In 2015, equity crowdfunding accounted for roughly $2.5 billion in online capital raising. *Crowdfunding Industry Statistics 2015 2016*, CROWD EXPERT, http://crowdexpert.com/crowdfunding-industry-statistics [https://perma.cc/ZN2L-N86A].

[30] Armstrong Teasdale, LLP, *JOBS Act Eases Regulatory Burdens on Capital Raising*, NAT'L L. REV (Apr. 18. 2012), http://www.natlawreview.com/article/jobs-act-eases-regulatory-burdens-capital-raising [https://perma.cc/QKW7-MB34].

[31] *See generally* Securities Act of 1933 § 2(a), 15 U.S.C. § 77b(a)(1) (including the definition of a security). Jumpstart Our Business Startups Act § 302 (codified as amended at 15 U.S.C. § 77d (2012)) (crowdfunding exemption); Securities Act of 1933 § 5, 15 U.S.C. § 77e (registration requirement).

[32] Securities Act of 1933 § 5, 15 U.S.C. § 77e.

[33] Jumpstart Our Business Startups Act § 302 (codified as amended at 15 U.S.C. § 77d(a)(6) (2012)) ("The provisions of [Section 5] of this title shall not apply to . . . transactions involving the offer or sale of securities by an issuer . . . provided that the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the [twelve-]month period preceding the date of such transaction, is not more than $1,000,000.").

[34] 17 C.F.R. § 227.100(a)(1) (2017) ("The aggregate amount of securities sold to all investors by the issuer in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) during the 12-month period preceding the date of such offer or sale, including the securities offered in such transaction, shall not exceed $1,000,000 . . . .").

[35] 17 C.F.R. § 227.100(a)(2) (2017) (If the investor's annual income and net worth are equal or more than $107,000, the aggregate amount sold to that investor during the twelve-month period shall not exceed ten percent of the lessor of the investor's annual income or net worth, not to exceed an amount sold of $107,000).

exemptions.[36] Title IV contains a mandate to the Commission to expand Regulation A to promote "small company capital formation."[37] Nevertheless, these new regulations pose serious concerns for businesses and their intermediaries. Notably, the final rules of Title III allow any investor, accredited or unaccredited, "to purchase unregistered securities from issuers utilizing . . . funding portals."[38] Intermediaries are the Internet-based platforms commonly referred to as funding portals[39] and brokers,[40] which under Reg CF must register with the Commission prior to eligibility.[41] They must also become a member of a registered national securities association, such as Financial Industry Regulatory Authority (FINRA).[42] Funding portals match interested investors with available crowdfunding ventures, and hold investor funds until the specified target offering amount is reached.[43] Intermediaries lament that Reg CF

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[36] Isaacson, *supra* note 25, at 441.

[37] *Id.* at 447 (quoting Jumpstart Our Business Startups Act § 401 (codified as amended at 15 U.S.C. § 77c(b)).

[38] *Id.* at 453.

[39] 15 U.S.C. § 78c(a)(80) (2012) (funding portals are defined as any "person" involved in transactions for the offer and sale of securities on behalf of the account of another).

[40] 17 C.F.R. § 227.300(c) (2017); Crowdfunding, 80 Fed. Reg. 71,387, 71,428 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 227) ("The term 'broker' is generally defined in the Exchange Act Section 3(a)(4) as any person that effects transactions in securities for the account of others. Exchange Act Section 3(a)(80) defines the term 'funding portal' as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Securities Act Section 4(a)(6), that does not: (1) Offer investment advice or recommendations; (2) solicit purchases, sales or others to buy the securities offering or displayed on its Web site or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its Web site or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the Commission, by rule, determines appropriate.").

[41] 17 C.F.R. § 227.100(a)(3) (2017) ("The transaction [must be] conducted through an intermediary that complies with the requirements in Section 4A(a) of the Securities Act . . . and the related requirements in this part, and the transaction is conducted exclusively through the intermediary's platform . . . ."); *id.* § 227.300 (requiring intermediaries to be registered); Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 180 (2013).

[42] 17 C.F.R. § 227.300 (2017); *see* JD Alois, *There are Now 14 FINRA Approved Funding Portals Created by Title III of the JOBS Act*, CROWDFUND INSIDER (Aug. 8, 2016, 8:47 AM), http://www.crowdfundinsider.com/2016/08/88857-now-14-finra-approved-funding-portals-created-title-iii-jobs-act [https://perma.cc/T6SN-TA7M]; *What We Do*, FINRA, http://www.finra.org/about/what-we-do [https://perma.cc/T2U7-59YZ]; *Funding Portals We Regulate*, FINRA, http://www.finra.org/about/funding-portals-we-regulate [https://perma.cc/XRF7-UBD2].

[43] *See* Heminway, *supra* note 41, at 180–82. Alois, *supra* note 42 ("14 funding portals . . . have been approved to offer securities under Title III of the JOBS Act."); JD Alois, *There are Now 17 Registered Reg CF Platforms. Can they be Sustained?*, CROWDFUND INSIDER (Oct. 13, 2016, 10:52 PM), http://www.crowdfundinsider.com/2016/10/91212-now-17-registered-reg-cf-platforms-can-sustained/ [https://perma.cc/62BS-38BW] ("In reviewing the overall data as provided by WeFunder, there have been 40 successful offering raising about $9.4 million as of this week.").

charges them with mandatory reporting requirements,[44] and requires them to bear the burden of identifying an "issuer or the offering [that] presents the potential for fraud or otherwise raises concerns about investor protection."[45] The requirement to thoroughly review each issuer places a cumbersome burden on intermediaries and consequently provides insufficient protection for investors.[46]

The maximum raise under Reg CF has caused startup entrepreneurs to seriously weigh its advantages against those of Reg A+. The maximum offering in a twelve-month period is $1.07 million—an insufficient amount to launch a successful offering.[47] Meanwhile, the maximum offering under Title IV Reg A+ rules is either $20 million (Tier 1) or $50 million (Tier 2).[48] The drawback to Reg A+ is the significant time and expenses to make a Reg A+ offering.[49] Therefore, issuers need a thorough understanding of both regulatory schemes before pursuing either financing strategy. Former Chair of the Commission Mary Jo White has said,

> [t]here is a great deal of enthusiasm in the marketplace for crowdfunding, and I believe these rules and proposed amendments provide smaller companies with innovative ways to raise capital and give investors the protections they need . . . [w]ith these rules, the Commission has completed all of the major rulemaking mandated under the JOBS Act.[50]

Now that Regulation Crowdfunding has officially been active[51] for over two years, funding portals are beginning to react to its effects, and small market issuers have two separate financing methods to consider.

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[44] *See* Heminway, *supra* note 41, at 205.

[45] 17 C.F.R. § 227.301(c)(2) (2017). Robert Robbins & Amy Modzelesky, *Can Regulation A+ Succeed Where Regulation A Failed?*, AM. L. INST. CONTINUING LEGAL EDUC., 1–10 (May 6, 2015).

[46] *Id.* at 7.

[47] 17 C.F.R. § 227.100(a)(1) (2017). *See Crowdsourcing a Title III Equity Crowdfunding Cost Model*, SEEDINVEST (Jan. 23, 2016), https://www.seedinvest.com/blog/jobs-act/crowdsourcing-title-iii-crowdfunding-cost-model [https://perma.cc/64DG-J3V6] ("A successful $1M raise will actually only net $750,000 in capital. This is an astronomical cost of capital.").

[48] 17 C.F.R. § 230.251(a)(1)-(2) (2017); *see* Robbins & Modzelesky, *supra* note 45, at 7.

[49] *Id.* at 7.

[50] Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), https://www.sec.gov/news/pressrelease/2015-249.html [https://perma.cc/Q84X-JZDR].

[51] *See* Robbins & Modzelesky, *supra* note 45, at 1.

II. REGULATION A+: THE "MINI IPO" AND THE BENEFITS OF A TWO-TIER SYSTEM

Effective as of June 19, 2015, "the SEC adopted amendments to Regulation A and other rules to implement Section 401 of the JOBS Act and provide an exemption from registration for offerings up to $50 million."[52] An expansion of Reg A, Reg A+ is a two-tier offering model exempt from Section 5 registration requirements of the Securities Act under Section 3(b).[53] Since Reg A+ was introduced to small businesses, it has been considered successful.[54]

Prior to the final rules, Reg A provided private companies an exemption from registration for up to $5 million.[55] Reg A required a revamp because many entrepreneurs and investors saw the financing scheme as futile given the relative costs in comparison to that of a traditional IPO.[56] Reg A+ raised this offering exemption to a $50 million ceiling.[57] During implementation, Mike Norman, CEO of the top funding portal WeFunder, called Reg A+ a "great first step to allow everyone to invest in the startups that inspire them."[58]

Reg A+ is often referred to as "mini-IPO" because aside from its $50 million investment limit and the less burdensome fees and ongoing reporting requirements, it functions near identical to an IPO.[59] Under Reg A+, companies must seek both state qualification and SEC review and approval.[60] Naturally, filing costs and compliance fees are lower than they would be under a traditional

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[52] Karmel, *supra* note 16, at 1.

[53] 17 C.F.R. § 230.251(a) (2017).

[54] *See* Robin Sosnow, *Reg A+: A Successful First Year Despite Regulatory Ambiguities*, CROWDFUND INSIDER (Mar. 31, 2016, 6:01 PM), http://www.crowdfundinsider.com/2016/03/83688-reg-a-a-successful-first-year-despite-regulatory-ambiguities [https://perma.cc/85TC-EBVT]. JD Alois, *The SEC Has Qualified 48 Reg A+ Offers for About $840 Million*, CROWDFUND INSIDER (July 19, 2016, 12:16 PM), http://www.crowdfundinsider.com/2016/07/88126-sec-qualified-48-reg-offers-840-million [https://perma.cc/6L6X-7DJW].

[55] *See* Robbins & Modzelesky, *supra* note 45, at 1.

[56] *See* JD Alois, *Deck: Marketplace Lending Using Reg A+*, CROWDFUND INSIDER (Apr. 8, 2016, 8:31 AM), http://www.crowdfundinsider.com/2016/04/84388-marketplace-lending-using-reg-a [https://perma.cc/G799-6WLG] (see slide seven, indicating that launching an IPO, or finding financing through a Rule 506 Regulation D platform would cost the essentially the same as an offering under old Regulation A).

[57] 17 C.F.R. § 230.251(a)(2) (2017).

[58] JD Alois, *Regulation A+: What Do Industry Leaders Think About the New Investment Crowdfunding Exemption*, CROWDFUND INSIDER (June 19, 2015, 5:27 PM), http://www.crowdfundinsider.com/2015/06/69823-regulation-a-what-do-industry-leaders-think-about-the-new-investment-crowdfunding-exemption [https://perma.cc/77UY-FDE4].

[59] *Raising Capital using a Regulation A+ Mini-IPO*, SEEDINVEST, https://www.seedinvest.com/blog/raising-capital/raising-capital-reg-a-mini-ipo [https://perma.cc/6YNN-KFAE].

[60] 17 C.F.R. § 230.251(d) (2017). *Raising Capital using a Regulation A+ Mini-IPO*, *supra* note 59.

IPO,[61] but under the exemption, companies must file a Form 1-A to minimize risk and eliminate fraudulent activity.[62]

Reg A+ allows for two kinds of offerings, Tier 1 and Tier 2.[63] Tier 1 offerings have a capital limitation of $20 million during any twelve-month period, including no more than $6 million offered by selling security holders that are affiliates of the issuer.[64] Under Tier 1, a company's financials are not subject to ongoing reporting or auditing costs, yet issuers are subject to state securities laws.[65] Further, for both a Tier 1 and Tier 2, the Commission restricts secondary sales by the issuer's affiliates, limiting security holders to "no more than 30 percent of a particular offering in the issuer's initial Regulation A offering and subsequent Regulation A offerings for the first twelve months following the initial offering."[66]

Under Tier 2, there is no minimum capital requirement, but the amount of investment during a twelve-month period cannot exceed $50 million[67] including no more than "$15 [million] offered by all selling security holders that are affiliates of the issuer."[68] Tier 2 offerings are preempted from state review and exempt from Blue Sky laws,[69] thereby saving issuers from

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[61] *Id. See* PWC, *supra* note 26, at 20. Compliance costs and filing fees are higher under Reg A+ than under Reg CF.

[62] 17 C.F.R. §§ 230.252(a)-(d), 230.253(a) (2017). Robbins & Modzelesky, *supra* note 45, at 4 ("Issuers are required to file an offering statement on Form 1-A, consisting of three parts: Part 1 (Notification), Part II (Offering Circular) and Part III (Exhibits). . . . Both Tier 1 and Tier 2 issuers are required to file balance sheets and other required financial statements as of the two most recent fiscal year ends (or such shorter time as such issuer has been in existence)."). Reg A+'s disclosure form, Form 1-A, is an extensive disclosure document that includes "business, legal and financial information about the company and is subject to review and comments by the SEC." Lior Ostashinsky, *Raising Funds Online via Crowdfunding from the General Public: Regulation A+ vs. Regulation Crowdfunding*, Crowdfund Insider (Jan. 8, 2017, 1:30 PM), http://www.crowdfundinsider.com/2017/01/94477-raising-funds-online-via-crowdfunding-from-the-general-public-regulation-a-vs-regulation-crowdfunding [https://perma.cc/7SVW-95PE].

[63] 17 C.F.R. § 230.251(a) (2017).

[64] *Id.* § 230.251(a)(1) Tier 1 allows companies to offer up to $20 million of their securities in any twelve-month period and secondary sales by affiliates may constitute up to 30% of the first round of offerings and up to $6 million in subsequent years. *Id.*; *see* Bonnie J. Roe, *Will Regulation A+ Find its Niche? Some Opportunities to Explore*, BUS. L. TODAY 1, 2 (2015), https://www.americanbar.org/content/dam/aba/publications/blt/2015/12/full-issue-201512.authcheckdam.pdf [https://perma.cc/8GVV-4JQR].

[65] *See* 17 C.F.R. § 230.257(a) (2015). Still, Tier 1 offerings must disclose reviewed financials and comply with Blue Sky Laws. Alois, *supra* note 56 (see slides 8 and 9 of the presentation).

[66] Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), https://www.sec.gov/news/pressrelease/2015-49.html [https://perma.cc/4B59-4WH8]; *see also* 17 C.F.R. § 230.251(a)(3) (2015).

[67] 17 C.F.R. § 230.251(a)(2) (2015).

[68] *Id.*

[69] SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital, *supra* note 66. Blue sky laws are state securities laws that are "designed to protect investors against fraudulent sales practices and activities." *Fast Answers: Blue Sky Laws*, SEC. &

exorbitant reporting costs.[70] Nevertheless, Tier 2 offerings are required to submit audited financials and ongoing disclosures to crowdfunding websites, potential investors, current investors, and the Commission. Audited financial statements alone can cost up to $75,000 for small businesses.[71]

One of the improvements of Reg A+ is the ability of businesses to "test the waters,"[72] by soliciting potential investors without offering securities.[73] By "gaug[ing] investor interest," a company is better positioned to make a more educated cost-benefit analysis.[74] Testing the waters allows issuers to measure potential investor demand, and the solicitation allows potential investors time to review an offer.[75] The opportunity to test the waters is absent from Reg CF, creating an additional obstacle for Reg CF issuers.[76] The ability

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EXCH. COMM'N (last updated Oct. 14, 2014), https://www.sec.gov/fast-answers/answers-blueskyhtm.html [https://perma.cc/QW2J-8JTM].

[70] 17 C.F.R. § 230.251 (2015); *See Raising Capital using a Regulation A+ Mini-IPO*, *supra* note 59.

[71] Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21806, 21,881 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, 260) (SEC states that it cannot provide an accurate and quantitative estimate but cited a ranged estimate that registered IPOs below $50 million in 2014 incurred auditing costs from $5,000 to $75,000, or about 1.65% gross in accounting fees). "The initial qualification and reporting costs for a Tier 2 offering is an estimated $400,000 in the first year and $200,000 annually . . . [t]hus, Regulation A+ requires far more disclosure requirements and costs than intrastate or accredited crowdfunding." Vignone, *supra* note 24, at 824 ("Audited financials can range from $5,000 to $75,000 for small businesses and nearly double the cost for reviewed financials.").

[72] 17 C.F.R. § 230.255 (2015); Michael Raneri, *Testing the Waters and Filing a Regulation A+ Offering with the SEC*, FORBES (May 26, 2015, 5:52 PM), http://www.forbes.com/sites/mraneri/2015/05/26/testing-the-waters-and-filing-a-regulation-a-offering-with-the-sec/#b05db479dec8 [https://perma.cc/UBZ4-G2XX] ("Rule 255 of the new Reg A+, 'Solicitations of interest and other communications,' specifically allows companies to promote a potential offering and see how much interest they receive . . . Issuers can use public channels like social media or email to let investors know they're considering offering securities . . . ."); Daniel M. Gallagher, Comm'nr, U.S. Sec. & Exch. Comm'n, Grading the Commissions Record on Capital Formation: A+, D, or Incomplete?, Address at Vanderbilt Law School's 17th Annual Law and Business Conference (Mar. 27, 2015), http://www.sec.gov/news/speech/032715-spch-cdmg.html#_edn17 [https://perma.cc/YYD9-WWHQ].

[73] 17 C.F.R. § 230.255(a) (2015) ("At any time before the qualification of an offering statement, including before the non-public submission or public filing of such offering statement, an issuer or any person authorized to act on behalf of an issuer may communicate orally or in writing to determine whether there is any interest in a . . . securities offering.").

[74] *See* JD Alois, *Testing the Waters is ALL About Transparency*, CROWDFUND INSIDER (June 13, 2016, 6:51 PM), http://www.crowdfundinsider.com/2016/06/86824-testing-the-waters-is-all-about-transparency [https://perma.cc/P876-MW8R].

[75] *See* Alois, *supra* note 74.

[76] *Id*; *see also* 17 C.F.R. § 227.204 (2017) (indicating the Reg CF advertising restrictions and the lack of a testing the waters provision).

to measure prospective investor demand distinguishes Reg A+ as an effective financing method.[77]

Prior to Reg A+ offerings, companies opted for other capital raising options because the $5 million capital investment limit was too stringent for startups looking for long-term expansion.[78] The Reg A+ exemption provides these companies with access to enough capital when an IPO is not a viable option. The companies that are most successful under a Reg A+ financing scheme are those that have: (1) already raised significant capital, (2) impressive annual revenue/pre-sales, and (3) a robust customer base.[79] Despite the obstacles, there are many reasons why a company would opt for Reg A+. For example, DSTLD, a designer clothing company, underwent a Reg A+ offering and generated over $17 million in potential investment demand during its "testing the waters" campaign in late 2015.[80] The CEO of DSTLD noted that a big social network, a somewhat established but growing client-base, and a solid business plan to present to the Commission and intermediaries helps generate interest from potential investors.[81]

Given the extensive reporting and auditing costs for a company struggling to reach a $50 million cap, this regulation is most suitable for established companies, rather than startups with inadequate capital. While it can prove to be cost efficient, the disclosure requirements and ongoing reporting under Tier 2 (which most companies have aimed to finance under) force issuers to have a sufficient infrastructure already in place.[82] Reg A+, however, gives emerging growth companies the economically feasible opportunity to raise capital with the possibility of expansion; the "mini IPO." In contrast, companies are financed under Reg CF with the hope of being acquired by some larger company in the future

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[77] *See id.*

[78] Reg D is a more traditional exemption for the sale of securities, and can allow issuers to raise an unlimited amount of funds through sale of securities. However, for the purposes of this note it will focus on Reg A+ and Reg CF. *See* Ryan Gunn, *The Difference Between Regulation A and Other Capital Raise Options*, WEALTHFORGE (Oct. 10, 2017), https://www.wealthforge.com/insights/the-difference-between-regulation-a-and-other-capital-raise-options [https://perma.cc/F8WS-5VCX].

[79] Amy Wan & Darren Marble, *Is Reg A+ Crowdfunding Right for Your Business?*, CROWDFUND INSIDER (Aug. 16, 2016, 5:17 PM), http://www.crowdfundinsider.com/2016/08/89185-reg-crowdfunding-right-business [https://perma.cc/R6U3-PT2J].

[80] Anthony Zeoli, *Why DSTLD is a Perfect Fit for Reg A+: Key Elements to Successful Equity Crowdfunding*, CROWDFUND INSIDER (Sept. 11, 2016), http://www.crowdfundinsider.com/2016/09/90000-why-dstld-is-a-perfect-fit-for-reg-a-key-elements-to-successful-crowdfunding [https://perma.cc/Z3JH-FKJG].

[81] *Id.*

[82] Rod Turner, *Guide to Regulation A+ Funding*, Manhattan Street Capital (Feb. 26, 2016), http://www.manhattanstreetcapital.com/regulation-a-guide-for-investors-and-startups [https://perma.cc/QVY5-BR8S].

because of the limited amount of startup capital, posing a stark difference between the two financing platforms.

III. REGULATION CROWDFUNDING: WHY THE FINAL RULES FAIL TO BENEFIT STARTUPS AND SMALL BUSINESSES

On May 16, 2015, the Commission activated the final rules to Title III and effectuated the Section 4(a)(6) federal exemption, permitting startups and small businesses to acquire capital through crowdfunding efforts.[83] Sophisticated investors and funding portals have both intensely scrutinized[84] and applauded[85] Reg CF because of its opportunistic future and destructive costs, respectively. Because of the anonymity of the Internet and the low success rate of startups and small businesses,[86] Reg CF is inherently risky.[87] Thus, it is the Commission's objective to protect investors. Nevertheless, Reg CF is meant to promote emerging business development, given the limited capital raising alternatives, such as family and friends, angel investors, commercial loans, peer-to-peer loans, and micro financing.[88] Therefore, entrepreneurs may opt for Reg CF since other mediums of capital financing would rather look at companies with higher growth potential and a likelihood of going public.[89]

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[83] *See* Crowdfunding, 80 Fed. Reg. 71,387, 71,388–90 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 227); *see also* SEC Adopts Rules to Permit Crowdfunding, *supra* note 50.

[84] *See* Marc Snover, *Title III Crowdfunding Might Not Be What Many Expected*, CROWDFUND INSIDER (Oct. 20, 2016, 10:51 PM), http://www.crowdfundinsider.com/2016/10/91447-title-iii-crowdfunding-might-not-many-expected [https://perma.cc/5JC6-SZFJ]; *see also* JD Alois, *WeFunder Plans to Triple Crowdfunding Growth in 2017*, CROWDFUND INSIDER (Jan. 19, 2017, 12:43 PM), http://www.crowdfundinsider.com/2017/01/94956-wefunder-plans-triple-crowdfunding-growth-2017 [https://perma.cc/SUF2-SJT6].

[85] Since February 22, 2018, WeFunder reported that investors funded over $55 million in Reg CF offerings with "184 successful offerings over $50 [thousand]." *The Current Status of Regulation Crowdfunding*, WEFUNDER (Feb. 2, 2018, 2:56 PM), https://wefunder.com/stats [https://perma.cc/5RVD-PASV]. *See* JD Alois, *Reg CF: 200% Growth Year over Year*, CROWDFUND INSIDER (Jan. 10, 2018, 8:36 AM), https://www.crowdfundinsider.com/2018/01/126911-reg-cf-200-growth-year-year [https://perma.cc/B7FV-EGD5] (indicating the amount of investments made in Reg CF offerings grew roughly 200% since last year, with most offerings made in the tech industry).

[86] Crowdfunding, 80 Fed. Reg. at 71,482–88.

[87] *Id.* at 71,391.

[88] *Id.* at 71,482–87.

[89] *See id.* at 71,487 ("A defining feature of VCs is that they tend to focus on startup companies with high-growth potential and a high likelihood of going public after a few years of financing. VCs also tend to invest in companies that have already used some other sources of financing, tend to be concentrated in certain geographic regions . . . and often require their investments to have an attractive business plan, meet certain growth benchmarks or fill a specific portfolio or industry niche.").

A. *Limits on Capital Raise: The $1.07 Million Cap and Its Limited Glory*

The most significant criticism, of which the Commission is aware, is the restrictive investment cap: $1.07 million over a twelve-month period.[90] The mandated $1.07 million limit on the aggregate amount sold to all investors over the twelve-month period curbs the total capital issuers' can raise under Reg CF.[91] Some issuers and intermediaries believe Reg CF is unworkable because the cap is insufficient, considering the intermediary fees, transfer agents, and accounting fees that cut against it.[92] The Commission remains firm on these rules, indicating that increasing the limits of capital raising via equity crowdfunding would undermine its mission to protect investors from fraud.[93] The Commission lacks quantifiable data to properly evaluate the "unrealized efficiency or capital formation associated with the adoption of the $1 million limit instead of the alternative of a higher limit,"[94] which evidences the Commission's lack of necessary research on successful crowdfunding ventures. Therefore, the $1.07 million cap indirectly suggests issuers combine Reg CF with alternative methods of capital raising, which ultimately makes Reg CF challenging and unattractive.

B. *Individual Investment Limits: the Weakness of the Lesser Provision*

Reg CF also limits individual investments depending on annual income or net worth. If an annual income or net worth of the investor is less than $100,000, the limit that the person can invest is "[t]he greater of $2,200 or [five] percent of the *lesser* of the investor's annual income or net worth."[95] If the investor's annual income and net worth are both $107,000 or more, the

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[90] *Id.*; *see also* 17 C.F.R. § 227.100 (2017).

[91] Crowdfunding, 80 Fed. Reg. at 71,487; *see also* 17 C.F.R. § 227.100 (2017).

[92] JD Alois, *Seedrs CEO Jeff Lynn Calls Title III Crowdfunding "Not Workable in its Current Form,"* CROWDFUND INSIDER (May 16, 2016, 7:42 AM), http://www.crowdfundinsider.com/2016/05/85627-seedrs-ceo-jeff-lynn-calls-title-iii-crowdfunding-not-workable-in-its-current-form/?platform=hootsuite [https://perma.cc/43X8-WDGB]. ("[B]usinesses will only [look] to turn to crowdfunding as a last resort after more efficient capital-raising methods have failed. . . . [Reg CF] [r]educes the likelihood of businesses succeeding raising capital.").

[93] Crowdfunding, 80 Fed. Reg. at 71,494 ("The limitation on the amount that may be raised is expected to benefit investors by reducing the potential loss from dilution or fraud in the securities-based crowdfunding market.").

[94] *Id.*; Groshoff et al., *supra* note 22, at 280.

[95] 17 C.F.R. § 227.100(a)(2)(i) (2017) (emphasis added).

limit is "[ten] percent of the *lesser* of the investor's annual income or net worth," subjected to a $107,000 sales cap.[96]

The final rules notably changed the restriction on investment per investor by including the *lesser* provision to eliminate ambiguity. For example, if an individual investor has a $50,000 annual income and $105,000 in net worth, then such investor would be subject to an investment of $2,500 (five percent of $50,000).[97] The Commission adopted the lesser provision due to concerns about investors suffering capacious losses given the indeterminate risk posed by crowdfunding.[98] The benefit is any member of the public, provided they have $2,200, is allowed to invest that cash into a small and potentially fruitful business. This amended limitation on individualized investments will also protect unsophisticated and unaccredited investors from bearing too great a risk.[99] The downside, however, is that as an investor, you must calculate net worth by the "lesser" provision, which may not only confuse investors but also deter them from investing.[100]

The individual aggregate limit on crowdfunding investments constrains the efficiency of capital formation. The restriction impedes investors from security diversification and other incentives to acquire information and securities from issuers.[101] The Commission is improving investor protection, but at the cost of making securities-based crowdfunding a potentially impracticable avenue to raise capital.

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[96] *Id.* § 227.100(a)(2)(ii) (emphasis added); Crowdfunding, 80 Fed. Reg. at 71,389–90.

[97] Crowdfunding, 80 Fed. Reg. at 71,394.

[98] *Id.*

[99] *Id.* ("[W]e believe that the investment limits in the final rules appropriately take into consideration the need to give issuers access to capital while minimizing an investor's exposure to risk in a crowdfunding transaction."); *Updated Investor Bulletin: Crowdfunding for Investors*, INVESTOR.GOV (Feb. 16, 2016), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-crowdfunding-investors [https://perma.cc/H8TK-NQH4]. ("Investments in startups and early-stage ventures are speculative and these enterprises often fail. Unlike an investment in a mature business where there is a track record of revenue and income, the success of a startup or early-stage venture often relies on the development of a new product or service that may or may not find a market.").

[100] *Updated Investor Bulletin: Crowdfunding for Investors*, *supra* note 99.

[101] Crowdfunding, 80 Fed. Reg. at 71,495 ("As securities-based crowdfunding investments might have inherently high failure rates, investors who do not or cannot diversify their investments across a number of offerings can face an increased risk of incurring large losses, relative to their investments, even when they investigate offerings thoroughly. By comparison, VC firms typically construct highly diversified portfolios with the understanding that many ventures fail, resulting in a complete loss of some investments, but with the expectation that those losses will be offset by the large upside of the relatively fewer investments that succeed.").

C. *Issuer Requirements: Issuers Need to Spend Money to Make Money*

Reg CF's issuer requirements are its most persuasive selling point because the necessary disclosure requirements—while still burdensome—are less complex and onerous than the Section 5 registration process for IPOs. To be a valid issuer and engage in crowdfunding transactions, an issuer must (1) be from the United States, (2) not be an investment company, (3) have a business plan, and (4) have filed ongoing annual reports required by Reg CF.[102]

Regarding issuer disclosure requirements, issuer costs are a cogent deterrent from pursuing a Reg CF approach. The Commission broke down costs associated with various securities offerings to show that Reg CF is indeed manageable for small market issuers.[103] The main costs for issuers are: intermediary fees, the costs of preparing, ensuring compliance with, and filing Form C, and accounting review or audit of financial statements.[104] To comply with disclosure requirements issuers must file Form C, a short form that functions as an understandable and easy-to-use method aimed to reduce the burden of preparing disclosures for crowdfunding issuers.[105]

Disclosure requirements under Rule 201 of Reg CF are less costly than disclosure requirements under Reg D or even Reg A+. For example, if an entrepreneur elects to use Reg CF to finance their latest venture, the average cost of a $1 million crowdfunding offering is $72,800 to $168,500.[106] It seems that the issuer costs will make smaller offerings more expensive,

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[102] The enumerated list is not exhaustive. For all issuer requirements, see generally 17 C.F.R. §§ 227.100(b), 227.201, 227.202, 227.203 (2017) (Reg CF set strict requirements for issuers).

[103] Crowdfunding, 80 Fed. Reg. at 71,497-510 (indicating the many potential costs for issuers).

[104] Crowdfunding, 80 Fed. Reg. at 71,497.

[105] 17 C.F.R. §§ 227.201, 227.202, 227.203 (2017) ("(1) The name, legal status, physical address and Web site of the issuer, (2) the names of directors and officers and each person holding more than 20 percent of the shares of the issuer; (3) a description of the business of the issuer and the anticipated business plan of the issuer; (4) a description of the financial condition of the issuer; (5) a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount; (6) the target offering amount, the deadline to reach the target offering amount and regular updates about the progress of the issuer in meeting the target offering amount; (7) the price to the public of the securities or the method for determining the price; and (8) a description of the ownership and capital structure of the issuer."). Crowdfunding, 80 Fed. Reg. at 71,398 (footnotes omitted).

[106] Crowdfunding, 80 Fed. Reg. at 71,497. In addition to the compliance costs, issuers will incur costs to obtain EDGAR access codes, prepare and file progress updates on Form C-U, and prepare and file Form C-TR to terminate ongoing reporting. *Id.* at 71,497, 71,504.

which will significantly deter issuers from conducting a crowdfunding offering. The benefit of these disclosure requirements, however, is that such financial data will inform investors about the financial condition of the business, the issuer's financial relationships, and will provide an overall understanding of the risk to help investors make a decision.[107] Through Rule 201, Form C, and a keen eye by an intermediary, crowdfunding endeavors are presented in a transparent format to investors, and encourage increased usage of the exemption in the future.[108]

In addition to the disclosure required through Form C prior to the offering, issuers must also comply with ongoing reporting requirements and file annual reports with the Commission.[109] Ongoing reporting is consistent with other regulatory schemes, and the Commission recognizes that in light of the small amount of capital raised, an annual reporting obligation is sufficient.[110] These reporting obligations are still overly stringent in terms of the costs associated with preparing reports, but the benefit to investors outweighs the issuer's financial burden in this regard.[111]

The Commission also prohibits issuers from potentially increasing the likelihood of investors becoming informed about the capital raising. An issuer must transact exclusively through one intermediary platform for an offering[112] This way, the Commission can protect investors from fraud, ensure transparency between intermediaries and issuers, provide easily accessible information in one place for investors, and promote uniform securities distribution.[113]

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[107] The financial condition of the business includes audited, GAAP approved, financial statements, information about total income, taxable income, and a financial narrative about the business. For more information on financial statement disclosure requirements. *See id.* at 71,405.

[108] *Id.* at 71,504.

[109] 17 C.F.R. § 227.202(a)-(b) (2017) (explaining what terminates continual ongoing reporting obligations).

[110] Crowdfunding, 80 Fed. Reg. at 71,419–22. In addition to compliance with disclosure forms, issuers must survive Rule 100(b), which excludes certain categories of issuers from eligibility based on whether they are investment companies, or companies organized outside of the United States. 17 C.F.R. § 227.100(b) (2017).

[111] Crowdfunding, 80 Fed. Reg. at 71,500 ("The disclosure requirements also may improve informational efficiency in the market. . . . [D]isclosure by issuers engaging in crowdfunding transactions in reliance on Section 4(a)(6) may inform financial markets more generally about new consumer trends and new products, thus creating externalities that benefit other types of investors and issuers.").

[112] 17 C.F.R. § 227.100(a)(3) (2017); Crowdfunding, 80 Fed. Reg. at 71,396 ("[T]he final rules define 'platform' as '*a program or application accessible via the Internet or other similar electronic communication medium* through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)).'" (emphasis in original)).

[113] Crowdfunding, 80 Fed. Reg. at 71,395–96.

D. Intermediary Requirements: Even the Middle Man is Restricted

Reg CF impacts the intermediaries—funding portals and broker-dealers—as much as issuers and investors. The first rule is that intermediaries must register as a broker or funding portal to post issuer's crowdfunding offerings.[114] As of this year, there are numerous FINRA approved funding portals with over $100 million committed to issues' Reg CF offerings.[115]

Intermediaries, such as WeFunder, are responsible for reviewing information that issuers provide online (i.e., background checks), and therefore act as the guardians against fraudulent activity by issuers for investors.[116] Under Rule 301(a), intermediaries must have a "reasonable basis" for believing an issuer involved in an equity-crowdfunding transaction complied with its own disclosure requirements.[117] Furthermore, intermediaries are prohibited from providing services to issuers in which the intermediary has a financial interest,[118] which protects investors against a potential conflict of interest or fraudulent misrepresentation.[119] Holding intermediaries to this standard creates a manageable transparency between investors and issuers.

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[114] 17 C.F.R. § 227.300(a); Michael McGrath, et al., *Joining the Crowd: SEC Adopts Final Crowdfunding Regulations—Part III—Intermediaries*, AM. L. INST. CONTINUING LEGAL EDUC., 261 (2016) ("[t]o register with the SEC, a funding portal must first complete Form Funding Portal").

[115] JD Alois, *FINRA Approved Reg CF Crowdfunding Portals: 38 and Counting*, CROWDFUND INSIDER (Mar. 30, 2018, 6:05 PM), https://www.crowdfundinsider.com/2018/03/131246-finra-approved-reg-cf-crowdfunding-portals-38-and-counting [https://perma.cc/6H5E-DPQF].

[116] 17 C.F.R. § 227.301 (indicating that intermediaries must have a 'reasonable basis' for believing that an issuer seeking to offer and sell securities in reliance on Title III Reg CF complies with Section 4A(b)).

[117] *Id.* at § 227.301(a) (indicating intermediaries have the responsibility to assess whether an issuer complied with Section 4A(b) and related requirements). Intermediaries can also deny access to issuers if it has a 'reasonable basis' for believing the issuer is subject to a disqualification. *See id.* § 227.301(c).

[118] According to 17 C.F.R. Section 227.300(b), ("Any director, officer or partner of an intermediary, or any person occupying a similar status or performing a similar function, may not have a financial interest in an issuer that is offering or selling securities in reliance on section 4(a)(6) . . . through the intermediary's platform, or receive financial interest in an issuer as compensation for the services provided to or for the benefit of the issuer in connection with the offer or sale of such securities."). *Id.* § 227.300(b). *See* 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 n.87 (2016).

[119] 17 C.F.R. § 227.300(b) (2017). Intermediaries must take additional measures to reduce the risk of fraud through issuer compliance, records of securities holders, bad actor disqualification, and investor protection obligations. *See* Crowdfunding, 80 Fed. Reg. at 71,513 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 227).

The final rules impose a heavy burden on funding portals and broker-dealers, also called intermediaries, to take measures to reduce the risk of fraud.[120] Intermediaries are in the best position to monitor fraud, hence the burden the Commission imposes on them to ensure issuer compliance.[121] For example, intermediaries can deny access to issuers if they have a "reasonable basis" for believing an issuer or offering presents a potential for fraud or raises investor protection concerns because of the failure to comply with accurate recordkeeping.[122]

Nevertheless, Rule 402 carves out a safe harbor for funding portals.[123] Funding portals can provide issuers advice on how to structure their offerings and raise capital effectively, but funding portals cannot advise investors on the issuers' investments.[124] Intermediaries must provide investors with educational materials and make any information provided by the issuer available to investors to prevent misrepresentation or fraud.[125] Also, to enhance transparency, an intermediary must establish a channel of communication so that investors can discuss the offering between each other and the issuer's representative.[126] Thus, while intermediaries take great efforts to reduce fraudulent activity, the Rule 402 safe harbor gives funding portals the means to protect investors, strengthen the funding portal industry, and therefore, improve the crowdfunding market.[127]

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[120] 17 C.F.R. § 227.301 (2017); Crowdfunding, 80 Fed. Reg. at 71,439; Gregory D. Deschler, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries*, 58 ST. LOUIS U. L.J. 1145, 1155–56 (2014).

[121] Deschler, *supra* note 120, at 1155–56.

[122] 17 C.F.R. § 227.301(c)(1) (2017); Deschler, *supra* note 120, at 1155–60.

[123] 17 C.F.R. § 227.402 (2017). Rule 305(a) prohibits intermediaries from compensating any person for providing it with the "personally identifiable information" of any investor. *See id.* § 227.305. Rule 402(b) is a conditional safe harbor which permits funding portals to compensate persons for directing issuers or investors to the platform among other permitted activities. *Id.* § 227.402(b). For example, a funding portal can compensate a third party for referring investors or issuers to the funding portal, so that the funding portal can gain additional business. This is meant to enhance market efficiency to increase investor awareness of available offerings while protecting the integrity of the market. *See id.* § 227.402(b)(6); *see also* Crowdfunding, 80 Fed. Reg. at 71,517.

[124] 15 U.S.C. § 78c(a)(80) (2012) (definition of funding portal); 17 C.F.R. §§ 227.301, 402 (2017); Crowdfunding, 80 Fed. Reg. at 71,514–17.

[125] Crowdfunding, 80 Fed. Reg. at 71,511.

[126] 17 C.F.R. § 227.402(b)(4) (2017). Rule 303(c) would require "an intermediary to provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform. An intermediary that is a funding portal would be prohibited from participating in these channels." Crowdfunding, 80 Fed. Reg. at 71,445. Rule 303(c) would also require intermediaries to make these communication channels publicly available, but only to those who have opened accounts, and require any person posting a comment to disclose their engagement with an issuer. *Id.* at 71,445–46.

[127] Crowdfunding, 80 Fed. Reg. at 71,461–62.

E. *Small Businesses Should be Wary of Choosing Reg CF over Reg A+*

For an emerging startup or small business, the first question is how much capital does the business need, and secondly, how to raise such capital. If the startup or small business needs more than $1.07 million, an issuer should finance through Reg A+. The disparity in capital raising between both formats is evidently clear and companies will make this decision quickly. Reg CF is still finding its footing amongst viable options of capital formation mechanisms, and it remains to be seen how effective this regulation will be compared to other methods of financing.

Currently, Reg A+ is also more attractive to investors in startups because of the $50 million cap and the presumably large pool of secondary-market investors.[128] Under Reg A+ shares sold to the public "are not restricted and not subject to a holding period before they may be resold."[129] Reg CF holders are restricted for a period of one year, which may deter potential investors.[130] This difference should be seen as a benefit for startups looking to finance under Reg CF, however, because any investor is automatically committed to holding onto their shares—an important condition for early stage companies.[131] Thus, Reg CF is generally more applicable to "early stage startups looking for seed capital."[132]

While many advocates for stringent regulation approve the final rules, there are also critics who question the viability of Reg CF given the compliance burdens and significant expenses in relation to the offering limit.[133] Therefore, potential rule changes, without compromising the disclosure requirements fixed to reduce the risk of fraud, are necessary to make Reg CF a practicable option for crowdfunding.

IV. ADJUSTMENTS TO REG CF IN LIGHT OF REG A+

While Reg A+ fits more mature businesses—those with an established capital structure—given its "mini IPO" nickname, Reg CF, in comparison, is more appealing to early stage companies that need pre-seed or seed investment given

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[128] *See* Ostashinsky, *supra* note 62.

[129] *Id.*

[130] *See id.*

[131] *Id.*

[132] *Id.*

[133] *See* John P. Cleary, *Is Crowdfunding Really a Viable Option?*, LAW360 (Sept. 1, 2016, 12:45 PM), http://www.law360.com/articles/835211/is-crowdfunding-really-a-viable-option- [https://perma.cc/9QMR-UR3Q].

the fundraising limits and potentially high costs.[134] Yet, given the necessary "time to market" for securities offerings (albeit significantly shorter than a Reg A+ offering) the reporting expenses, intermediary fees, disclosure fees, and advertisement restrictions, Reg CF may still impose a strain on a startup's budget.[135] Further, Reg CF has harsher restrictions on advertising and general solicitation[136] than Reg A+, which allows businesses to "test the waters."[137] In evaluating the differences between regulations, the Commission should recognize the burdens Reg CF places on startups. A proposed solution, and one that has potential given the new political zeitgeist, is one Congress has implemented: the Fix Crowdfunding Act.[138]

Nevertheless, to make Reg CF as popular as Reg A+, issuers must be able to: (1) raise more than $1 million in a twelve-month period, (2) increase the amount that each investor can invest during that twelve-month period, and (3) allow issuers to "test the waters," similar to the Reg A+ solicitation scheme, all while reducing the offering costs. The goal is to solve some of the problems presented to issuers by Reg CF, while still keeping investor fraud protection. Raising the maximum offering amount to $5 million under either a twelve-month period, or perhaps an eighteen or twenty-four-month period, might give more startup companies the opportunity to raise sufficient capital. A change to Rule 100(a) of Reg CF would increase issuers' attractiveness to the final rules considering the costs, and "provide for a meaningful addition to the existing capital formation options for smaller companies while maintaining important investor protections."[139]

An adjustment to the cap on individual investments by investors, an increase on the funding cap under Reg CF, the opportunity for startups to "test the waters," and a reduction in issuers' costs would make Reg CF a more attractive and practicable method of capital raising for early stage companies.

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[134] Crowdfunding, 80 Fed. Reg. 71,387, 71,488–89 (Nov. 16, 2015) (to be codified at 17 C.F.R. pt. 227).

[135] Crowdfunding, 80 Fed. Reg. at 71,398; Ostashinsky, *supra* note 62.

[136] 17 C.F.R. § 227.204 (2017).

[137] 17 C.F.R. § 230.255 (2017). *See* Alois, *supra* note 74. Testing the waters is permitted before filing and general solicitation is permitted after qualification.

[138] The Fix Crowdfunding Act proposed including Special Purpose Vehicles (SPVs) as authorized investors in crowdfunding offerings, and proposed increasing the dollar amount thresholds of what a company can raise through crowdfunding, specifically Section 12(g) of the Exchange Act. For a more detailed explanation of the Congressional bill, *see generally* Fix Crowdfunding Act, H.R. 4855, 114th Cong (2016); *see also* H.R. REP. NO. 114-661 (2016).

[139] Crowdfunding, 80 Fed. Reg. at 71,391.

First, the Commission should adjust the "lesser provision" to a "greater provision" because the current rules put too significant a constraint on capital formation.[140] "Investment limitations will likely have a negative effect on capital formation . . . [and] investment limitations may make it more difficult for some issuers to reach their funding targets."[141] This seems like a major deterring factor for investors when opting for a crowdfunded investment.[142] If the investor can invest the greater of five percent of their annual income or net worth as opposed to the lessor of the two, then the investor will have the ability to diversify within the securities-based crowdfunding market.[143] While the limits expect to reduce the risk of loss for investors, the Commission notes that there is "no available market data that would allow us to empirically evaluate the magnitude of these effects."[144] Therefore, the Commission should gather information on crowdfunding transactions or change this rule to optimize capital formation before limiting such a harsh cap on investments.

Second, perhaps with the support of Congress, the Commission should increase the $1.07 million cap to at least $5 million per twelve-month period. This is crucial to allowing companies to truly reap a benefit from the exemption considering the offering costs and intermediary fees. The Commission could develop a two-tiered system under Reg CF, with offerings available at $1.07 million and $5 million. Due to the success of Reg A+, borrowing the exemption's two-tiered model may be an ideal solution because the Commission can keep the current investment limitations disclosure requirements, and integration rules,[145] without eliminating the basic framework of the exemption.

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[140] Georgia Quinn, *Potential Pitfalls of Regulation CF—Part 1: Practical Concerns for an Issuer*, Crowdfund Insider (Jan. 6, 2016, 1:18 PM), https://www.crowdfundinsider.com/2016/01/79776-potential-pitfalls-of-regulation-crowdfunding-part-i-practical-concerns-for-issuer [https://perma.cc/8AKF-THZP].

[141] Crowdfunding, 80 Fed. Reg. at 71,496.

[142] *Id.*

[143] Crowdfunding, 80 Fed. Reg. at 71,495. ("We recognize that these provisions also will limit the potential upside for investors. This may particularly affect the decisions of investors with large portfolios who might be able to absorb losses and understand the risks associated with risky investments . . . . Moreover, limiting the participation of such investors may negatively affect the informational efficiency of the securities-based crowdfunding market.").

[144] *Id.* at 71,496.

[145] The Commission has noted that the issuers may conduct other exempt offerings without integrating those offerings with a Reg CF. This concern, however, is that issuers will have to take on additional measures to meet the exemption's solicitation restrictions. *Id.* at 71,494. For example,

> an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6). Alternatively, an issuer conducting a concurrent exempt offering for

Thirdly, the Commission should allow Reg CF issuers to "test the waters" and make an offering announcement to determine their potential success to raise capital going forward. "Testing the waters" allows issuers the opportunity to solicit non-binding interest from potential investors prior to the filing of mandated disclosure documents and the initial offering, thereby gauging success prior to incurring additional disclosure costs. Reg CF is currently unattractive because the rules only permit issuers to compensate offering promoters through communication channels provided by an intermediary on the intermediary's platform.[146] Issuers cannot "effectively use the Internet or social media to promote their equity crowdfunding raise."[147] For example, if an entrepreneur had a novel idea for a new startup, they could properly gauge the investor demand before spending exorbitant filing costs with the Commission. Moreover, the entrepreneur could realize that $1.07 million is not enough, and the venture should seek additional capital.

The drawback to "testing the waters" under a Reg CF scheme, perhaps, is the imposition of an additional cost on the issuer. While this opportunity to increase communication with investors could enhance capital formation efforts by issuers, it might also result in increased disclosure requirements and overall cost. Yet, by adjusting the advertising and solicitation restrictions, the Commission can still protect investors by directing them to the materials on the intermediary's platform which includes disclosures necessary for them to make informed investment decisions.[148] Even if issuers can "test the waters" through a funding portal, the Commission avoids improper

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> which general solicitation is permitted, for example, under Rule 506(c), cannot include in any such general solicitation an advertisement of the terms of an offering made in reliance on Section 4(a)(6), unless that advertisement otherwise complies with Section 4(a)(6) and the final rules.

Id.

146 17 C.F.R. § 227.205(a) (2017).

147 Samuel Guzik, *JOBS Act Crowdfunding Begins on May 16, 2016: Don't Get Busted for Solicitation!*, CROWDFUND INSIDER (Mar. 28, 2016, 4:00 AM), http://www.crowdfundinsider.com/2016/03/83470-jobs-act-crowdfunding-begins-on-may-16-2016-dont-get-busted-for-solicitation [https://perma.cc/H3BX-H2YD].

148 The final rules "prohibit an issuer from advertising the terms of the offering, except for notices that direct investors to an intermediary's platform. The terms of the offering include the amount offered, the nature of the securities, price of the securities and length of the offering period . . . . The notices are similar to the 'tombstone ads' permitted under Securities Act Rule 134." Crowdfunding, 80 Fed. Reg. at 71,505; *see also* John R. Hempill, *Crowdfunding Moves Forward: The Securities and Exchange Commission (SEC) Issues Proposed Rules on Crowdfunding*, THE NATIONAL LAW REVIEW (Oct. 31, 2013), https://www.natlawreview.com/article/crowdfunding-moves-forward-securities-and-exchange-commission-sec-issues-proposed-ru [https://perma.cc/9UJ3-YJDB].

promotion and advertising while monitoring the risk of fraud. By restricting issuers to a single communication channel provided by one sole intermediary, the Commission can protect investors and improve the crowdfunding market.

A "testing the waters" provision could fit the Reg CF scheme by adjusting the communication channels. Allowing issuers to advertise for no more than a twenty-one-day span before offering equity through a funding portal can ultimately help issuers reduce "upfront cost[s] of conducting a Title III offering and the risk of paying significant compliance/legal fees for an unsuccessful offering."[149] Alternatively, if an issuer can publish a startup on multiple Commission-approved funding portals and other media platforms, accessibility to the general public would be more realistic and the ability to raise $1–5 million would be more feasible. The Commission could also allow issuers to advertise their offering on their websites, so long as the specific terms of the offering are found only through the intermediary. This way, the Commission can impose less strict liability on intermediaries while providing issuers with a greater opportunity to promote their offering.

CONCLUSION

As Reg CF stands right now, the Commission must make adjustments to the exemption. The investment cap, investor limitations, and issuer costs demand it. Reg CF is subjected to criticism and reform, and in a new political climate, changes in regulation may help improve the plight of young startups and small businesses. Nevertheless, the Commission should continue to promote Reg CF because the exemption has created an opportunity for small market enterprises to raise capital.[150] Given the early success rate for Reg CF offerings, the exemption proves that there are many issuers seeking to raise capital and many investors looking to diversify. The attractiveness of Reg CF is rapidly growing, and therefore the Commission must monitor how the increase in offerings affects issuers, investors, and intermediaries alike. The Commission must monitor how the disclosure requirements and costs affect issuers, and continue to find ways to improve investor protection. The increase in

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[149] Anthony Zeoli, *The Fix Crowdfunding Act. What it Fixes & What it Does Not*, CROWDFUND INSIDER (July 28, 2016, 5:45 PM), http://www.crowdfundinsider.com/2016/07/88536-fix-crowdfunding-act-fixes-not [https://perma.cc/TDL5-Z3QW].

[150] Sherwood Neiss, *Here's How Regulation Crowdfunding Performed in 2016*, VENTURE BEAT (Jan. 11, 2017, 5:05 PM), http://venturebeat.com/2017/01/11/heres-how-regulation-crowdfunding-performed-in-2016 [https://perma.cc/8BMX-U9BN].

offerings indicates that Regulation Crowdfunding is here to stay. But rest assured, rules are meant to be amended.

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