TILBURG UNIVERSITY

CROWDFUNDING: Securities Laws & Capital Formation

Master's Thesis

Submitted to Tilburg University Law School in partial fulfilment of the requirements for the degree of LL.M International Business Law

Department of International Business Law

by

Ruslana Zablowskaja

S521799

Professor: Prof. dr. Erik P.M. Vermeulen

Supervisor: Vladimir Mirkov

Tilburg, Netherlands

May 2014

Copyright © 2014 by Ruslana Zablowskaja

All rights reserved

CONTENTS

ABSTRACT iii

ACKNOWLEDGEMENTS iv

LIST OF ABBREVIATIONS – TERMS USED v

INTRODUCTION 1

LITERATURE REVIEW 5

Part I: CROWDFUNDING 8

1.1. Introduction 8

1.2. Historical background 8

1.3. Crowdfunding models 11

Part II: CROWDFUNDING AND THE FEDERAL SECURITIES LAWS 13

2.1. Introduction 13

2.2. Crowdfunding Investments 13

2.2.1. What is a security? 13

2.2.2. Are crowdfunding platforms offering securities? 17

2.2.3. Possible Exemptions 21

2.2.4. Consequences 22

2.3. Crowdfunding Platforms 23

2.3.1. Brokers 24

2.3.2. Dealers 26

2.3.3. Investment advisors 26

2.3.4. Consequences 29

2.4. Conclusion 31

Part III: CROWDFUNDING AFTER THE JOBS-ACT 33

3.1. Introduction 33

3.2. Title III of the JOBS-Act 34

3.2.1. Crowdfunding Exemption 34

3.2.2. Crowdfunding Portals 35

3.2.1. Funding Portal Safe Harbours 37

3.2.2. Transfer and trade of Crowdfunded Securities 37

3.3. Issuers of crowdfunding interests 38

3.4. Conclusion 40

Part IV: CROWDFUNDING COMPARED 43

4.1. Introduction 43

4.2. Traditional sources of financing 43

4.3. Crowdfunding evaluated 44

4.4. Expectations of success 45

4.5. Conclusion 47

CONCLUSION 48

BIBLIOGRAPHY 49

ABSTRACT

Small businesses account for roughly half of American employment and are essential to job creation. The decline in survival rates of start-ups and small businesses over the last years has therefore raised many concerns. Within this economic climate crowdfunding emerged as the new type of capital formation that could be the solution to the current financing gap starting entrepreneurs face. The JOBS-Act displayed the U.S. government's answer to the demand for new sources of capital. However equity-based crowdfunding already faced many regulatory issues before the implementation of the JOBS-Act and will remain highly regulated once the SEC has finalized the additional rules. This Thesis will analyse the regulatory environment equity-crowdfunding faced before and after the implementation of the JOBS-Act. Where extensive regulation of crowdfunding is very likely to have a negative effect on its viability as a business financing technique, a certain degree is required to guarantee investor protection. Unfortunately where regulatory costs and other burdensome regulatory requirements were the main aspects eliminating crowdfunding as an option for small ventures, the new issuer requirements remain complicated and costly. While introduction of equity-crowdfunding is not likely to be the solution to the financing gap starting business face, the new crowdfunding exemption nevertheless provides for a new much needed source of capital.

ACKNOWLEDGEMENTS

The author wishes to thank several people. Firstly I would like to thank the Department of International Business Law for the knowledge and guidance offered throughout the whole programme and especially my supervisor Vladimir Mirkov who allowed me to enjoy significant freedom while writing my Thesis. As a consequence this major task has never felt like a burden and free to follow my personal interests while writing, I could keep myself motivated until the very end. While my knowledge in respect of securities regulations has expanded far beyond anything I could ever imagine, sadly it is futile in the efforts of expressing the immense gratitude I owe to my parents. Elaborations on their inexhaustible patience and support would provide sufficient material for a second Master’s Thesis. Finally I would like to thank my dear friends, to whom I solemnly swear to temporarily remove the term crowdfunding from my vocabulary immediately after my graduation.

LIST OF ABBREVIATIONS – TERMS USED

EGC Emerging growth company: *defined in Sec. 101(a)(19) of the JOBS-Act as an issuer that had total annual gross revenues of less than $1 billion during its most recent completed fiscal year.*

Exchange Act The Securities Exchange Act of 1934: *a law governing the secondary trading of securities (stocks, bonds, and debentures) in the United States of America; also established the Securities and Exchange Commission.*

FINRA Financial Industry Regulatory Authority: *a self-regulatory organization, a non-governmental organization that performs financial regulation of member brokerage firms and exchange markets.*

IPO Initial public offering: *a type of public offering where shares of stock in a company are sold to the general public, on a securities exchange, for the first time.*

JOBS-Act The Jumpstart Our Business Startups Act: *a law intended to encourage funding of United States small businesses by easing various securities regulations.*

P2P Peer-to-peer

R&D Research & Development

SEC The U.S. Securities and Exchange Commission: *an agency of the United States federal government; holds primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other activities and organizations, including the electronic securities markets in the United States.*

Securities Act Securities Act of 1933: *enacted by the United States Congress in the aftermath of the stock market crash of 1929 and during the ensuing Great Depression. Legislated pursuant to the interstate commerce clause of the Constitution, it requires that any offer or sale of securities using the means and instrumentalities of interstate commerce be registered with the SEC pursuant to the 1933 Act, unless an exemption from registration exists under the law.*

SRO Self Regulating Organization

VC Venture capital is financial capital provided to early-stage, high-potential, high risk, growth start-up companies.

Venture Capitalist An investor who either provides capital to start-up ventures or supports small companies that wish to expand but do not have access to public fundi

INTRODUCTION

"Entrepreneurs and their small enterprises are responsible for almost all the economic growth of the United States" - Ronald Reagan

Where the creation of new enterprises increases jobs,[1] strengthens competition and might even lead to increased productivity through technological progress, it comes as no surprise that entrepreneurs have always played a pivotal role in the pursuit of economic growth.[2] However these entrepreneurs and their enterprises will not manifest out of thin air. Every successful business has gone trough a process of growth and development and if traced back to its very inception has started with merely an entrepreneur and his idea. Unfortunately while starting entrepreneurs can contribute their innovating ideas and know-how, they lack collateral, sufficient cash flow and other tangible assets that are needed to complete the journey from the idea-stage to the eventual existence of a profit making company. Financing the venture in its early stages through bootstrapping and/or help from friends and family is a familiar situation for most start-ups, yet their recourses are often limited and more capital is required before the venture will be able to generate revenue.[3] This results in the emergence of an obvious financing gap between the "birth" of a new venture and the moment the venture has grown to a point where it can become self-sustaining through its internal cash flows. This process that is often referred to as the journey from the "Valley of Death" to the "Promised Land"[4] is seen as the fundamental reason for entrepreneurs to usually resort to venture capitalists who are perceived to be the actors that can close the financing gap.[5]

However when looking at the VC industry in the last couple of years, the Venture Capital cycle has undergone various changes. Where financial gains are the main goal of a typical venture capitalist, subsequently its strategy is extremely focused on the exit. The IPO has been the most popular alternative amongst venture capitalists, however they have become more risk averse due to the decline in IPO's in

[1] (Bernanke 2010).
[2] (Acs 2006), p. 97.
[3] A good example is the biotechnology sector where an investment up to $100 M might be needed before the venture can even get close to producing their final product.
[4] At a certain point the amount of money that comes in will become even to the amount that goes out (breakeven point). That turning point indicates the maximum negative amount on the bank balance of the new venture will reach and hence the total amount of cash needed to reach the "Promised Land".
[5] (Pearce 2006), p. 6.

the recent years and instead of investing in early stage start-ups their interests shifted towards already profitable later stage companies. As a result an investment gap occurred in the seed and early stage of new ventures, followed by a liquidity gap due to the long exit horizons.[6] Contrary to the slightly morbid outlooks of some rendering the VC cycle to be broken, others consider it to be merely evolving with the "survival of the fittest" trend to be caused by the institutional investors who as of late prefer to invest their capital in a relatively small group off well-established high quality funds.[7] Either way, crowdfunding might provide the solution to the financing gap faced by small businesses that are unable to obtain financing by these and other conventional types of capital formation.[8]

Crowdfunded initiatives, projects or ventures were mostly known to be of a charitable or artistic nature such as films or music recordings, but in a market economy where starting ventures at their very initial stage have difficulties attracting external capital,[9] crowdfunding started to receive increased attention as a new business financing technique that would allow entrepreneurs to address the general public, "tap the crowd", when seeking investment capital.[10]

Crowdfunding platforms have been emerging all over the Internet for some time now and a distinction can roughly be made between four types of crowdfunding platforms; donation-based; reward-based; debt-based and equity-based crowdfunding.[11] Equity-based crowdfunding allows the investor to receive a part of the company in return for his investment or gives rise to additional expectations of profits resulting from the investment. It is understandable why such profit-sharing crowdfunding models might be considered involving the offer and sale of securities. If crowdfunding instruments indeed fit the definition of a security in terms of the Securities Act 1933, and no exemption applies, any offer or sale thereof is not allowed until a registration statement has been filed with the Securities Exchange Commission (SEC).[12] Registered offerings are expensive and the additional ongoing reporting obligations under the Securities Exchange Act of 1934 that accompany a registered offering make it not a practical choice for those trying to raise relatively small amounts of capital.[13] Additionally crowdfunding platforms thus engaged in the securities business would also become subject to regulatory requirements since they might then fit the

[6] (Mendoza and Vermeulen 2011), p. 10-12.
[7] (Vermeulen and Pereira Dias Nunes 2012), p. 28.
[8] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 335.
[9] (Cosh, Cumming, and Hughes 2007)p. 6-7.
[10] (Schwienbacher and Larralde 2010), p. 3.
[11] (Young 2013), p. 51.
[12] (Gueyie 2013).
[13] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 8.

broker/dealer or investment advisor definition. Acquiring capital through an open call to a large number of potential investors is an integral part of the crowdfunding concept and it might therefore prove equally challenging to rely on private placement exemptions due to the restrictions on general solicitation and advertising as well as investor sophistication requirements they contain. It was therefore not until April 5, 2012, when President Obama signed the Jumpstart Our Business Startups Act (JOBS-Act) into law, that crowdfunding could effectively become the efficient new type of financing that might potentially be capable of closing the funding gap starting entrepreneurs face. Title III of the JOBS-Act provides for a regulatory structure that allows starting ventures to raise capital through equity-crowdfunding, exempting crowdfunded securities from the registration requirements of the Securities Act and establishes a framework to facilitate the portals conducting the transactions. The task of finalizing the rules was bestowed upon the SEC and the Financial Industry Regulatory Authority (FINRA). Both organizations published a set of proposed rules and the SEC is currently in the process of reviewing the submitted comments from the general public before deciding before adopting the final rules.[14] While crowdfunding has been met by many with large enthusiasm proclaiming this new type of capital formation as a wonderful opportunity to support start-ups, create jobs and eventually lead to economical growth, concerns regarding investor protection and loss of capital are equally raised. While essentially the introduction of equity crowdfunding will provide both entrepreneurs and investors with a new financing method it is yet unknown whether this method will ultimately be the solution to the current financing gap starting entrepreneurs face.

Research question:

It is therefore the purpose of this Thesis to answer the question: "Could the introduction of equity-based crowdfunding as a new business financing technique be the solution to the current financing gap starting entrepreneurs face?"

The traditional business financing techniques existing within the current regulatory environment proved insufficient in terms of facilitating the financing of starting businesses and the implementation of the JOBS-Act displayed the U.S. government's answer to the demand for new sources of capital. However equity-based crowdfunding already faced many regulatory issues before the implementation of the JOBS-Act and will remain highly regulated once the SEC has finalized the additional rules. In order to answer the main research question it is therefore firstly necessary to gain insight into how exactly the regulatory framework was limiting the effective application of equity-based crowdfunding. For that purpose the first

[14] ("SEC.gov | SEC Issues Proposal on Crowdfunding" 2014).

sub-research question is: “What was the regulatory framework crowdfunding faced before the implementation of the JOBS-Act?” The second sub-research question is: “What was the regulatory environment after the implementation of the JOBS-Act?” Which then makes it possible to compare equity-crowdfunding as it will become effective to the traditional means of financing thereby answering the third sub-research question: “Why should certain entrepreneurs and investors prefer crowdfunding above other types of financing?” Combined the answers to the sub-research questions will allow to critically assess whether the proposed changes to the law can be perceived to attribute sufficiently (or at all) to the creation of a new regulatory environment where equity-crowdfunding could become the new business financing technique that might be the solution to the current financing gap starting entrepreneurs face, thereby answering the main research question.

Limitations to the research

Although various forms and applications of crowdfunding can be found globally, the focus of this thesis will be predominantly on the laws and law reforms of the United States.

Outline of the thesis

First the concept and historical background of crowdfunding will be explained in Part I, followed by an overview of the regulatory matters accompanying equity-based crowdfunding in Part II. After having discussed the applicable US securities laws before the implementation of the JOBS-Act, the state of law in the United States after the signing of the JOBS-Act will be discussed in detail in Part III. Subsequently Part IV will compare crowdfunding in its capacity as a business financing method to the traditional ways of financing a start-up such as Venture Capital or Angel Investors. Lastly based on the previous Parts, Part V will conclude by answering the main research question.

Research method

The research has been conducted by means of the traditional legal method, more specifically using the doctrinal approach. Correspondingly mainly traditional legal sources were consulted to serve as a basis for the research. The further application of the doctrinal legal research ranged depending on the purpose of the sub-research questions from descriptive (first two sub-research questions) to more comparative (third sub-research question).

LITERATURE REVIEW

Crowdfunding as we know it today originates from two older concepts: crowdsourcing and microfinance. Microfinance, sometimes referred to as micro lending, is a concept where small loans are provided to borrowers that are usually located in poorer living circumstances and are in need of small amounts of money to improve their living situation. Crowdsourcing as the term already implies makes use of the ideas, feedback and solutions offered by the crowd in order to develop corporate activities and add value to the company (Bayus 2013; Howe 2006). Given the continuing demand for new products and services, the need for innovation has constantly been a top priority for firms. Reliance on traditional innovation activities (Ernst, Leptien, and Vitt 2000), internal staff of professional inventors to generate ideas, resulted in disappointed innovation outcomes (Zablit 2010). To boost the innovation process firms started to outsource their ideation efforts. Jeff Howe is generally seen as the creator of the term in 2006 when he mentioned crowdsourcing for the first time in an article in Wired magazine (Howe 2006). Crowdsourcing can be defined as: "outsourcing tasks originally performed inside an organization, or assigned externally in form of a business relationship, to an undefinably large, heterogeneous mass of potential actors. This happens by means of an open call via the Internet for the purpose of free, value creative use. The incentive to participate can be monetary and/or non-monetary in nature" (Hammon and Hippner 2012). In this context crowdfunding is a financing method and crowdsourcing a value creation method. By adding value through funds crowdfunding can therefore be seen as an element of crowdsourcing (Metzler 2011). Crowdfunding can be defined as: "an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes" (Belleflamme, Lambert, and Schwienbacher 2012). Crowdfunding as a financing method can be deployed in many ways and across a variety of disciplines, from disaster relief to artists calling out to fans for support in launching an album, to political campaigns (Lee 2011). These crowdfunded initiatives, projects or ventures were mostly known to be of a charitable or artistic nature, but in a market economy where starting ventures at their very initial stage have difficulties attracting external capital (Cosh, Cumming, and Hughes 2007), crowdfunding started to receive increased attention as a new business financing technique that would allow entrepreneurs to address the general public, "tap the crowd", when seeking investment capital (Schwienbacher and Larralde 2010).

Given the continuous evolving nature of the concept Mollick therefore prefers a narrower definition of the term in an entrepreneurial context: "referring to the efforts by entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries." (Mollick 2014) Crowdfunding can be divided in roughly four categories; donation-based; reward-based; debt-based and equity-based crowdfunding (Young 2013). Equity-based crowdfunding allows the investor to receive a part of the company in return for his investment or gives rise to additional expectations of profits resulting from the investment. Such interests in the firm that non-bank funders demand in return are therefore easily deemed securities resulting in the possibility that the financing transaction is regulated by either federal or state securities laws, or both. The costs of compliance with the regulatory requirements outweigh the benefits (Heminway 2011). Secondly the available exemptions from the registration requirement proved not very useful. Crowdfunding sites trying to fit within these exemptions have had to restrict access either to sophisticated, wealthy investors or to preexisting acquaintances of the entrepreneur seeking funds (C. Bradford 2012). In effect it became unfeasible for entrepreneurs to finance their start-up through equity-crowdfunding (Pope 2011; Heminway 2011; C. Bradford 2012).

Several proposals have been made to the Securities and Exchange Commission and Congress suggesting a departure from the current regulatory scheme and requesting the adoption of a tailored crowdfunding exemption. While the introduction of equity-crowdfunding could prove very helpful to starting entrepreneurs who face a capital funding gap by connecting those who would not otherwise get financing to a new source of capital, it is not without risks. Crowdfunding involves sales to the general public, not just sophisticated or accredited investors, and many members of the general public are remarkably unsophisticated financially. Furthermore investing in small business, especially start-ups, is inherently risky. The potential for fraud and self- dealing is high, and, even in the absence of wrongdoing, small businesses are much more likely to fail than more established companies (C. S. Bradford 2012). Conversely Martin finds the fraudulent investment argument probably overstated. Although the new crowdfunding exemption will reduce transparency, supplemented with limited disclosures to investors, a compromise might be found between the business industry and investor protection so in the end the fundamental safeguards will be in place while issuing crowdfunding securities will be no longer cost-prohibitive. Correspondingly Bradford argued that crafting such a crowdfunding exemption would require a careful balancing of investor protection and capital formation. If the SEC would focus greatly toward investor protection this could result in an exemption that is still too costly for many small businesses. Unwise regulation or over-regulation may create a backlash by creating an environment for deregulators aiming to repeal some long- standing rules and regulations (Cross 2006) while ignoring investor protection concerns entirely could create a regulatory and public relations backlash that will set back crowdfunding for years (C. Bradford 2012). Hazen stresses even more the importance of investor protection stating that only with meaningful disclosure to investors can an exemption strike the right balance to encourage small business financing without unduly sacrificing investor protection (T. L. Hazen 2011). Martin argues that the JOBS-Act actually rests on a faulty premise that reducing the regulatory burden on raising capital will lead to better capital formation (Martin 2012). Disclosure requirements and other capital markets regulations enhance, rather than impede, capital formation (Cross 2006). Concluding Martin rightly points out the debate regarding the new crowdfunding-exemption is demonstrative of an older, more fundamental debate over the general role of government in markets. Where supporters of the JOBS-Act favor a laissez-faire approach in which the government plays a minimalist regulatory role,[15] and where opponents fearful of fraud and reduced investor protection desire more governmental involvement to correct certain market failures (Martin 2012).

[15] Deferring to Adam Smith's classical theory of the "invisible hand" to solve market problems.

Part I: CROWDFUNDING

1.1. Introduction

Prior to the examination of any specific U.S. securities laws concerning crowdfunding within the current regulatory framework, and before discussing the future legislative climate, this Part will first attempt to contribute to a better understanding of the topic by providing an introduction into the concept. Starting with an overview of the origins and historical background of crowdfunding and followed by a description of the various existing crowdfunding models.

1.2. Historical background

Crowdfunding as we know it today originates from two older concepts: crowdsourcing and microfinance. Microfinance, sometimes referred to as micro lending, is a concept where small loans are provided to borrowers that are usually located in poorer living circumstances and are in need of small amounts of money to improve their living situation. Kiva is a good example of a non-profit organization that connects borrowers and lenders with the goal of alleviating the poverty in the world.[16] Crowdsourcing is a combination of the words *crowd* & *outsourcing*, and entails a situation where the "crowd" is offering ideas, feedback or solutions, thus creating value for the company.[17] Jeff Howe is generally seen as the creator of the term in 2006 when he mentioned crowdsourcing for the first time in an article in *Wired* called "The Rise of Crowdsourcing".[18] Crowdsourcing takes place when different firms who require help in solving certain specific research problems make use of the Internet by publishing their R&D problems on a crowdsourcing website such as Innocentive.com. The members of the platform, amongst which engineers and researchers then can address the problems in exchange for financial compensation, hereby adding value to the firm. Platforms adding value to the general public without any financial remuneration also exist a good example of which is Wikipedia.org. Although the discussion of customer or consumer inputs into the innovation process was going on before the famous article by Howe, the notion of the "crowd" participating became extremely popular after the rise of the Internet in the late 1990s.

[16] ("Kiva - Loans That Change Lives" 2014).
[17] (Belleflamme, Lambert, and Schwienbacher 2012), p. 2.
[18] (Howe 2006).

Crowdsourcing was defined by Hammon & Hippner as:

"Outsourcing tasks originally performed inside an organization, or assigned externally in form of a business relationship, to an undefinably large, heterogeneous mass of potential actors. This happens by means of an open call via the Internet for the purpose of free, value creative use. The incentive to participate can be monetary and/or non-monetary in nature". [19]

Even though the rise of crowdsourcing is often attributed to the emergence of the Internet, many historical and even famous examples of people joining forces to realize a project exist, one of them being the release of the *Oxford English Dictionary* in 1928. When in 1857 the Philological Society of London realized to what extent the English language had developed in the past centuries they started an initiative to replace the existing out-dated dictionaries. This required the assistance of 'armies of word-searching volunteers'[20] who submitted 'citations' of English words and their practical use. In spite of the fact that this project took nearly 70 years, the collaboration resulted in the actual release of the first *Oxford English Dictionary* in 1928.[21] Approximately at the same time in 1876 across the ocean in the United States, another fascinating historical example of the crowd collaborating on a large project was going on, the financing of The Statue of Liberty. The Statue of Liberty was a present from the French people to the American people symbolizing their friendship that was established during the American Revolution. The American people were assigned with the task of building the pedestal and the French people received the responsibility regarding the Statue and its assembly once on US grounds. [22] The French and American citizens gathered the funds for the project by organizing performances, auctions and other forms of entertainment. The assigned architect Frédéric Auguste Bartholdi made use of what we now would call reward-based crowdfunding when he offered to provide the donors with a miniature version of the Statue of Liberty. Still the US were lacking funds. Joseph Pulitzer, who was the owner of a daily paper in New York at the time, used it to publish a request for donations.[23] Surprisingly this resulted in an enormous success and the completed statue was presented to the people on the 28th of October 1886.

[19] (Hammon and Hippner 2012), p. 163-166.
[20] (Penn 2003), p. 88.
[21] (Young 2013), p. 25.
[22] ("Statue of Liberty – Statue of Liberty History" 2014).
[23] (Neiss 2013), *see* Part II.

Whereas through crowdsourcing value is added mostly in the form of ideas or feedback, crowd*funding* as the term already implies, focuses on finding the funds to finance a project or business start-up. By adding value through funds crowdfunding can therefore be seen as an element of crowdsourcing.[24] Contrary to other ways of funding involving professional parties, such as venture capitalists or angel investors, crowdfunding involves a "crowd" of individuals. Such as was the case with the financing of the Statue of Liberty, instead of trying to raise the money from a small group of sophisticated investors, small contributions made by individuals of a large group combined supply the necessary amount of money needed for the venture. Whereas the biggest problem used to be how to reach all those individuals, nowadays crowdfunding, just as crowdsourcing, cleverly makes use of the Internet and its social networking possibilities. One of the first examples of a crowdfunding campaign through the internet stems from 1997, when the fans of a British rock group Marillion raised $60,000 enabling the band to finance their North American tour. Crowdfunding was defined by Belleflamme et al. (2012), as:

"An open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes".[25]

Those specific purposes vary from disaster relief to artists calling out to fans for support in launching an album, to political campaigns.[26] Well-known names amongst crowdfunding-platforms in the music industry are *Sellaband* (filed for bankruptcy in 2010), *MyMajorCompany* and *Artistshare.* These crowdfunding platforms are all structured according to a similar business model where potential investors can browse the site and decide whether they want to support an artist by listening to the music that the artists provided on the platform. Subsequently the artist can use the money to produce and distribute his album. More sectors followed this example and started to make use of the crowdfunding concept, varying from journalism (*Spot.Us*), beer (*Beer-Bankroll*) and even software, of which *Trampoline Systems* is a famous example. In 2009 *Trampoline Systems* became the first technology business that concluded financing through equity crowdfunding.[27] It shows how crowdfunding as a financing method can be deployed in many ways and across a variety of disciplines. Therefore I agree with Mollick (2014) that in an entrepreneurial context a narrower definition of the term would retain relevance given the continuous evolving nature of the concept. Mollick (2014) defines crowdfunding as: *"referring to the efforts by*

[24] (Metzler 2011), p. 7.
[25] (Belleflamme, Lambert, and Schwienbacher 2012).
[26] (Lee 2011).
[27] (Belleflamme, Lambert, and Schwienbacher 2012), p. 2-3.

entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries."[28]

1.3. Crowdfunding models

As already mentioned in the introduction, crowdfunding can be roughly divided into four categories. This division is based on the expectations the investor has on the returns of his investment. Some authors advocate for a division into five categories, splitting the reward-based crowdfunding model in two - the pre-purchase model and the reward-model.[29] Since both models contain the same expectations of the investor regarding the return on his investment, this thesis will follow the four-category approach.

The first model is the highly philanthropic donation-based crowdfunding, which as the term "donation" already implies is not reward-based. This type of crowdfunding has proven to be extremely successful. A good example of a typical non-reward based crowdfunding platform is Razoo where individuals can donate money to over a million officially registered non-profit organizations or they can choose to set up a fundraiser for a charity of own choice. This latter option imposes no obligation to pay neither incidental nor monthly subscription fees.[30] Towards the end of February 2013 Razoo had managed to raise an astounding amount of 138 million dollars. Even though the motivations to invest through a donation-based model might be of a purely charitable nature without any expectations of profit, the project that is funded can nevertheless have a for-profit nature.[31] Well known donation-based crowdfunding platforms include RocketHub, KickStarter & IndieGoGo. KickStarter adheres to the "all or nothing" principle, every project has a target amount of money that is needed to reach certain goals and only if that amount is raised will the money be transferred.[32] RocketHub on the other hand allows all the money that was raised to go towards the project.[33] IndieGoGo provides the entrepreneur or project manager with possibility to choose between the two types of funding. Depending on the project and the individual goals the

[28] (Mollick 2014), p. 2.
[29] (C. Bradford 2012), p. 14.
[30] ("Overview of Razoo - Razoo" 2014).
[31] (C. Bradford 2012), p. 15.
[32] ("Help Center – Kickstarter" 2014).
[33] ("Our Movement | RocketHub" 2014).

entrepreneur can choose between fixed funding similar to the "all or nothing" principle used by KickStarter, or with the flexible funding method that is used by RocketHub.[34]

The second and probably best-known model amongst the regular public is the reward-based crowdfunding model. This model offers incentives in the form of small rewards to the investors in return for their contributions. There exists a large variety of different types of rewards ranging from the promise to receive copy of the finished music album by a certain upcoming artist, to being credited on the album (*ArtistShare*), or to even receive a meet and greet with the artist.[35] This model of crowdfunding does not offer any financial returns on investment such as interest, dividends or a part of the revenues.[36]

The third crowdfunding model that is also known as peer-to-peer lending (P2P) or social lending, is a debt-based model where a crowdfunding platform brings potential borrowers and lenders together. P2P lending can be divided into direct loans, where the lender can choose the borrower individually, versus indirect loans that are pooled over many lenders as to mitigate the risk through diversification. Furthermore a distinction can be made between secured versus unsecured loans. Secured loans require a collateral right to be attached to the loan. This collateral right might entail the borrower to liquidate an object of value in the case the lender is not able to repay his debt. Unsecured loans are based on the borrower's credit rating and often require a higher interest rate because of the bigger risk attached to it.[37] Models without any interest-rate might be classified as not reward-based, however the requirement to repay the money still separates this model from the donation-based crowdfunding type. Originating from the United Kingdom, *Zopa* was the first P2P lending platform launched on the Internet, followed by *Prosper* in 2006. The final crowdfunding model is equity-based crowdfunding. Equity-based crowdfunding allows the investor to receive a part of the company or other expectations of a return on his investment. Because equity-based crowdfunding can be seen as a general solicitation for securities it is highly regulated. Part II will discuss these regulations in more detail.

[34] ("Indiegogo FAQ" 2014).
[35] (Belleflamme, Lambert, and Schwienbacher 2012), p. 2.
[36] (C. Bradford 2012), p. 16.
[37] (Young 2013), p. 53-54.

Part II: CROWDFUNDING AND THE FEDERAL SECURITIES LAWS

2.1. Introduction

Before the enactment of the JOBS-act crowdfunding faced many difficulties regarding state and federal regulations, but above all on two particular matters. Section 5 of the Securities Act, if no exemption applies, prohibits the offering of a security until a registration statement has been filed with the SEC. Not until the registration statement has become effective is the issuer allowed to sell a security. For the federal regulations to apply the question whether equity crowdfunding investments can be regarded as securities has to be answered in the affirmative. This Part will discuss the situation before the enactment of the JOBS act and whether crowdfunding investments can be regarded as an offering of securities. Subsequently the second regulatory issue concerning equity crowdfunding will be discussed in the second paragraph, concerning the crowdfunding platforms enabling these offerings since they might be seen as investment advisors or brokers/dealers if applying the SEC criteria.

2.2. Crowdfunding Investments

2.2.1. What is a security?

To understand the rationale behind the over-regulation in the US on the topic of securities law we firstly need to understand what the term entails. Securities differ from other commodities and investments in which people deal. Their very nature requires the government to takes certain precautions. For starters they are created (not produced) and can be issued in unlimited amounts on relatively low costs given their kind - having no value on their own because they represent a right or interest in something else. This explains why the US securities laws are focused on assuring that investors have an accurate representation on what this "something else" might be and what the amount of interest the particular security contains. Secondly because securities are eventually traded as a currency on secondary markets the securities laws also have as their goal to assure up-to-date information about the entity whose securities are being traded. The third difference derives from the nature of the markets where securities are traded. They are susceptible to manipulation and deception demanding existence of antifraud provisions that in general all securities laws contain.[38]

The enactment of the Securities Act of 1933 was a reaction to the Great Depression. The legislators wanted to prevent a disaster of such magnitude to occur ever again and enacted a regulation that was aimed at ensuring market stability and integrity in order to prevent such damages caused by free market failures from happening again. The legislation would provide for the full and truthful disclosure of information on the matter of all securities that were offered to the general public on the market.[39]

The key point in the application of the most federal securities laws to equity-crowdfunding is therefore the definition of a "security" and whether crowdfunding investments can be regarded as such.

The Securities Act of 1933 provides for a definition of a security in sec. 2(a)(1): *"The term ''security'' means any 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."*[40]

In addition to the more typical financial instruments (stock, bonds, notes, debentures and transferable shares), the various federal securities acts define a "security" also with broad catch-all terms: evidences of indebtedness, investment contract and certificates of interest in profit sharing agreements. However even if an instrument is covered by one of the listed categories, it can be excluded when "the context otherwise requires".[41] The term "investment contract" is the most extensive part of the definition and encompasses

[38] (T. Hazen 2009a), p. 2.
[39] (Stemler 2013).
[40] Sec. 3(a)(1) Securities Act of 1933; This definition of a "security" can also be found in some federal laws (the 1934 Act § 3(a)(1), ICA § 2(a)(36)) and also some state laws (USA §401(e)).
[41] (Palmiter 2008), p. 49.

all those instruments regarding investments in profit-seeking undertakings[42] that do not involve the traditional equity, debt and derivative instruments.[43] Even though equity-crowdfunding offerings do not resemble any of the traditional financial instruments deemed a security pursuant sec. 2(a)(1) of the Securities Act, they might still be subject to securities regulation if the offerings on the crowdfunding portals constitute investment contracts. Neither the Securities Act nor the state laws offer a clear definition of the term "investment contract", even though many state "blue sky" laws mention the term. It was therefore up to the state courts to give a broad interpretation of an "investment contract" in order to provide investors with as much protection as possible.[44] In the case SEC v. W. J. Howey[45], the Supreme Court has developed a common law test to determine whether investments in different money raising schemes can be considered to be an "investment contract" and therefore a security. The Supreme Court stated that: *"an investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party…"*[46] The *Howey* test thus consists of four important elements (1) investment of money, (2) common enterprise, (3) expectation of profit & (4) solely from the effort of others, which have been refined by the Supreme Court and some federal courts over the years. In order to determine whether crowdfunding investments can be seen as "investment contracts" first the abovementioned four elements will be briefly discussed in the next paragraph.

(1) Investment of money;

The Supreme Court in the United Housing Foundation case dealt with what constitutes an investment in terms of the *Howey*-test.[47] The existence of an investment according to the Court depends on the motivation of the prospective investor. If the potential investor made the decision to invest based on the expectation of future profits, then this is considered to be an investment. The Supreme Court illustrated the topic in the case Teamsters v. Daniel[48], where interests in a non-contributory pension plan were concluded as not being "securities" because the contributions that were made by the employees could not

[42] (T. Hazen 2009a), p. 28.
[43] (Heminway 2011), p.7.
[44] (Choi 2012), p. 104.
[45] SEC v. W. J. Howey Co., 328 U.S. 293 (1946).
[46] Ibid., at 298-301.
[47] United Housing Foundation, 421 U.S. 837 (1975).
[48] Teamsters v. Daniel, 439 U.S. 551 (1979).

be regarded as an "investment of money". Subsequently the SEC followed that view regarding as securities only those pension plans to which employees make voluntary contributions.[49]

(2) Common enterprise;

The existence of a common enterprise is the second element of the *Howey*-test. Here the courts have shown different approaches, requiring in some cases the existence of horizontal commonality (where multiple investors have interrelated interests in a common scheme) and in others a vertical commonality (where the investors and managements interests are aligned). Vertical commonality can be broad, requiring the investment of all the investors to be dependent on the expertise of the management, or narrow where the investor's success has to be "interwoven with and dependent upon the efforts and success of those seeking the investment or third parties". In addition to different courts adhering different approaches as to what constitutes a common enterprise, the courts also differ on the extent of their commitment to a single standard of commonality leaving the question which type of commonality is vital to fulfil the common enterprise requirement of the *Howey* test unanswered.[50]

(3) Expectation of profits;

The third element requires the investors to have made the decision to invest based on their expectation of a return. While this element seems quite self-explanatory, on several occasions the courts have been given the opportunity to further clarify this criterion. In United Housing Foundation v. Forman[51], the court ruled shares of stock in a cooperative housing corporation not to be "securities". According to the court "In searching for the meaning and scope of the word "security" in the Act(s), form should be disregarded for substance and the emphasis should be on economic reality." Consequently the mere fact that the shares of stock in the Forman case are called "stock" and the statutory definition of a definition of a security includes the word "stock" is not enough to subject them to the application of securities laws.[52] The Forman case involved investors who made the decision to invest based on the prospect of acquiring living instead of their expectation of a return. A more recent case SEC v. Edwards[53], dealt with the form of the expected profits. Since securities often offer profits based on a variable return the question arose whether

[49] (T. Hazen 2009a), p. 34.
[50] (Choi 2012), p. 116.
[51] United Housing Foundation v. Forman, 421 U.S. 837 (1975).
[52] (Choi 2012), p. 123.
[53] SEC v. Edwards 540 U.S. 389 (2004).

a contractual entitlement to a fixed return satisfies the required "expectation of profits".[54] The court ruled it irrelevant whether the return is fixed or variable, as long as the expected return has been the primary reason for the investor to invest.[55]

(4) Solely from the effort of others;

The fourth element of the *Howey*-test requires the abovementioned profits to derive solely from the efforts of the promoter or a third party. This element caused especially problems in determining the presence of an investment contract in cases involving partnerships and franchises since the investors are often involved in the management of the enterprise. The courts therefore in general allow some efforts of the investor to be present in the common enterprise as long as "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise".[56]

2.2.2. Are crowdfunding platforms offering securities?

After having briefly discussed the general definition of a security and the elements of the *Howey*-test the next paragraphs will apply them to the various crowdfunding models.

(1) Donation-based Crowdfunding

The most prominent feature of the donation-based model is the absence of any return on investment. This eliminates the possible characterization of an offering of the traditional instruments. Furthermore since the investor made the decision to invest without the expectation of future profits the transaction cannot be qualified as an investment contract not fulfilling the first element of the *Howey* test.

(2) *Reward-based Crowdfunding*

The second crowdfunding model also does not trigger state or federal regulations because the only thing that is offered in return for the investment is the "reward" which can neither be qualified as one of the standard financial instruments, nor as an investment because the third element of the *Howey* test is not

[54] (T. Hazen 2009a), p. 35.
[55] (Palmiter 2008), p. 50.
[56] SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

fulfilled. In United Housing Foundation v. Forman[57], the court held profits to be "either capital appreciation resulting from the development of the initial investment … or a participation in earnings resulting from the use of investors' funds." In accordance with *Howey* investors should have an expectation of a profit on top of their investment as such in this case the reward cannot be qualified as being profit.

(3) Debt-based Crowdfunding

Whether securities laws apply to debt-based crowdfunding depends on whether an interest rate is attached to the loan. In cases where no interest-rate is offered to the investor debt-based crowdfunding resembles highly the donation-based crowdfunding model, where the investors motivation for the investment is not primarily based on his expectations of future profits. Subsequently the first element of the *Howey* test remains unfulfilled, and as none of the traditional financial instruments can be held present as well, this crowdfunding model falls outside of the application of securities laws. However once the investor is offered an interest-rate this constitutes a fixed rate of return[58] on his investment fulfilling the third requirement of the *Howey* test. Following the *Forman*-case the first element is also satisfied because the main motivation to invest is based on the expectation of future profits. As for the second *Howey* element, if more than one investor has contributed to the common scheme, at least the requirement of horizontal commonality is fulfilled. Regarding the vertical commonality this will depend on a case-to-case basis. Conclusively offerings of crowdfunding interests with an interest-rate attached to them will be subject to state and federal securities laws since the four elements of the *Howey* test are satisfied.

Because the general definition of a "security" also includes debt-instruments ("note, … bond, debenture, evidence of indebtedness"[59]), in addition to being investment contracts, crowdfunding-interests can also be subject to securities laws on the ground of being structured as a debt-instrument.[60] In those cases where crowdfunding-platforms provide investors with "notes" as evidence in return for their investment, these "notes" might be securities. However, contrary to "stock" which practically always is presumed to be a security under Section 2(a)(1) of the Securities Act, the courts have excluded many types of notes from the classification of a security because "the context otherwise requires".[61] The Supreme Court provided

[57] United Housing Foundation v. Forman, 421 U.S. 837 (1975).
[58] SEC v. Edwards 540 U.S. 389 (2004).
[59] Securities Act of 1933 §2(a)(1).
[60] (Heminway 2011), p. 12.
[61] 15 U.S.C. § 77b(a)(1) (2006).

for an analysis in *Reves v. Ernst & Young*[62] in order to determine which notes are securities.[63] The *Reves*-test, also known as the "family resemblance test", consists out of three parts starting with the rebuttable presumption that every note is a security. The second part of the *Reves*-test provides for possible exemptions from this overall presumption with a list of notes that are considered not to be securities;

> *"The note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, . . . a note which simply formalizes an open account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized), . . . [and] . . . notes evidencing loans by commercial banks for current operations."*[64]

Despite the fact that this list does not include crowdfunding-notes, after applying the final part of the *Reves*-test, they still might be qualified as non-security notes if they bear a "strong family resemblance" to one of the notes on the *Reves* list of exemptions. To determine the existence of a strong family resemblance four factors have to be taken into account: (a) motivation of the seller and the buyer; (b) plan of distribution; (c) the reasonable expectations of investing public; (d) other risk reducing facts.[65] The resemblance with the four elements of the *Howey* test is noteworthy. Whether crowdfunding notes bear a "strong family resemblance" to one of the listed notes will depend on whether the offered notes have interest attached to them. If so then the first *Reves* element (motivations of the seller and buyer) is not met, since the issuer is trying "to raise money for the general use of a business"[66]. In those cases where the note is offered in return for consumer goods or for some other "commercial" purposes, it can be qualified as a non-security. Regarding the second element (plan of distribution), the notes have to be instruments in which there is "common trading for speculation or investment".[67] To satisfy this requirement in the absence of a trading market the court held it sufficient if the notes were "offered and sold to a broad segment of the public".[68] This element is probably satisfied since crowdfunding by definition involves a

[62] Reves v. Ernst & Young, 494 U.S. 56, 63 (1990).
[63] (T. Hazen 2009a), p. 30.
[64] See *supra* note 62.
[65] (Palmiter 2008), p. 58.
[66] See *supra* notes 62, 64.
[67] (Choi 2012), p. 158.
[68] Reves v. Ernst & Young 494 U.S. 56, 68 (citing *Landreth Timber Co. v. Landreth,* 471 U. S. 681(1985)).

significant amount of small investors.[69] Regarding the third factor the court in *Reves* held the fundamental essence of a security to be its character as an "investment", consequently characterizing notes as securities if there are no countervailing factors that would lead a reasonable person to question this characterization.[70] As notes with interest rate attached to them qualify as investments it is reasonable to expect the general public to see them as such. The final element of the *Reves*-test demands the presence of a risk-reducing factor. Crowdfunding notes are uncollateralized and uninsured to begin with and while no other regulatory schemes that might significantly reduce the risk of the instrument are applicable they would escape federal regulation entirely if the federal securities laws were held not to apply.[71] Thoughts differ on whether it is necessary or even desirable to nevertheless apply the *Howey*-test when an instrument is not a security under the *Reves*-test.[72] Ultimately irrespective of whether the *Howey* or the *Reves*-test will be applied, debt-based crowdfunding interests with an interest-rate attached to them shall most likely be regarded "securities".

(4) Equity-Crowdfunding

Equity-crowdfunding is the final crowdfunding model to be discussed in this paragraph. In this model the investors are offered company equity, or ownership, offering them a share of the profit. This type of investment would be considered an offering of securities since the investors are promised investment-return on top of the return of their initial investment. These offerings would require registration under the Securities Act of 1933 and are therefore currently non-existent in the US. In 2011 the California Department of Corporations issued a consent order allowing ProFounder to offer securities to the general public only after registering as a broker/dealer under Californian law. Subsequently in June 2011 the leading equity-crowdfunding site ProFounder announced not to be offering securities any longer which resulted in a wake-up call for other equity-crowdfunding websites. The knowledge of the costly regulatory hurdles accompanying public crowdfunding-equity offerings reduced equity-crowdfunding sites to only those offering private equity to sophisticated and accredited investors.[73]

The before mentioned regulatory hurdles accompanying the classification of crowdfunding instruments as securities could however be avoided if an exemption would apply. The securities laws provide for several

[69] (C. Bradford 2012), p. 38.
[70] Reves v. Ernst & Young 494 U.S. 56, 69 (1990).
[71] Ibid., at 69.
[72] (Verstein 2011).
[73] (C. Bradford 2012), p. 24.

exemptions to the registration requirements such as: the private offering exemption in Section 4(2) of the Securities Act; Rule 506 of Regulation D; Section 4(5) of the Securities Act; Rule 504 of Regulation D; Rule 505 of Regulation D; or Regulation A. Unfortunately none of these exemptions could be applicable on the subject of crowdfunding. The next sub-paragraph will discuss this in more detail.

2.2.3. Possible Exemptions

The public offering exemption of Section 4(2) Securities Act exempts "transactions by an issuer *not* involving any public offering". The Supreme Court elaborated in the *Ralston Purina*[74] case on the scope of the exemption stressing the offerees need the protection of the Act and their ability to fend for themselves. In subsequent cases the Court stated this to relate to the sophistication of the offerees and their access to information about the user.[75] Since the core nature of crowdfunding revolves around raising money from the general public, without distinction regarding their level of knowledge or sophistication, this exemption clearly cannot apply. Consequently the exemptions of Rule 506 of Regulation D and Section 4(5) of the Securities Act will not apply. Rule 506 of Regulation D requires the offering to be made to "accredited investors" or any other person that has "such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the perspective investment."[76] Additionally Rule 506 prohibits "general solicitation" and "general advertising" of the offering which the biggest obstacle for the possible application of Regulation D. Offerings to the general public on crowdfunding websites would probably violate this prohibition since any solicitation of an investor with whom the issuer or its sales representatives do not have a pre-existing relationship, according to the SEC and its staff, violates the general solicitation restriction.[77] Of course there might be exceptions but it is highly unlikely that the investors forming the "crowd" on the crowdfunding platforms would individually have pre-existing relationships with the platform. Similar to Rule 506, Section 4(5) of the Securities Act allows offers and sales only to accredited investors in the absence of "advertising or public solicitation". While Rule 505 exempts offerings up to $5 million[78] and is not restricted to accredited or sophisticated investors it nevertheless contains the same general solicitation restriction.

[74] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[75] Ibid.
[76] 17 C.F.R. § 230.506(b)(2)(ii).
[77] Ibid., at 46.
[78] 17 C.F.R. § 230.505(b)(2)(i).

Furthermore the issuer is only allowed to sell to no more than thirty-five non-accredited investors[79], all in all rendering this exemption of no use in this situation. Regulation A provides for an exemption to offerings by non-reporting companies up to $5 million and does not prohibit general solicitation. However it contains a requirement to file a disclosure document becoming instead of an exemption in effect a cheaper "mini-registration". Proposed amendments to some of these exemptions will be discussed in more detail in the next Part concerning the regulatory environment after the implementation of the JOBS-Act. Since crowdfunding interests would most likely not qualify for any of the previously mentioned exemptions they can unfortunately not escape the registration requirements, this and other consequences of the classification as a security will be discussed in the following sub-paragraph.

2.2.4. Consequences

The immediate consequence of the qualification of crowdfunding interests as securities is the triggering of the application of securities laws. Already mentioned was the registration requirement (unless an exemption is available) of sec. 5(c) Securities Act prohibiting offerings of securities until a registration statement has been filed with the SEC, followed by the prohibition to sell these securities until the registration statement has become effective.[80] The costs attached to the preparing and filing of the registration statement can add up to hundreds of thousands of dollars, exceeding thereby the amount starting entrepreneurs even desire to raise.[81] In addition to the practical side, some crowdfunding platforms might unintentionally act in violation of sec. 5 of the Securities Act due to the broad interpretation of the terms "sale" and "offer for sale" which also include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security".[82] Effectively mere communications with potential investors without prior registration could amount to a violation of sec. 5 Securities Act, with major consequences. The investor who bought the security is granted with a private cause of action pursuant sec. 12(a)(1) allowing him to either recover the money paid in return for the security with interest, or to claim for damages if he no longer owns the security.[83]

[79] 17 C.F.R. § 230.505(b)(2)(ii); 17 C.F.R. § 230.501.
[80] Securities Act of 1933 §5(a)(1), 15 U.S.C. §77e.
[81] (Heminway 2011), p. 907.
[82] 15 U.S.C. § 77b(a)(3).
[83] 15 U.S.C. §77l(a)(1).

While registration might be costly and time-consuming it is not impossible. After having to completely restructure their business models Prosper and Lending club registered the notes they offered. In this construction the investors loan the money to the platform, which provides them with non-recourse notes dependent on payment by the underlying borrower. Prosper and Lending Club then both file a single shelf registration statement for all the notes that they have issued. Each funding tread has to be handled as a separate series and requires its own prospectus supplement.[84] Applying this structure to crowdfunding offerings would be an extremely costly and burdensome process that would not outweigh its benefits. While the offerings of crowdfunding interests trigger security regulations, the platforms enabling these offerings are also faced with some regulatory hurdles. These will be discussed in more detail in the next paragraph.

2.3. Crowdfunding Platforms

Where the Securities Act of 1933 regulates the offerings of securities, the enforcement of the federal securities laws and the regulation of the securities industry is bestowed upon the Securities Exchange Commission - established by the Securities Exchange Act of 1944.[85] The SEC focuses to a great extent on the regulation of firms engaged in the securities business which are mainly those who are acting as brokers, dealers and investment advisors.[86] If the crowdfunding sites are indeed offering securities they risk being regarded as such. Sec. 15(1)(a) of the Exchange Act contains the registration requirement for brokers/dealers obliging them to register in accordance with sec. 15(1)(b) of the Exchange Act.

The Investment Advisors Act of 1940 governs the actions of investment advisors. Therefore a crowdfunding platform that can be defined as such pursuant sec. 202(a)(11) of the Advisers Act would also be required to register with the SEC. Even in those cases where the offerings on crowdfunding sites would be exempt from the registration requirements, the platforms offering the securities could be acting as unregistered brokers/dealers or investment advisors. Therefore the following paragraphs will discuss whether crowdfunding platforms could be considered brokers/dealers or investment advisors according to the SEC criteria.

[84] (C. Bradford 2012), p. 44.
[85] Exchange Act of 1934, 15 U.S.C. §77a et seq.
[86] (T. Hazen 2009b), p. 558.

2.3.1. Brokers

Pursuant section 3(a)(4) of the Exchange Act a "broker" is "any person engaged in the business of effecting transactions in securities for the account of others."[87] In some cases it is obvious whether an individual or a company is operating as a broker. For instance when a person executes transactions for others on a securities exchange. However there are many cases when additional guidance is needed. The Exchange Act does not offer any explanation on the interpretation and/or application of the general definition and case law on this matter is scarce as well. Yet the Guide to Broker-Dealer Registration issued by the SEC might as well as the SEC no-action letters offer some assistance on the matter.[88]

The Guide provides for a list of various persons and businesses that would probably have to register as a broker depending on their activities. If one of the following questions can be answered in the affirmative then this is a strong indication that the platform is acting as broker and requires registration:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?[89]

BondGlobe Inc. No-Action letter[90] by the Securities and Exchange Commission summarizes the most important factors to determine whether someone can be stated a broker: "To qualify as a broker, the activities of the alleged broker must be characterized by a certain regularity of participation in securities transactions at key points in the chain of distribution.[91] This test requires an analysis of the role the entity plays at each stage of securities transactions. Among the factors relevant to the determination of whether an entity is a broker are whether the entity: (1) receives transaction-based compensation, such as

[87] Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4).
[88] ("SEC.gov | Compliance Guide to the Registration and Regulation of Brokers and Dealers" 2014)
[89] Ibid.
[90] (House 2014), p. 77,516.
[91] SEC v. Zubkis, No. 97 Civ. 8086, 2000 WL 218393 (S.D.N.Y. Feb. 23, 2000); Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp., 411 F.Supp. 411, 415 (1976); MuniAuction, Inc., SEC No-Action Letter, 2000 WL 291007 (March 13, 2000).

commissions or referral fees; (2) is involved in negotiations between the issuer and the investor; (3) makes valuations as to the merits of the investment or gives advice; and (4) is an active rather than passive finder of investors."[92] For a crowdfunding platform to be considered a broker, the company has to (i) "be engaged in the business" of (ii) "effecting transactions in securities" and (iii) "for the account of others". Since the statute does not provide for a definition, the courts and the SEC have provided for some indicators that might help decide whether a person is "engaged in the business".[93] If the crowdfunding-platform would receive transaction-related compensation; present itself as a broker by executing trades and assisting in transaction securities[94]; would be soliciting securities transactions; participating in the securities business with some degree of regularity.[95] The degree of regularity is considered to be to be a primary indication of being "engaged in the business".[96] Factors displaying this regularity of participation are (i) the number of transactions, (ii) the dollar amount of the securities sold[97] & (iii) the extent to which advertisement and investor solicitation were used.[98]

In general, to be "effecting transactions in securities", the crowdfunding platform has to "participate in securities transactions with a certain regularity at key points in the chain of distribution."[99] Such participation includes, among other activities, assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities, soliciting securities transactions, and participating in the order-taking or order-routing process (for example, by taking transaction orders from customers).[100] In addition to indicating that a person is "effecting transactions," soliciting securities transactions is also evidence of being "engaged in the business."

Crowdfunding platforms definitely facilitate the matching of investors and entrepreneurs on a regular basis, however their involvement in the transactions extends to more than just matching them. Crowdfunding sites provide for a negotiation platform; facilitation of on going communications between

[92] SEC v. Zubkis, 2000 WL 218393, Hansen, 1984 WL 2413, MuniAuction, Inc., SEC No-Action Letter, 2000 WL 291007 (March 13, 2000); Charles Schwab & Co., Inc., SEC No-Action Letter, 1996 WL 762999 (November 27, 1996); Angel Capital Electric Network, SEC No-Action Letter, 1996 WL 636094 (October 25, 1995).

[93] SEC v. Kenton Capital LTD, 69 F.Supp.2d 1 (1998).

[94] Progressive Technology, Inc., SEC No-Action Letter, 2000 WL 1508655, p. 5 (Oct. 11, 2000).

[95] Oil-N-Gas, Inc. SEC No-Action Letter, 2000 WL 1119244.

[96] Ibid., *supra* note 93.

[97] SEC v. National Executive Planners, Ltd., 503 F.Supp. 1066, 1073 (M.D.N.C.1980).

[98] Ibid., supra note 93, SEC v. Deyon, 977 F.Supp. 510, 518 (D.Me.1997).

[99] Massachusetts Financial Service, ibid. *supra* note 91, P. 213 Hazen THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 403–21 (6th ed. 2009)

[100] Ibid., *supra* note 95.

the parties and facilitate the transferring of funds and investment documents.[101] The nature of the advice and recommendation provided by the crowdfunding platforms to the investors and entrepreneurs might also be an indication of a larger involvement in the transactions. If the involvement is more of general nature such as advice on the prevention of fraud this is considered minor involvement. However advice and recommendations of a more specific nature such as rating of borrowers or helping to structure offerings constitute a more extensive involvement in the transaction. The involvement in the structuring of a securities transaction, as well as the receipt or transmission of funds or securities, are two other factors that might help to determine whether someone can be regarded as a broker.[102]

2.3.2. Dealers

The Exchange Act defines a dealer as any person who (i) "is engaged in the business" of (ii) "buying and selling securities for his or her own account (through a broker or otherwise)"[103] where this activity has to be performed (ii) "as part of a regular business"[104] (iii) "at key points in the chain of distribution".[105] Contrary to the broker status, which merely requires participation in securities transaction, a dealer has to both buy and sell securities.[106] Crowdfunding platforms would obviously not satisfy this criterion since they do not buy the securities from entrepreneurs for the purpose of selling them.

2.3.3. Investment advisors

Sec. 202(a)(11) of The Investment Advisers Act defines an investment advisor as any person "who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[107] According to the SEC this generally entails that an investment advisor is any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice,

[101] (C. Bradford 2012), p. 61.
[102] Ibid., at 62.
[103] Exchange Act sec. 3(a)(5)(A); Eastside Church of Christ v. Nat'l Plan, Inc., 391 F.2d 357, 361 (5th Cir. 1968).
[104] Ibid.; S.E.C. v. Offill, 2012 WL 246061 (N.D. Tex. Jan. 26, 2012).
[105] Ibid., *supra* note 95.), SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).
[106] Ibid., *supra* note 91.
[107] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b- 2(a)(11) (2006).

making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.[108] To be qualified as an investment advisor all three elements have to be satisfied.

Crowdfunding sites offering securities generally receive compensation for their services whether through a fixed fee, interest or a ratio of the total amount of money raised.[109] This will easily satisfy the first element since the receipt of any economic benefit in this context amounts to "compensation". The fee does not have to result from advisory services that are separate from other fees, nor does it have to be received directly from a client,[110] as long as there exists 'a clearly definable charge' for the advisory services given.[111]

To be "engaged in the business" for the purposes of sec. 202(a)(11) Advisers Act, the investment advisory business does not have to be the persons or firms sole or principal business activity. It is sufficient the person of firm presents itself to the outside world as being an investment advisor or as providing investment advice[112]; the person or firm receives separate or additional compensation for providing advice about securities; or the person or firm typically provides advice about specific securities or specific categories of securities.[113] It should be noted that the provision of the specific advice should have a periodic nature, whereas "rare, isolated and non-periodic" incidents will probably not satisfy the business requirement.[114] Subsequently those crowdfunding platforms that satisfied the first requirement will also satisfy this second requirement if they are indeed engaged in the business of giving "advice about securities"

The SEC stated in its General Information on the Regulation of Investment Advisors that to satisfy the last criterion, "advice about securities", the abovementioned investment advisory business has to relate to securities.[115] Obviously those crowdfunding models that in the previous Part were concluded to be offering securities will satisfy this third element. However the main issue at hand is whether crowdfunding sites are indeed providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications to the investors?

To answer this question we need to look at the basic activities of the crowdfunding platforms relating to securities. Crowdfunding platforms that exist today are mostly matching entrepreneurs and investors.

[108] United States v. Elliott, 62 F.3d 1304, 1309–10 (11th Cir. 1995).
[109] (C. Bradford 2012), p. 69.
[110] ("General Information: Regulation of Investment Advisers" 2014).
[111] United States v. Elliott, 62 F.3d 1304, 1309–11 (11th Cir. 1995).
[112] Ibid.
[113] Ibid., *supra* note 110.
[114] Ibid., *supra* note 111.
[115] Ibid., *supra* note 110.

However suppose that crowdfunding platforms would indeed be offering securities, the compensation/profit of this activity would still derive from the matching of the investors and the entrepreneurs. The qualification of an investment advisor does not depend solely on the type of product offered on the platform but on the services rendered. This means that in those cases where it is up to the investors to decide in which project they want to invest their money, the main activity of the crowdfunding platforms remains the matching of investors and entrepreneurs and not the giving of investment advice on securities.

Even when taking into account that the provided advice does not have to relate to specific securities, and the mere positive advertising of an investment in securities above other types of investment would already amount to the status of an investment advisor, this makes no difference since crowdfunding platforms do not even do this.

Nevertheless the matching services could in effect be considered as provision of "advice about securities". Since matching services by their nature are focused on bringing two parties together, the result of a match implies the offering meets the investors needs and thus constitutes an "advice about securities". [116] However as mentioned before crowdfunding sites merely provide investors with information about different types of investments leaving it up to the investor to decide which investment is most suitable for his wishes.

Still, while crowdfunding platforms might not be considered as providing investment advice they might be issuing "analyses or reports concerning securities". The SEC concluded that in this context the information that is readily available to the public in its raw state; the categories of information presented that are not highly selective: and the information which is not organized or presented in a manner that suggest the purchase, holding or sale of any security does not amount to an "analyses or reports concerning securities". The information provided by the crowdfunding platforms is furnished by the entrepreneur seeking funds and concerns the nature of the company/project itself. Publication of such information would not amount to an issuing of "analyses or reports concerning securities".

As mentioned before, several exceptions exist to the general definition of an investment advisor, which can be found in sec. 202(a)(11) of the Investment Advisers Act. One of them is the publisher exception of sec. 202(a)(11)(D), which might be applicable to crowdfunding sites. This exception does not only apply to a person using paper media, the use of the Internet or a fax machine does not exclude the application of

[116] (C. S. Bradford 2012), p. 76.

the exception.[117] The purpose of the Investment Advisers Act is primarily to regulate the business of rendering personalized advice and not the publication of non-personalized publishing activities.[118] The Supreme Court in the case *Lowe v. SEC*[119] stated the rendering of personal advice not equivalent to the publication of advice and comment about specific securities, and that the publication of such does not precludes the application of the exception of sec. 202(a)(11)(D). Following the Court in the *Lowe v. SEC* case, to qualify for the publisher exemption (i) the publications have to be offered to the general public on a regular schedule; (ii) have a bona fide nature; (iii) and not contain individual advice attuned to any specific portfolio or to any client's particular needs, but rather, circulated at large in free, open market.[120] The SEC staff followed this line of reasoning of the Court in a collection of no-action letters explaining the three criteria in more detail.[121] Unfortunately crowdfunding sites will probably not qualify for the publisher exception firstly because their publications cannot be regarded "bona fide". The publications are clearly made for promotional purposes and do not contain disinterested commentary or analyses.[122] Secondly the publications by the crowdfunding sites might be regarded not general and regular since their updates might be seen as timed to a specific market activity; they are changed each time an entrepreneur posts a new fundraising request.[123]

2.3.4. Consequences

The federal securities laws focus to a great extent on investor protection and provide a comprehensive framework for the registration and regulation of persons engaged in the business of buying and selling securities. The main federal legislation governing brokers and dealers is The Securities Exchange Act of 1934. In addition to the Exchange Act, brokers and dealers also have to comply the SEC rules thereunder and the rules of self-regulatory organisations. Brokers/dealers are required to file a registration with the SEC pursuant Section 15 of the Exchange Act. Furthermore certain provisions of the Exchange Act apply

[117] Nito GmbH, SEC No-Action Letter, 1996 WL 473433.
[118] *Lowe v. SEC,* 472 U.S. 181 (1985).
[119] Ibid.
[120] Ibid.
[121] (1) offer of only impersonalized advice, i.e., advice not tailored to the individual needs of a specific client or group of clients; (2) be "bona fide" or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and(3) be of general and regular circulation, i.e., not timed to specific market activity or to events affecting or having the ability to affect the securities industry, *see* Nito GmbH, SEC No-Action Letter, 1996 WL 473433; Mr. Russell H. Smith, SEC No-Action Letter, 1996 WL 282564, InTouch Global, LLC, SEC No-Action Letter, 1995 WL 693301; David Parkinson, Ph.D., SEC No-Action Letter, 1995 WL 619930.
[122] Ibid., *supra* note 117.
[123] (C. Bradford 2012), p. 80.

to all brokers/dealers (registered or not) while others are only applicable to registered brokers/dealers. Therefore if crowdfunding platforms would be considered to fit the definition of broker/dealer they would have to comply with the registration requirement of Section 15 Exchange Act. Once registered, as a broker/dealer they would be subject to compliance requirements and obligations under the Exchange Act amongst which: meeting certain standards of operation capability; training, experience,[124] becoming a member of a self-regulatory organization[125], complying with minimum net capital requirements.[126] Furthermore brokers/dealers are also subject to federal anti-fraud and anti-manipulation provisions as well as specific antifraud requirements.

The first consequence of crowdfunding platforms being considered investment advisors under sec. 202(a)(11) of the Advisers Act, is the requirement to register with the SEC if they; are not excepted from the definition of investment adviser by Section 202(a)(11)(A) through (E) of the Advisers Act; not exempt from Commission registration under Section 203(b) of the Advisers Act; and is not prohibited from Commission registration by Section 203A of the Advisers Act.[127]

In addition to the registration requirement The Investment Act imposes also other obligations on investment advisors (e.g. avoidance of certain types of fee arrangements and maintenance of specified books and records).[128]

[124] Exchange Act § 15(b)(7); Rule 15b7-1.
[125] Exchange Act § 15(b)(8).
[126] Exchange Act § 15(c)(3); Rules 15c3-1, 15c3-3 and 17a-11.
[127] ("General Information: Regulation of Investment Advisers" 2014).
[128] (Choi 2012), p. 39.

2.4. Conclusion

The purpose of this Part was to give a comprehensive overview of the regulatory environment and the regulatory hurdles different models of crowdfunding faced before the enactment of the JOBS-Act. A general solicitation for securities is highly regulated, therefore it was first necessary to determine whether the crowdfunding interests offered to the investors could indeed be qualified as securities in terms of The Securities Act of 1933. Out of the four crowdfunding models only the debt-based crowdfunding model and the equity-based crowdfunding model could be considered as an offering of securities under certain circumstances. Equity-crowdfunding instruments provide the investors with company equity, offering them a share of the profit, satisfying the definition of security since the investors are promised investment return on top of the return to their initial investment. Whether securities laws apply to debt-based crowdfunding depends on whether an interest rate is attached to the loan giving the investor expectations of future profits combined with a fixed rate of return. Additionally since the general definition of a security also includes debt-instruments, crowdfunding instruments can also be subject to securities laws if crowdfunding-platforms provide investors with "notes" as evidence in return for their investment. Ultimately debt-based crowdfunding notes with an interest rate attached to them can satisfy the definition of "security" since the criteria of *Howey* & *Reves* are satisfied.
The offering of debt-based crowdfunding interests with interest rate attached to them and equity-crowdfunding interests would constitute an offering of securities requiring the filing of a registration statement with the SEC if no exemption applies. While the securities laws provide for several exemptions to the registration requirements, unfortunately none of these could be found to be applicable regarding crowdfunding instruments. Most exemptions require the securities to be offered to "accredited investors" or meet a "sophistication requirement". Where crowdfunding instruments are offered to the crowd this requirement is not easily met. Given the nature of crowdfunding, which aims at gathering funds from a large crowd of people one might wonder whether it would even be desirable to only allow accredited/sophisticated investors to buy instruments, since this seems not to align with the nature of crowdfunding. Furthermore the prohibition on general solicitation and advertisement will be violated easily since the issuer is not likely to have a pre-existing relationship with the "crowd" of investors.

The second regulatory issue crowdfunding could face was the possibility that the platforms enabling these offerings might be seen as investment advisors or brokers/dealers. While guidance to the definitions of broker, dealer and investment advisor can be found in several no-action letters, the letters offer relief only to the requestor regarding that specific situation.[129] Furthermore since they represent the views of the SEC staff the no-action letters are not legally binding.[130] Additionally the SEC Guide to Broker-Dealer Registration is not fully comprehensive. Brokers and dealers have to comply with all the applicable rules and regulations, and not just with those summarized in the Guide.[131] Whether someone can be regarded a broker will ultimately be decided by the courts applying a "facts and circumstances" approach.[132]

All in all whom to consider a broker or dealer is very hard, making it impossible to decide upon the applicability of the Exchange Act on crowdfunding platforms with certainty. It is possible that the activities of crowdfunding sites cumulatively: offering securities, receiving transaction based compensation, combined with a continued involvement in the relationship between the investor and the entrepreneur, handling public advertising and given their general for profit status, might be enough to consider them brokers.[133]

On what constitutes and investment adviser is evenly ambiguous. Whether crowdfunding platforms will fall within the definition of "investment advisor" will depend on the basic activities of the crowdfunding platforms relating to securities. While crowdfunding platforms receive compensation for their services and also satisfy the second criterion of the "investment advisor" definition since they are engaged in a business, the question remains whether they are providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. In my view the core of their activities exists out of the matching of the entrepreneurs and investors. While the bringing together of the two parties might in itself constitute an advice, crowdfunding platforms merely provide investors with information, as it was presented to them by the entrepreneurs. The investors are completely free to decide on whether and where to invest their money. Therefore I consider there to be insufficient evidence to consider last criterion of the definition satisfied. However there is no guarantee the Securities Exchange Commission will be of the same opinion.

[129] http://www.sec.gov/answers/noaction.htm
[130] http://www.sec.gov/interps.shtml
[131] http://www.sec.gov/divisions/marketreg/bdguide.htm
[132] (Colby 2012), p. 2-12.
[133] (C. Bradford 2012), p. 77.

Part III: CROWDFUNDING AFTER THE JOBS-ACT

3.1. Introduction

On The 5th of April 2012, President Obama signed the Jumpstart Our Business Start-ups Act into law.[134] The purpose of the Act is to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies[135] (hereafter EGC's).[136] The Act has received massive media attention primarily regarding the new so-called crowdfunding exemption of Title III and the lift of the ban on general solicitation of Title II. However consisting out of five Titles in total, the Act is aimed at increasing small business's access to capital in more ways than merely exempting crowdfunding transactions and simplifying rules regarding certain private offerings. Title I of the Act – Reopening American Capital Markets to Emerging Growth Companies – sometimes referred to as: the IPO On-Ramp[137], responds to the recent decline in IPO's, temporarily exempting (wholly or partially) EGC's from certain disclosures requirements that were presumed to be discouraging companies from going public.[138] Title II of the JOBS-Act modifies Regulation D, lifting the general solicitation and advertising ban if all buyers of the offering are accredited investors, and subject to conditions exempts certain persons from broker/dealer registration.[139] Title III of the JOBS-Act - Crowdfund Act ("Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012") – creates a regulatory framework legalizing equity-crowdfunding, and will be discussed in more detail in the following paragraphs. Title IV modifies the Regulation A exemption by increasing the offering limit by ten times from $5 million to $50 million in a 12-month period provided investors receive certain filings and annual audited financial statements are submitted. Title V raises the limit on the number of shareholders a private company is allowed to have from 500 to 2000 (or 500 unaccredited shareholders) before it becomes subject to the 10-Q or 10-K Exchange Act annual reporting requirements.

[134] Pub. L. No. 112-106, 126 Stat. 306 (2012).
[135] 'Emerging growth company' is defined in Sec. 101(a)(19) of the JOBS-Act as an issuer that had total annual gross revenues of less than $1 billion during its most recent completed fiscal year.
[136] (Cunningham 2012).
[137] (Brian Hamilton 2014)
[138] Sec. 101-104 JOBS-Act.
[139] Sec. 201(c) JOBS-Act.

The JOBS Act was passed in early 2012 and from thereon it was up to the SEC and the FINRA to finalize the rules that would allow companies to sell equity stakes using crowdfunding platforms to also non-accredited investors. Failing to meet the initial deadline of 270 days, on October 23, 2013 the SEC finally proposed rules for Title III of the JOBS Act and the comment period passed for the proposed SEC rules as well as the proposed FINRA rules on February 3, 2014.[140][141] The SEC is yet to present the finalized rules on Part IV and V before they officially come into effect.

This Part will provide an overview of the new regulatory framework crowdfunding will face. First the requirements crowdfunding transactions must meet in order to qualify for the crowdfunding exemption will be discussed, followed by an overview of the obligations under the proposed SEC rules applicable to all intermediaries as well as the proposed new regulatory scheme for funding platforms. Finally the requirements set out in Section 4A(b) of the JOBS Act concerning issuers of the crowdfunding securities will be discussed.

3.2. Title III of the JOBS-Act

3.2.1. Crowdfunding Exemption

The so-called crowdfunding exemption, which can be found in Title III of the JOBS Act, added Section 4(a)(6) to the Securities Act and allows for certain crowdfunding transactions to be exempt from the registration requirements of Section 5 Securities Act. Additionally since crowdfunded securities are deemed to be "covered securities" they are also exempt from state registration.[142]

In order to qualify for the exemption of Section 4(a)(6), the funding raised by an entrepreneur must not exceed $1 million over a 12-month period.[143] Individual investors are only allowed to invest the greater of $2000 or 5% of annual income or net worth if their income or net worth is less than $100 000.[144] Investors with an annual income or net worth of $100 000 or more are allowed to invest up to 10% (however not

[140] ("FINRA Regulatory Notice 13-34 (October 2013)" 2014).
[141] For a more extensive overview of the legislative history of the crowdfunding exemption *see*: (Belleflamme, Lambert, and Schwienbacher 2012).
[142] Pub. L. No. 112-106, § 305, 126 Stat. 306 (2012).
[143] Sec. 302(a) JOBS-Act; Sec. 4(6)(A) Securities Act of 1933.
[144] Sec. 302(a) JOBS-Act; Sec. 4(6)(B)(i) Securities Act of 1933.

more than $100 000) of their annual income or net worth.[145] It should be noted all types of investors accredited or not, are treated equally. The income limitations apply to all transactions made through crowdfunding portals.

3.2.2. Crowdfunding Portals

Crowdfunding transactions have to be conducted through an intermediary that is either a registered broker or a funding portal[146] that meets the requirements as set out in Section 4A(a) of the JOBS Act. These new funding portals can take any organization form, and can be created by an individual, cooperative, partnership, LLC or corporation.[147] A funding portal is defined as a crowdfunding intermediary that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or others persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in such other activities as the SEC, by rule, determines appropriate.[148] Funding portals are not capable of effecting secondary market transactions in securities since they are limited to acting as intermediaries in the transactions.[149]

Pursuant the new Section 3(h) Exchange Act, the Commission is required to adopt rules exempting (either conditionally or unconditionally) "funding portals" from having to register as brokers or dealers pursuant to Section 15(a)(1) Exchange Act.[150] Funding portals are nevertheless required to register as such and have to become member of any applicable self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act).[151] The rules proposed by the Financial Industry Regulatory Authority (hereafter FINRA) will also be applicable to future funding members.

Investor protection is an important element of the JOBS Act and all acting as intermediaries in connection with a crowdfunding offering are subject to certain restrictions and obligations. Some strict limitations on certain activities however might preclude funding portals from operating their portal properly. To avoid

[145] Sec. 302(a) JOBS-Act; Sec. 4(6)(B)(ii) Securities Act of 1933.
[146] Funding portals are defined in Section 3(a)(80) of the Exchange Act.
[147] (Cunningham 2012), p. 83.
[148] Section 305 JOBS-Act.
[149] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 227.
[150] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p.10.
[151] Section 4A(a)(2) JOBS-Act.

this from happening the proposed SEC rules provide for funding portal safe harbours,[152] which will be discussed in the next subparagraph.

The first major task funding portals are appointed with is the education and training of investors. Not only do they provide information to the investors but they also have to certify that the investors have reviewed and understood the information regarding the risk of their investment. Pursuant Section 4A(a)(4) JOBS Act, the intermediary has to affirm that the investor understands: the existing risk of losing his entire investment and that he can bear such a loss; the level of risk that is generally applicable to investments in start-ups, emerging businesses and small issuers; the risk of illiquidity; and other matters as the Commission determines appropriate by rule. In order to affirm this understanding the portals have to quiz investors on their knowledge. The portals also have to take measures to reduce the risk of fraud, by obtaining background checks, including securities enforcement regulatory history, on each officer, director and any person that holds more than 20% of the outstanding equity of each entrepreneur issuing the security.[153] If an intermediary believes (i) that the issuer or offering presents the potential for fraud or raises other investor protection concerns or (ii) has a reasonable basis for believing that an issuer or certain of its directors, officers or principal shareholders are subject to certain disqualifying events, he must deny access to its platform.[154]

After the first day crowdfunding interests are sold the clock starts ticking and funding portals are required to make information provided by the issuer available to the SEC and potential investors within 21 days before any securities are sold. The information has to remain publicly available on the platform until the offer and sale ere either completed or cancelled.[155] Moreover Section 4A(a)(7) JOBS ACT contains an "all or nothing" provision: funding portals are only allowed to provide the entrepreneur with the raised capital if "the aggregate capital raised from all investors is equal to or greater than a target offering amount". It also provides investors with the possibility to cancel their commitments to invest.

Investors also enjoy protection regarding their privacy with all the investor information being kept confidential. Portals are prohibited from buying leads and must develop an investor database organically. Additionally, insiders such as "directors, officers or partners (or any person occupying a similar status or performing a similar function) are prohibited from having any financial interest in an issuer using its

[152] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 227.
[153] Section 4A(a)(5) JOBS Act.
[154] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p.141.
[155] Section 4A(a)(6) JOBS Act.

services.[156] In other words entrepreneurs are not allowed to create a funding portal merely to raise money for their own business.

3.2.1. Funding Portal Safe Harbours

As mentioned earlier, because some strict limitations - such as the prohibition to engage in solicitations, to provide advice or recommendations - would be easily violated by funding portals, for instance the mere maintenance of a website might be viewed as solicitation, and the selection of which securities to make available might be seen as recommendation, the proposed SEC rules include a number of non-exclusive safe harbours that clarify certain limited activities which are allowed. A funding portal may, amongst other things: limit offerings made on or through the funding portal's platform, highlight certain offerings, or provide search functions, in each case based on certain objective eligibility requirements; provide communication channels[157] for potential investors and issuers subject to restrictions; advise issuers on the structure of offerings and content of disclosures; compensate others for referring persons to the funding portal and for other services, subject to restrictions; and advertise the funding portal's existence, including identifying available offerings.[158]

3.2.2. Transfer and trade of Crowdfunded Securities

Pursuant Section 4C(3)(e) buyers of Crowdfunded securities must hold the securities and shares for a minimum period of one year and can only be transferred if they are transferred to: (i) the issuer of the securities; (ii) an accredited investor; (iii) as part of a SEC registered offering; (iiii) a member of the family of the purchaser (or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the Commission).[159] This does not apply to purchasers of crowdfunding securities that: are on tribal territory "or other lands not subject to State or Federal law"; are subject to SEC reporting requirements; or is an investment company.[160] This constitutes a very big exemption since

[156] Section 4A(a)(9) JOBS Act; Section 4A(a)(10) JOBS Act; Section 4A(a)(11) JOBS Act.

[157] While not mentioned in the JOBS Act, the proposed rules by the SEC introduce the requirement for an intermediary to provide for communication channels on its platform giving investors the possibility of communicating under certain conditions with each other and/or representatives of the issuer about offerings. Funding portals however would not be allowed to participate in these communications since they are prohibited from providing investment advice or recommendations. They would however be allowed to establish guidelines for the communications in terms of the length or size of individual posting and be in charge of the content removing abusive or potentially fraudulent communications.

[158] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p.228-229.

[159] Section 4C(3)(e) JOBS Act.

[160] Section 4C(3)(f) JOBS Act.

it will allow mutual funds, closed-end funds, unit investment trusts, investment advisors, brokers/dealers and public companies to trade crowdfunding interests as they please, contrary to the general public. It also creates fraud possibilities. Investment companies aiming at bigger profits and competition advantages might facilitate the creation of fraudulent crowdfunded securities by trading them amongst themselves at higher prices, selling them to the general crowd right before the prices fall and the actual lower value of the security is reflected.[161]

3.3. Issuers of crowdfunding interests

In addition to crowdfunding platforms, also the entrepreneurs issuing the crowdfunding instruments will be subject to new rules, requiring them to provide a large variety of information to potential investors as well as to the portals and the SEC.[162] Section 4A(b) of the JOBS Act requires issuers to provide certain specific information such as their name, legal status, physical address and website. But also the names of the directors, officers (and any persons occupying a similar status or performing a similar function), and persons holding more than 20% of the shares of the issuer. Furthermore a business plan describing the current or projected anticipated business must be disclosed supplemented with information regarding the firm's current financial condition. The type of information depends on the size of the offering: offerings lower than $100 000 require income tax returns of the issuers or financial statements certified by the CEO; offerings between $100 000 and $500 000 require a CPA-reviewed financial statement; and offerings above $500 000 require an audited financial statement.[163]

Additional requirements are implemented to protect investors from changes that might significantly and unfairly reduce their share of ownership in the firm. Firstly information regarding the price of the offered securities; the terms (price, structure of the deal, etc.); as well as the legal and other conditions/rules that might impact these ownership stakes should be provided. Furthermore those changes in the ownership structure affecting potential investors must be described, including information regarding the percentage bought and the conditions under which the ownership interest might change. Additionally detailed description of the risks involved with the purchase of that particular security must be provided.[164]

[161] (Cunningham 2012), p. 90.
[162] (Cunningham 2012), p. 65.
[163] Section 4A(b)(D) of the JOBS-Act.
[164] Section 4A(b)(H) of the JOBS Act.

Firms issuing crowdfunding securities should take into account that until the SEC issues finalized rules, they are not allowed provide compensation to anyone promoting their offerings. Advertisement in terms of the offering is not allowed, except by means of so-called "notices"[165] that guide investors to the funding portal or broker. The permitted notices would be similar to the "tombstone ads" permitted under Securities Act Rule 134, except that the notices would be required to direct investors to the intermediary's platform through which the offering is being conducted, such as by including a link directing the potential investor to the platform.[166] The SEC found this approach to protect investors the most and while limiting the ability issuers have to advertise the terms of the offering without providing the required disclosures, nevertheless allowing them to make use of social media to attract potential investors.[167]

Issuers should be aware of the consequences if the information they provided proves to be erroneous, since they are strictly liable for any material misstatements and omissions. Investors are given the possibility of bringing a legal action against a firm in order to recover their money if it becomes known the issuer has omitted, hid or shaded information as to give a more favorable presentation of the situation.[168] Unfortunately while protecting investors, this provision might give rise to legal abuse if statements made by issuers at the start of the fundraising process will be used against them at a later moment.[169]

[165] The proposed rules by the SEC allow for notices advertising the term of the offering to include no more than the 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 potential 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 website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer. Under the proposed rules, "terms of the offering" would include: (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period.
[166] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 109-110.
[167] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 110.
[168] Section 4A(c) of the JOBS-Act.
[169] (Cunningham 2012), p. 121.

3.4. Conclusion

The wording of the JOBS Act includes some ambiguities, inconsistencies and even drafting errors such as the pre-emption provision containing a cross-reference to the wrong subsection of the Securities Act.[170] Section 4A(b), requires the issuer to disclose the names of every person owning more than 20% of their *shares*.[171] Section 4A(b) then continues by requiring disclosure of the names of each person owning more than 20% of *any class of its shares*.[172]

Made by men, all rules and regulations are sadly equally prone to flaws as their creators rendering the occurrence of some errors and inconsistencies unfortunately inescapable. More importantly is the question whether in the long run the Act can achieve its primary purpose. Based on the premise that social media technologies in particular are more likely to facilitate rather than decrease the potential for fraud,[173] it comes as no surprise that already prior to the enactment of the JOBS-Act many concerns regarding investor protection were raised. However at present these worries seem to be rather unfounded when looking at the numerous regulatory requirements accompanying the crowdfunding exemption. The JOBS-Act imposes such a large variety of additional requirements in order for the crowdfunding-exemption to apply that it seems the SEC has lost sight of the initial purpose of the Act in the exercise of its rulemaking authority. While fraud is indeed a valid and important concern,[174] the primary purpose of the Act was to increase access to capital markets by removing obstacles as costly registration requirements. Already prior to the publication of the proposed rules some - dreading the negative impact over-regulation could have on the crowdfunding industry and job creation[175] – advocated a less onerous exemption.[176] Many requirements might not have been necessary in the first place if the exemption had been created to facilitate relatively smaller offerings - not more than $250,000, or offerings up to $500,000 with investments limited, for example, to no more than $1,000[177] - instead of the selected authorized amount of

[170] The JOBS Act adds a new subsection section 18(c)(2)(F) to the Securities Act which is applicable to securities covered pursuant Subsection (b)(4)(B). Section 18(b)(4)(B) however covers securities that are exempt pursuant to section 4(4) of the Securities Act and has nothing to do with crowdfunding. It is evident the drafters intended subsection (F) to cover Section 4(6) whereas the heading of subsection (F) is "FEES NOT PERMITTED ON CROWDFUNDED SECURITIES."
[171] Section 4A(b)B JOBS Act.
[172] Section 4A(b)H(iii) JOBS Act.
[173] (T. L. Hazen 2011), p. 36.
[174] (Schwartz 2012), p. 34-35.
[175] (Fink 2012), p. 27.
[176] (T. L. Hazen 2011), p. 5.
[177] (Cohn 2012), p. 1436.

one million dollars during a twelve-month period. Furthermore setting the maximum aggregate amount at $1 million over a 12-month period could result in lost opportunities for entrepreneurs who might not be able to raise the required capital.[178]

While the Congressional process started with a rather simple exemption, as a result of the many concerns regarding investor protection eventually substantial additional requirements were imposed on issuers and intermediaries.[179] Both issuers and intermediaries are required to register with the SEC. Furthermore intermediaries are burdened with an additional requirement to file for registration with the applicable SRO. The eventual development of funding portals will strongly depend on whether the possible liabilities and transaction costs resulting from the considerable amount of responsibilities intermediaries are charged with are proportionate to the profits generated from crowdfunded offerings.[180] It is doubtful whether intermediaries and issuers will be eager to assume the time, cost and risks of possible liabilities for offerings under $250,000.

Another peculiarity of the Act concerns the issuers' disclosure requirement about the financial condition of the firm where the type of information depends on the size of the offering. If investor protection and transparency are the benchmark this provision makes perfect sense: the larger the targeted amount is the more elaborate and sophisticated the disclosure requirements become. However nowhere does the Act contain a restriction prohibiting the issuer from raising more than the specified targeted amount. The disclosure requirement focuses merely on the targeted amount and not on the sold amount.[181] Platforms could provide for a solution by denying the possibility to purchase any more securities once a certain quantity of securities is sold. In this way the targeted amount and the sold amount of securities would be aligned. However the portals have enough responsibilities of their own and without incentives to structure their platform this way there might be no incentive to intervene. Secondly it is equally strange to impose the requirement to certify financial statements by the CEO while no other federal or state registration exemption contains such an obligation. Nor does the Rule 504 small business exemption require the disclosure of financial statements for offerings up to one million dollars.[182] Furthermore Rule 504 also does not mandate the use of an intermediary; neither does it require annual or other reports to be submitted to the SEC and investors nor any obligations regarding investor qualification in terms of

[178] Sec. 302(a) JOBS-Act; Sec. 4(6)(A) Securities Act of 1933.
[179] (Cohn 2012), p. 1437.
[180] (Cohn 2012), p. 1441.
[181] (C. S. Bradford 2012), p. 204.
[182] (Cohn 2012), p. 1442.

education or understanding of the risks.[183] The biggest advantage of the crowdfunding exemption compared to Rule 504 is the preemption of state registration laws since the costs of registering the offering in each state where it takes place would exceed those accompanying a crowdfunding offering. It should be noted however that while compared to the limited advertising possibilities under the JOBS-Act, Rule 504 allows the issuer to be actively engaged in the advertising of the offering.[184]

Altogether the regulatory environment after the implementation of the JOBS-Act seems to remain rather impractical for relatively small offerings.[185]

[183] (Cohn 2012) Regulation D, Rule 504, 17 C.F.R. § 230.504.
[184] (Cohn 2012), p. 1444.
[185] (Cohn 2012), p. 1444.

Part IV: CROWDFUNDING COMPARED

4.1. Introduction

In the previous Parts the regulatory environment crowdfunding faced before and after the implementation of the JOBS Act was discussed. Until the SEC has finalized the rules regarding Title III of the JOBS Act, start-ups and small businesses seeking to raise capital by offering securities on crowdfunding platforms would be confronted with the regulatory structure as described in Part II. This Part will compare equity crowdfunding to the existing traditional ways of financing a start-up in order to resolve why certain entrepreneurs or investors should prefer crowdfunding above other types of financing.

4.2. Traditional sources of financing

Already early in the lifecycle of start-up the entrepreneur can raise capital by bootstrapping or by seeking help from family and friends whether in the form of donations, loans or equity stakes. Personal relationships are the main motivation to provide the capital and factors such as the ability to repay the loan and the viability of the business are of little of no concern to the providers of capital. Unfortunately family and friends will only be able to provide capital up to a certain limit and eventually the venture will need more capital to grow and generate revenue.

Financial institutions are a second source of capital for starting businesses. Already early in their lifecycle start-ups resort to external debt-sources such as bank financing (personal and commercial bank loans, business credit cards and credit lines). However in exchange for the capital that is provided, the financial institutions generally require the borrower to provide some sort of collateral or guarantee. Unfortunately starting ventures have difficulties meeting the requirements imposed on them.[186]

Venture Capitalists and Angel Investors are another possible source of capital for starting ventures. Venture Capitalists are mainly focused on the return of their investment and therefore tend to focus mainly on start-ups portraying certain characteristics such as high growth potential and the venture's likelihood of going public within a few years. Consequently starting entrepreneurs face difficulties attracting VC's. After their investment VC's expect the value of their shares to grow whereupon they can

[186] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 328.

sell them with large profits.[187] As a consequence of these differences in interests between the VC's and the entrepreneurs their relationship is dominated by agency costs, uncertainties and information asymmetries. These obstacles are mainly mitigated through private ordering. Still it should be borne in mind that even though many agency costs can be reduced through contracting, as a result of these contracting techniques venture capitalists, who neither necessarily possess the passion nor interest regarding the long-term success of the company[188] become partial owners of the venture giving them the possibility to be actively involved in the course of business.[189] Nonetheless their involvement is at the same time one of the biggest advantages of venture capital financing, for in addition to the provision of capital venture capitalists also contribute their expertise.[190]

While equity crowdfunding might not be a feasible option for raising small amounts of capital in terms of cost and time, other crowdfunding models nevertheless remain available. The first two crowdfunding models (donation based & reward-based crowdfunding) do not require the entrepreneur to give up part of the ownership of the venture, which is an advantage over the traditional Venture Capitalists.

4.3. Crowdfunding evaluated

Crowdfunding offers many advantages. Crowdfunding makes direct contact with the crowd, this can be a potential investor but also a potential consumer. The interest of the crowd to finance a project is a great indication for the entrepreneur that the market is interested in his product. Furthermore through the use of the Internet large amounts of people can be reached and the product can be advertised and financed at the same time.[191] Crowdfunding in this way can help the entrepreneur to gain better knowledge of the tastes of consumers in an easier way and absolutely free, contrary to the focus groups that were used in the old days, where the entrepreneur would pay several hundred dollars per day to the participants.[192] Distance is an important factor in financing a venture. Costs of certain activities that are particularly important for investors of starting businesses such as gathering information, monitoring progress and providing input, are sensitive to distance.[193] Research shows investors in start-ups tend to be local

[187] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 331.
[188] (Young 2013), p. 15-16.
[189] (Gilson 2002), p. 1069.
[190] (The National Venture Capital Association 2009), p. 6.
[191] (Belleflamme, Lambert, and Schwienbacher 2012).
[192] (Young 2013), p. 16.
[193]("Friends, Family, and the Flat World: The Geography of Crowdfunding" 2014), p. 1.

whereas distant investors are mostly investing in publicly trading company.[194] Additional research shows that more than 50% of Angel Investors are within a half a day of travel from the entrepreneurs they finance. By making use of the Internet, crowdfunding can reach investors everywhere and overcome the distance related economic frictions.[195]

In addition to creating or validating the market of the product, crowdfunding allows the entrepreneur to maintain control of all the aspects the financing process of the offering. The entrepreneur decides upon the amount he intends on raising, the timing of the issue, the site on which he wants to list his venture and most importantly he is not obliged to give up parts of his ownership stakes in order to obtain capital.[196]

Crowdfunding has also several disadvantages. Dealing with such a large number of investors can be stressful and where other ways of financing a start-up involve a small group or often merely one investor coaching and guiding the new venture from its inception, taking advice from a thousand investors will in addition to the practical aspects, will also deprive the entrepreneur from skilled guidance and experienced advice.

4.4. Expectations of success

Repeatedly referred to as a the new financing method able to potentially fill the financing gap start-ups and small businesses in their early stage phase, it remains to be seen in what ways crowdfunding might accomplish this task. Where it is obviously not possible to predict the exact amount, type and size of the potential issuers willing to rely on the crowdfunding exemption, based on the current number of businesses pursuing similar levels of financing through alternate capital raising methods[197], the SEC estimates the amount of issuers to be in the thousands annually.[198] The SEC based this estimate on the following numbers:

- 54,500 small businesses received funding through SBA's main lending programs, 7(a) and 504 loans according to the SBA's fiscal year 2011 annual performance report;
- 181,440 unique issuers conducting donation- or reward based crowdfunding campaigns;

[194] The average distance between a Venture Capitalist and a firm is approximately 70 miles.
[195] ("Friends, Family, and the Flat World: The Geography of Crowdfunding" 2014), p. 1.
[196] (Cunningham 2012), p. 70.
[197] Small business loans, reward-based and donation-based crowdfunding & Regulation D offerings.
[198] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 337.

- 15,616 unique issuers of Regulation D offerings sizes of $1 million or less.[199]

While these statistics can serve as a basis in order to deliver an estimate of the potential number of issuers that might rely on the new crowdfunding exemption, the exact outcome remains to be seen. The success of crowdfunding will depend on different factors such as whether these financing methods will substitute or complement each other and if so how.

[199] Amount is excluding hedge funds and investment companies since they would not be eligible to raise capital in reliance on the Section 4(a)(6) exemption.

4.5. Conclusion

Whether an entrepreneur would prefer crowdfunding above other types of financing when seeking capital for his starting venture would mainly depend on the type of entrepreneur, venture and amount of capital he seeks to raise. According to the SEC potential issuers of crowdfunding securities would be start-ups which are close to the "idea" stage of the business venture which have business plans that are not sufficiently well-developed or do not offer the profit potential or business model to attract VC's or Angel Investors.[200] An entrepreneur seeking to raise funds through crowdfunding would therefore typically be focussed on raising small amounts of individual contributions provided by a large number of people.[201] Since the general public is providing the capital it becomes clear that the appeal of the venture requiring financing will be of great importance. Depending on the nature and size of the project, crowdfunding can be used to raise smaller amounts of capital meant to support small artistic, philanthropic projects or be aimed at raising hundreds of thousands of dollars if used as an alternative to a traditional venture capital investment.[202]

Even though the relationship between the entrepreneur and venture capitalist serves as fertile soil where agency costs, uncertainties and information asymmetries can grow, they clearly possess a higher level of knowledge and expertise concerning the risks associated with investments in starting businesses. Entrepreneurs seeking financing should bear in mind that while crowdfunding not only provides the needed capital but also validates the product, the crowd is not likely posses the same valuable expertise that makes venture capitalists so attractive.

[200] "Crowdfunding; Proposed Rules", 79 FR 3926-01, 2014 WL 232492 (F.R.), p. 338-339.
[201] (C. Bradford 2012), p. 5.
[202] (Schwienbacher and Larralde 2010).

CONCLUSION

Based on the presumption of small businesses being the engine of job creation, directly interdependent with economic prosperity, it comes as no surprise the decline in survival rates of start-ups and small businesses over the last years has raised many concerns. Within a climate where start-ups are struggling to obtain financing through the use of conventional types of capital formation, crowdfunding emerged as the contemporary new type of business financing technique that allows a large group of ordinary investors to provide small amounts of capital by making clever use of the Internet. As we have seen, until the SEC has finalized the rules regarding Title III of the JOBS Act, the costly and time consuming registration requirements accompanying equity-crowdfunding within the current regulatory framework render it not to be viable financing method in terms of raising smaller amounts of capital. Whether the JOBS-Act is able serve its primary purpose and be useful to start-ups will strongly depend on the rules proposed by the SEC. The SEC has certainly not been assigned with a simple task. Where extensive regulation of crowdfunding is very likely to have a negative affect on its viability as a business financing technique, a certain degree is required to guarantee investor protection. Unfortunately where regulatory costs and other burdensome regulatory requirements were the main aspects eliminating crowdfunding as an option for small ventures, the new issuer requirements remain complicated and costly - issuers are required to prepare financial statements even for the smallest offerings. Furthermore statements from $100 000 have to be reviewed by an independent accountant and offerings above $500 000 have to be audited. And even after the offering is completed there is an additional annual reporting requirement. It is doubtful whether intermediaries and issuers will be eager to assume the time, cost and risks of possible liabilities for offerings under $250,000.

Had the SEC not elected the old regulatory environment as the benchmark when drafting the rules and instead focused primarily on the eventual aim of the Act, they might have been able to create both an effective exemption while sufficiently safeguarding investor protection. Nevertheless while the new rules might prevent equity crowdfunding from meeting the high expectations of becoming the new type of capital formation individually responsible for closing the financing gap starting entrepreneurs face, in spite of their drawbacks they nevertheless provide for a much needed new source of capital.

BIBLIOGRAPHY

Acs, Zoltan. 2006. "How Is Entrepreneurship Good for Economic Growth?" *Innovations: Technology, Governance, Globalization* 1 (1) (January 29): 97–107. doi:10.1162/itgg.2006.1.1.97. http://www.mitpressjournals.org/doi/abs/10.1162/itgg.2006.1.1.97#.U0laSuZ_tgs.

Bayus, Barry L. 2013. "Crowdsourcing New Product Ideas over Time: An Analysis of the Dell IdeaStorm Community." *Management Science* 59 (1) (January 1): 226–244. doi:10.1287/mnsc.1120.1599. http://dl.acm.org/citation.cfm?id=2432642.2432657.

Belleflamme, Paul, Thomas Lambert, and Armin Schwienbacher. 2012. "Crowdfunding: Tapping the Right Crowd." *SSRN Electronic Journal* (July 9). doi:10.2139/ssrn.1836873. http://papers.ssrn.com/abstract=1836873.

Bernanke, Ben S. 2010. "Restoring the Flow of Credit to Small Businesses: A Speech at the Federal Reserve Meeting Series: 'Addressing the Financing Needs of Small Businesses,' Washington, D.C., July 12, 2010." *Speech*. http://ideas.repec.org/p/fip/fedgsq/534.html.

Bradford, C. 2012. "Crowdfunding and the Federal Securities Laws". DigitalCommons@University of Nebraska - Lincoln.

Bradford, C. Steven. 2012. "The New Federal Crowdfunding Exemption: Promise Unfulfilled" (May 24). http://papers.ssrn.com/abstract=2066088.

Brian Hamilton. 2014. "The JOBS Act: IPO on-Ramp or Public Company off-Ramp? - Forbes." Accessed February 20. http://www.forbes.com/sites/sageworks/2012/05/07/the-jobs-act-ipo-on-ramp-or-public-company-off-ramp/.

Choi, Stephen. 2012. *Securities Regulation : Cases and Analysis*. [New York NY]: Foundation press/Thomson West.

Cohn, Stuart R. 2012. "New Crowdfunding Registration Exemption: Good Idea, Bad Execution, The." *Florida Law Review* 64. http://heinonline.org/HOL/Page?handle=hein.journals/uflr64&id=1453&div=&collection=journals.

Colby. 2012. "What Is a Broker-Dealer? - Davis Polk & Wardwell." https://www.yumpu.com/en/document/view/6687580/what-is-a-broker-dealer-davis-polk-wardwell.

Cosh, Andy, Douglas J. Cumming, and Alan Hughes. 2007. "Outside Entrepreneurial Capital" (August 17). http://papers.ssrn.com/abstract=663841.

Cross, F. 2006. "The Economic Value of Securities Regulation." *Cardozo Law Review.* 28 (1): 333 – 390.

Cunningham, William. 2012. "The Jobs Act Crowdfunding for Small Businesses and Startups". Berkeley, CA :: Apress :;Imprint: Apress,.

Ernst, H., C. Leptien, and J. Vitt. 2000. "Inventors Are Not Alike: The Distribution of Patenting Output among Industrial R&D Personnel." *IEEE Transactions on Engineering Management* 47 (2) (May): 184–199. doi:10.1109/17.846786. http://ieeexplore.ieee.org/lpdocs/epic03/wrapper.htm?arnumber=846786.

Fink, Andrew C. 2012. "Protecting the Crowd and Raising Capital through the CROWDFUND Act." *University of Detroit Mercy Law Review* 90. http://heinonline.org/HOL/Page?handle=hein.journals/udetmr90&id=7&div=&collection=journals.

"FINRA Regulatory Notice 13-34 (October 2013)." 2014. Accessed May 7. http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p370743.pdf.

"Friends, Family, and the Flat World: The Geography of Crowdfunding." 2014. Accessed February 3. http://www.crowdsourcing.org/document/friends-family-and-the-flat-world-the-geography-of-crowdfunding/11219.

"General Information: Regulation of Investment Advisers." 2014. Accessed May 7. http://www.sec.gov/divisions/investment/iaregulation/memoia.htm.

Gilson, Ronald J. 2002. "Engineering a Venture Capital Market: Lessons from the American Experience." *Stanford Law Review* 55. http://heinonline.org/HOL/Page?handle=hein.journals/stflr55&id=1081&div=&collection=journals.

Gueyie, Jean-Pierre. 2013. "Microfinance in Developing Countries Issues, Policies and Performance Evaluation". Houndmills, Basingstoke, Hampshire ;;New York, NY :: Palgrave Macmillan,.

Hammon, Larissa, and Hajo Hippner. 2012. "Crowdsourcing." *WIRTSCHAFTSINFORMATIK* 54 (3) (April 26): 165–168. doi:10.1007/s11576-012-0321-7. http://link.springer.com/10.1007/s11576-012-0321-7.

Hazen, Thomas. 2009a. *Securities Regulation in a Nutshell*. St. Paul MN: West.

———. 2009b. *The Law of Securities Regulation*. St. Paul MN: Thomson/West.

Hazen, Thomas Lee. 2011. "Crowdfunding or Fraudfunding - Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure." *North Carolina Law Review* 90. http://heinonline.org/HOL/Page?handle=hein.journals/nclr90&id=1747&div=&collection=journals.

"Help Center — Kickstarter." 2014. Accessed May 7. https://www.kickstarter.com/help.

Heminway, J. 2011. "Proceed at Your Peril: Crowdfunding and the Securities Act of 1933." *Tennessee Law Review.* 78 (4): 879 – 972.

House, Commerce Clearing. 2014. *Federal Securities Law Reporter: Federal Regulation of Securities : Laws, Regulations, Forms, Rulings and Decisions Currently Supplemented and Indexed, Issue 2398*. Commerce Clearing House. Accessed May 7. http://books.google.com/books?id=x8Y-AQAAIAAJ&pgis=1.

Howe, Jeff. 2006. "The Rise of Crowdsourcing." *Wired*. http://archive.wired.com/wired/archive/14.06/crowds.html.

"Indiegogo FAQ." 2014. Accessed May 7. https://www.indiegogo.com/indiegogo-faq.

"Kiva - Loans That Change Lives." 2014. Accessed May 7. http://www.kiva.org/.

Lee, John. 2011. *The Producer's Business Handbook : The Roadmap for the Balanced Film Producer*. Burlington MA: Focal Press.

Martin, Thomas A. 2012. "The Jobs Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd." *SSRN Electronic Journal* (April 12). doi:10.2139/ssrn.2040953. http://papers.ssrn.com/abstract=2040953.

Mendoza, Jose Miguel, and Erik P. M. Vermeulen. 2011. "The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity." *SSRN Electronic Journal* (May 3). doi:10.2139/ssrn.1829835. http://papers.ssrn.com/abstract=1829835.

Metzler, Tobias. 2011. "Venture Financing by Crowdfunding". München: GRIN Verlag GmbH.

Mollick, Ethan. 2014. "The Dynamics of Crowdfunding: An Exploratory Study." *Journal of Business Venturing* 29 (1) (January): 1–16. doi:10.1016/j.jbusvent.2013.06.005. http://www.sciencedirect.com/science/article/pii/S088390261300058X.

Neiss, Sherwood. 2013. "Crowdfund Investing for Dummies". Hoboken, N.J. :;Chichester :: Wiley ;;John Wiley [distributor],.

"Our Movement | RocketHub." 2014. Accessed May 7. http://www.rockethub.com/about.

"Overview of Razoo - Razoo." 2014. Accessed May 7. http://www.razoo.com/p/overview.

Palmiter, Alan. 2008. *Securities Regulation*. New York NY ;Austin TX [etc.]: Aspen Publishers ;;Wolters Kluwer Law & Business.

Pearce, Rupert. 2006. "Raising Venture Capital". Chichester, West Sussex, England :: John Wiley,.

Penn, Tom. 2003. "HISTORY - The Meaning of Everything - The Story of the Oxford English Dictionary." *TLS, the Times Literary Supplement.* (5248).

Pope, Nikki D. 2011. "Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption" (August 25). http://papers.ssrn.com/abstract=1916985.

Schwartz, Andrew A. 2012. "Crowdfunding Securities." *Notre Dame Law Review* 88. http://heinonline.org/HOL/Page?handle=hein.journals/tndl88&id=1491&div=&collection=journals.

Schwienbacher, Armin, and Benjamin Larralde. 2010. "Crowdfunding of Small Entrepreneurial Ventures." *SSRN Electronic Journal* (September 28). doi:10.2139/ssrn.1699183. http://papers.ssrn.com/abstract=1699183.

"SEC.gov | Compliance Guide to the Registration and Regulation of Brokers and Dealers." 2014. Accessed May 7. http://www.sec.gov/divisions/marketreg/bdguide.htm.

"SEC.gov | SEC Issues Proposal on Crowdfunding." 2014. Accessed May 7. http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.U2pOLOZ_tgt.

"Statue of Liberty — Statue of Liberty History." 2014. Accessed May 7. http://statueofliberty.org/Statue_History.html.

Stemler, A. 2013. "The JOBS Act and Crowdfunding: Harnessing the Power-and Money-of the Masses." *Business Horizons* 56 (3): 271 – 275.

The National Venture Capital Association. 2009. "Venture Impact: The Economic Importance of Venture Backed Companies to the U.S. Economy." *Fifth Edition*. http://www.nvca.org/index.php?option=com_content&view=article&id=255&Itemid=103.

Vermeulen, Erik P. M., and Diogo Pereira Dias Nunes. 2012. "The Evolution and Regulation of Venture Capital Funds." *SSRN Electronic Journal* (October 17). doi:10.2139/ssrn.2163193. http://papers.ssrn.com/abstract=2163193.

Verstein, Andrew. 2011. "The Misregulation of Person-to-Person Lending." *SSRN Electronic Journal* (November 21). doi:10.2139/ssrn.1823763. http://papers.ssrn.com/abstract=1823763.

Young, Thomas. 2013. *Guide to Crowdfunding : Learn How to Use Social Media for Small Business Funding - Understand Crowd Psychology, Gain an Online Presence, Create a Successful Crowdfunding Campaign, Promote Your*. Adams Media Corporation.

Zablit, Andrew JP; Manget J; Michael DC; Taylor A; 2010. "Innovation 2010: A Return to Prominence and the Emergence of a New World Order." *Report, Boston Consulting Group, Bethesda, MD*. http://www.bcg.nl/documents/file42620.pdf.

Securities Act of 1933, 15 U.S.C. §78a et seq.
Available at: http://www.sec.gov/about/laws/sa33.pdf.

Securities Exchange Act of 1934, 15 U.S.C. §77a et seq.
Available at: http://www.sec.gov/about/laws/sea34.pdf.

Jumpstart Our Business Startups Act, 2012.
Available at: http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

Eastside Church of Christ v. Nat'l Plan, Inc., 391 F.2d 357, 361 (5th Cir. 1968).

SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

United Housing Foundation, 421 U.S. 837 (1975).

Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp., 411 F.Supp. 411, 415 (1976).

Teamsters v. Daniel, 439 U.S. 551 (1979).

SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

Lowe v. SEC, 472 U.S. 181 (1985).

Reves v. Ernst & Young, 494 U.S. 56, 63 (1990).

United States v. Elliott, 62 F.3d 1304, 1309–10 (11th Cir. 1995).

SEC v. Deyon, 977 F.Supp. 510, 518 (D.Me.1997).

SEC v. Kenton Capital LTD, 69 F.Supp.2d 1 (1998).

SEC v. Zubkis, No. 97 Civ. 8086, 2000 WL 218393 (S.D.N.Y. Feb. 23, 2000).

SEC v. Edwards 540 U.S. 389 (2004).

S.E.C. v. Offill, 2012 WL 246061 (N.D. Tex. Jan. 26, 2012).

Nito GmbH, SEC No-Action Letter, 1996 WL 473433.

Progressive Technology, Inc., SEC No-Action Letter, 2000 WL 1508655.

MuniAuction, Inc., SEC No-Action Letter, 2000 WL 291007.

Oil-N-Gas, Inc. SEC No-Action Letter, 2000 WL 1119244.