Crowdfunding Securities in the United States: Who wins and who loses?

REGULATORY ANALYSIS

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César Andrés Barajas Ruiz

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Supervisor: Vladimir Mirkov

ABSTRACT

Securities-based crowdfunding has already been regulated in the United States by means of the Jobs Act. The Jobs Act was intended to provide start-up companies with access to a wider variety of investment capital. Title III of the Jobs Act, which was finally adopted and took effect on May 16, 2016, allowed small and unaccredited investors to make investments in start-up companies that had previously been offered solely to so-called “accredited’’ investors.

Securities-based crowdfunding has been subject to substantial criticism. Potential fraud has been the driving concern. Combining high-risk investments, unaccredited (unsophisticated) investors, and the Internet could be a perfect recipe for fraud. Therefore, regulators face the challenge of effectively balancing access to capital by small businesses and investor protection. Yet, beyond fraud, there are a lot of issues that have not been correctly addressed yet. This thesis explains and analysis the impact of the existing regulation in the United States on securities-based crowdfunding industry. This thesis also analyses how the absence of an organized efficient secondary market where crowdfunding securities can be traded will affect the securities-based crowdfunding industry and will constrain the growth of this market.

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INTRODUCTION

Capital is the lifeblood of a growing business. [1] Raising capital for start-up companies and small businesses is challenging and requires creativity and perseverance. These companies are not always able to access to traditional sources of financing mainly due to the lack of funding opportunities. In recent years, the financial services industry is becoming increasingly democratic as it continues to move online and becomes more automated, at once empowering consumers, disrupting existing banking services and creating new markets for the benefit of their participants.[2] Goldman Sachs, in its report on socialization of finance in 2015 stated that finance meet the network effect[3] since more people have access to financial services beyond the walls of traditional financial institutions.[4] Under this context, crowdfunding has emerged as an efficient alternative of financing for start-up companies.

This thesis focuses, but no exclusively, on equity-based crowdfunding in accordance with the Title II and III of the Jobs Act (Jumpstart Our Business Startups Act) which relate to securities-based crowdfunding to accredited and non-accredited investors in the United States. Under this framework, this thesis will address, how the existing regulation in the United States along with the absence of an organized secondary market will affect the equity crowdfunding industry and will constrain the growth of this market?

It is no secret that start-up companies present extreme levels of uncertainty about their businesses and performance. As a consequence, bank loans and other financing mechanisms are typically out of reach for start-up companies who have no collateral, credit history, or track-record.[5] Bankers do not take the risk to lend money to this kind of businesses that could not have the ability to repay

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[1] D. Mathieson, E. Kalter, M. Watson and G. Kincaid, *International Capital Markets: Developments and Prospects* (International Monetary Fund 1986).
[2] Heath Terry, Debra Schwartz and Tina Sun, 'The Future of Finance: The Socialization of Finance' (2015) Part 3 Goldman Sachs Equity Research 1 page 7.
[3] A product displays positive network effects when more usage of the product by any user increases the product's value for other users <http://oz.stern.nyu.edu/io/network.html>
[4] Heath Terry, Debra Schwartz and Tina Sun, 'The Future of Finance: The Socialization of Finance' (2015) Part 3 Goldman Sachs Equity Research 1.
[5] Gmeleen Faye B. Tomboc, 'The Lemons Problem in Crowdfunding' (2013) XXX J. Information Technology & Privacy Law 253, 256.

the debt. Hence, small businesses are forced to seek funding alternatives mainly due to the lack of financing options.[6]

Equity-based crowdfunding (securities-based crowdfunding) provides an alternative source of funding that could help plug the capital gap facing start-up companies.[7] Using this model, startups and small businesses may raise money from the crowd (i.e. a large number of people) over the Internet. The crowd may invest in early-stage unlisted companies (i.e. a company which is not listed on a stock exchange) in exchange for an ownership stake. Investors receive equity, meaning shares of a company, instead of a simple reward.[8] A mobile device with access to the Internet would be sufficient to fund anything at any time via crowdfunding platforms. In equity-based crowdfunding, there are three primary actors, to wit: (i) entrepreneurs (start-up companies), (ii) investors, and (iii) funding platforms.[9]

In a relatively short period and with millennials as agents of change, equity-based crowdfunding has become a phenomenon worldwide. Crowdfunding has evolved from being a primarily non-equity model that allowed people to donate money through online platforms without receiving any stock participation to an equity-crowdfunding investment alternative.[10]

As a result, in 2015, the total equity crowdfunding volume worldwide was USD$2.56 billion[11] and the World Bank estimated that equity crowdfunding would reach USD$90 billion by 2020.[12] China is currently the world's largest equity-based crowdfunding market regarding market volume, reaching USD$948.26 million in 2015 and ranking above both the US (USD$598.05 million) and

[6] A Sherman, *Raising Capital: get the money you need to grow your business* (Amacom 2012).
[7] David Mashburn, 'The Anti–Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies' (2013) 63 Emory Law Journal 127, 140.
[8] Heath Terry, Debra Schwartz and Tina Sun (n2) para 10.
[9] Ajay Agrawal, Christian Catalini and Avi Goldfarb, 'Some Simple Economics of Crowdfunding' (2013) 14 Innovation Policy and the Economy 63, 70.
[10] Jake Fisher, 'Top Trends in Equity Crowdfunding: Big Things are Happening '(Medium.com 28th January, 2017) para 5 <https://medium.com/crowdfund-research/top-trends-in-equity-crowdfunding-7db76efd7cae> accessed 8 May, 2017.
[11] Crowdfunding Industry Statistics 2015 2016 <http://crowdexpert.com/crowdfunding-industry-statistics/> accessed on 9 May 2017.
[12] Chance Barnett, 'Trends Show Crowdfunding to Surpass VC In 2016' (Forbes.com, 9 June 2015) para 5 <https://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/2/#666fab49666f> accessed on 19 May, 2017.

the UK (£332 million, about USD$405.45 million). Also, as per World Bank forecasts, the size of China's crowdfunding market is expected to reach USD 46 billion to 50 billion by 2025, of which equity-based crowdfunding would comprise 70% to 80%.[13]

New generations are highly attracted to this model in which they have more control over their funds. Equity crowdfunding provides flexibility to entrepreneurs to achieve their capital requirements. Therefore, it is a meaningful financing alternative for start-up companies and small businesses to raise capital directly from a broad range of prospective investors without financial intermediaries and with less administrative burdens than a registered offering, such as, an initial public offering which requires several registration requirements and assistance of attorneys, accountants, and underwriters.[14]

Nevertheless, not all is a bed of roses, and securities-based crowdfunding has created a challenge for lawmakers and regulators around the globe since although this model created new investment opportunities it also created the potential for investment fraud. Combining high-risk investments, unaccredited (unsophisticated) investors, and the Internet could be a perfect recipe for fraud. Therefore, regulators face the challenge of effectively balancing access to capital by small businesses and investor protection.[15]

Regulators across the globe choose one of four positions to deal with this matter, to wit: (i) ignore this phenomenon, (ii) reaffirm which regulations apply, (iii) create new rules, or (iv) restrict this phenomenon.[16] Based on these different approaches, for instance, in China, Egypt, India, and parts of Africa, securities regulators have adopted a wait-and-see approach to weigh the balance between potential gains of equity-based crowdfunding and the risks of fraud and abuse. In the United Kingdom, France, Germany, and Australia, regulators have used existing securities regulation to

[13] Dr. Lin Lin, 'Managing the Risks of Equity Crowdfunding: Lessons from China: Journal of Corporate Law Studies, forthcoming 2017' (2017) National University of Singapore, Centre for Banking & Finance Law, Faculty of Law, page 3.
[14] David Mashburn (n7) page 141.
[15] Thomas Lee Hazen, 'Crowdfunding or Fraudfunding - Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure' (2012) 90 UNC School of Law, North Carolina Law Review, 1735, 1738.
[16] Garry A. Gabison, 'Equity Crowdfunding: All Regulated but Not Equal' (2015) 13 Depaul Business & Commercial Law Journal 359, 362.

create limited exemptions for securities-based crowdfunding. In the United States, Italy and New Zealand, specific rules to permit securities-based crowdfunding have been adopted.[17] In Colombia, the Colombian Finance Superintendency, which is the government agency in charge of the surveillance and control of the finance sector in Colombia, has restricted securities-based crowdfunding until the Colombian Congress has duly enacted specific regulation and so far it has not occurred.[18]

Notwithstanding the different approaches of the local regulators, many issues involved in the equity-based crowdfunding industry have not been correctly addressed and many practical problems about this emerging industry have not been tested yet. For instance, in the United States, where equity crowdfunding has already been regulated by means of the Jobs Act, the major part of the equity-crowdfunding regulation relates to the primary market and how start-up companies may offer and sell its securities (i.e. shares) through electronic platforms to investors in order raise money. However, there is limited regulation of crowdfunding securities' secondary market (i.e. how investors may resell crowdfunding securities to another investor promptly and at low cost).

Furthermore, there is no organized secondary market where these securities can be traded, such as NASDAQ or NYSE, and to make it worse, crowdfunding securities in the United States are not freely tradable. Hence, investors who hold crowdfunding shares in the US are limited in their capability to resell them within the first year of ownership. These securities are referred to as "restricted" securities.[19] As a consequence, crowdfunding securities are less liquid and costlier to resell than any other regular security which is traded on an organized secondary market. The legal restriction on resale and the absence of an organized secondary market severely impact the liquidity and market for crowdfunding securities given that investors willing to resell their securities might waste time and money to complete a resale transaction.[20] A lack of exit strategies jeopardizes equity-based crowdfunding.

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[17] Joseph J. Dehner and Jin Kong, 'Equity-Based Crowdfunding Outside the USA' (2014) 83 University of Cincinnati Law Review 413, 418.
[18] *Superintendencia Financiera de Colombia*, 'Alternativas de regulación del crowdfunding' (August, 2016).
[19] S. Choi and A.C. Pritchard *Securities Regulation: Cases and Analysis* (University Casebook Series 2015) page 610.
[20] S. Choi and A.C. Pritchard (n19).

An organized secondary market plays a significant role in securities transactions. As explained by professors Pritchard and Choi in their book, *Securities Regulation: Cases and Analysis*, investors who can rely on a liquid and transparent secondary market in which to resell their securities will be more willing to purchase securities from issuers in the primary market.[21]

Moreover, without an organized secondary market it would be tough to prove loss causation in a claim for fraud. Therefore, as will be explained in Chapter II, plaintiffs seeking to recover investment losses under Rule 10b-5 of the Securities Exchange Act of 1934, which is the principal statutory provision against fraud in the United States, would not have the grounds to establish a claim for fraud.[22]

Also, an organized secondary market is essential to determine if a particular market is efficient. That is, whether the all the available information is duly reflected in the stock price.[23] Thus, an organized secondary market would help to mitigate the lemons problem[24] in the equity-based crowdfunding industry as will be explained in Chapter II below.

This thesis proceeds in four chapters. Chapter I below provides a background on equity crowdfunding, including a description of US regulation and the benefits and risks associated with this industry. Chapter II critically examines the US law regarding crowdfunding securities and how this regulation and the absence of an organized secondary market affect the crowdfunding industry from a commercial, economic, legal and practical point of view. Chapter III includes a case study which provides a detailed contextual analysis (empirical) on a securities-based crowdfunding transaction within its real-life context. Chapter IV provides some views about the future of crowdfunding and how Blockchain technology would have an impact on this business.

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[21] S. Choi and A.C. Pritchard (n19) page 11.

[22] Sherief Morsy, 'The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs'' (2014) 79 Brooklyn Law Review 1373, 1374.

[23] Sherief Morsy (n22) para 3.

[24] A "lemons market" is a market in which asymmetric information exists between sellers and buyers. Since the buyers are not fully informed as to the quality of the products, they discount the price of all products. High quality products will not sell for a price that reflects their quality and will, thus, exit the market. Only "lemons" are left in the market. (Darian M. Ibrahim, 'Equity Crowdfunding: A Market for Lemons?' (2015) 100 Minnesota Law Review 561, 591)

CHAPTER I - AN INTRODUCTION TO SECURITIES-BASED CROWDFUNDING

To understand how the existing US regulation and the absence of an organized secondary market may affect the equity crowdfunding industry, it is first necessary to briefly consider the background of crowdfunding, including the different types of crowdfunding, the risks, and benefits associated with this industry and its regulation in the United States.

1. What is crowdfunding?

As explained by Professor C. Steven Bradford in his article, *Crowdfunding and the Federal Securities Laws*,[25] the basic concept of crowdfunding is to raise money through relatively small contributions from a large number of people (i.e. the crowd) by means of the Internet. Under this model, an entrepreneur can in real time and with no incremental costs sell securities to millions of potential investors. To make a contribution, no intermediary such as a bank or an underwriter would be required. Anyone who can convince the public he has a good business idea can become an entrepreneur, and anyone with a few dollars to spend can become an investor.

1.1. Crowdfunding background

As pointed out by Professor Andrew Schwartz in his paper, *Crowdfunding Securities*, the concept of crowdfunding has its origins in "crowdsourcing" which is a type of participative online activity in which a company or individual proposes to a group of individual via Internet the voluntary undertaking of a task (e.g. Wikipedia). Crowdfunding differs from crowdsourcing in the sense that the crowd (i.e. the people) is called to contribute capital instead of labor to the project.[26]

Crowdfunding arose in response to the lack of financing options faced by small companies. Small businesses have limited access to capital, and they must rely on the traditional banking system. This has been even harder after 2008 US financial crisis and banks which can grant loans to small

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[25] C. Steven Bradford, Crowdfunding and the Federal Securities Laws' (2012) Columbia Business Law Review.
[26] Andrew A. Schwartz, 'Notre Dame Law Review' (2013) 88 Crowdfunding Securities 1457, 1459.

businesses without collateral are charging high-interest rates, which results in the loans becoming less viable. In addition, financial institutions have been forced by the 2008 financial crisis to scale back on riskier consumer and small business lending. An increase in the regulatory and capital requirements have made the loans to start-up companies less attractive to both entrepreneurs and banks.[27]

Furthermore, globalization and innovation are changing the current financial industry. As a result, the structure of some of the most relevant international financial markets worldwide has been altered in the latest years by the development and evolution of new financial instruments. In the interest of the consumers, technology and innovation are driving toward to a new era of financial services. An era where there is a democratization of finance and access to credit due to the broader access to more financial instruments to raise capital by online means at a lower cost and in an efficient way. All of these elements have paved the road for innovators and the rising of new financial instruments, including, of course, crowdfunding.

Crowdfunding could be categorized into five main types, distinguished by what investors are promised in return for their contributions: (i) the donation model (e.g. charitable fund-raising with nothing given in exchange); (ii) the reward model (e.g. donor gets a voucher in return for a contribution); (iii) the pre-purchase model (e.g. concert tickets in exchange for donating to fund a CD);[28] (iv) debt-based crowdfunding; and (v) equity-based crowdfunding.[29]These two last models are subject to surveillance of US securities laws since the underlying instruments (e.g. shares and debt instruments) are considered securities. Taking into account that this thesis focuses on equity-based crowdfunding further description on this model will be provided in the following paragraphs.

[27] Morgan Stanley, 'Can P2P Lending Reinvent Banking?' (2015) <https://www.morganstanley.com/ideas/p2p-marketplace-lending> accessed on 9 May, 2017.
[28] Joseph J. Dehner and Jin Kong, 'Equity-Based Crowdfunding Outside the USA' (2014) 83 University of Cincinnati Law Review 413, 415.
[29] C. Steven Bradford (n25) page 15.

1.2. Equity-based crowdfunding

Equity-based crowdfunding implies that somebody invests money in a company in exchange for an ownership stake. It is a mechanism that allows investors to fund start-up companies in return for shares of the enterprise. In this case, the investment success will depend on the underlying business performance. Consequently, equity financing would be the best source of financing for early-stage companies since unlike in debt-based crowdfunding where the debt (i.e. the money) must be repaid along with payment of interest, in equity-based crowdfunding no monetary obligations arise for the company. In debt-based crowdfunding, the start-up company must have the enough cash flow to honor debt-service[30], and start-up companies often do not have certainty about their future cash flows.

Although studies show that millennials are less interested in stocks compared to prior generations, they are more interested in crowdfunding as an investment opportunity. Millennials hold approximately 52% of their assets in cash and only 28% in stocks, compared to non-millennials who own about 23% of their assets in cash and 46% in stocks. Millennials are more likely to participate in equity crowdfunding; 47% of millennial respondents have backed or are likely to back a crowdfunding campaign, compared to 30% of Gen-Xers, 13% of Boomers, and 4% of Matures. [31] In addition, pursuant to a survey by US Trust, millennials are more likely to accept a lower return or a higher risk related to an investment if it is in a company that could have a positive environmental or social impact.[32]

Equity-based crowdfunding came up as a feasible alternative for start-up companies to raise capital. The Internet allowed individuals to invest money through online platforms to fund entrepreneurs, start-up companies and any small businesses. Consequently, the range of financing techniques available to small businesses to fund their projects has been expanded during the last years. [33]

[30] Andrew Schwartz (n26) pages 1482-1489.
[31] Heath Terry, Debra Schwartz and Tina Sun (n2) page 14.
[32] Heath Terry, Debra Schwartz and Tina Sun (n2) page 16.
[33] Dr. Lin Lin (n13) page 6.

As explained by Professor Andrew Schwartz in his paper, *Crowdfunding Securities*,[34] it can be expected that crowdfunding of securities under the Jobs Act have two primary effects on the US capital markets, (i) crowdfunding will emerge as an important, low-cost method of raising business capital from the public, thus expanding the opportunity for entrepreneurship, and (ii) crowdfunding would break down the regulatory barrier between accredited and retail investors, at least to some extent, and allow non-accredited investors the opportunity to invest in strangers' start-up companies and small businesses.

2. Benefits and Risks

The benefits associated with equity-based crowdfunding have been demonstrated over the last years. The risks related to this business are likewise very relevant. In the next paragraphs, the reader will find a summary of the main benefits and risks associated with equity-based crowdfunding industry.

2.1. Benefits

Equity-based crowdfunding gives an attractive alternative to raise funds for start-up companies and small businesses, and it is an investment choice for prospective investors. Crowdfunding enjoys the advantages of the financial system, without its costs since they have lower operating expenses, all of which is translated into better conditions for both entrepreneurs and investors.[35]

The following are some of the benefits (motivations) for each of the participants involved in an equity-based crowdfunding transaction:[36]

- ✓ Entrepreneurs (Start-up Companies): (i) lower cost of capital than traditional sources of capital, and (ii) access to more information, a crowdfunding campaign serves a marketing purpose.

[34] Andrew Schwartz (n26) page 1466.
[35] Morgan Stanley (n27) para 12.
[36] Agrawal A, Catalini C and Goldfarb A (n9) page 70.

- ✓ Investors: (i) access to new investment opportunities, (ii) early access to new products, (iii) community participation (social activity), and (iv) support for a product, service, or idea.

- ✓ Platforms: most platforms employ a revenue model based on a transaction fee. Thus, it would be possible to state that the primary motivation of the platforms is an economic motivation.

2.2. Risks and feasible solutions

In an equity-based crowdfunding transaction, individuals purchasing securities from start-up companies face a highly risky investment given that the return of the investment depends 100% on the performance of the underlying business and no collateral or any guarantee is provided to secure the equity investment.

Early-stage companies present extreme levels of uncertainty about their business, information asymmetry and agency problem. Crowdfunding investors obtain their information mostly from crowdfunding platforms, and due to the little amount of the investments, investors do not conduct due-diligence over the issuer company. As a consequence, investors would not be able to assess the start-up team's perseverance, interpersonal dynamics, and worthiness online. Entrepreneurs have more information than investors mainly due to a lack of extensive disclosure requirements. All of these facts generate that information asymmetry is presented in an extreme form in an equity-based crowdfunding context.[37] Moreover, it is possible to find agency problem fear in the sense that in a post-investment scenario the entrepreneur will act in a way that benefits himself and not the crowdfunding investors.[38] For instance, start-up companies may use the funds in an inappropriate way or simple issue more shares to themselves in order to dilute other minor shareholders investors.

Another significant issue to invest in start-up companies is the valuation. Potential investors need to know the most accurate value of the companies to determine if the share price is well determined, and in the case of early stages companies a pre-money valuation is a difficult task,

[37] Dr. Lin Lin (n13) page 11.
[38] Darian M. Ibrahim, 'Equity Crowdfunding: A Market for Lemons?' (2015) 100 Minnesota Law Review 561, 573.

and it creates uncertainty about the stock price. The valuation of private companies, especially start-up companies, is quite challenging and there is a high risk of overpaying for the equity investment.[39]

The SEC (Securities Exchange Commission) is also aware of the risks involved in an equity-based crowdfunding transaction. Thus, on May 10, 2017, the SEC issued a bulletin which stated that equity-based crowdfunding offers investors a chance to participate in an early-stage venture, yet, investors must be aware that these investments involve very high risks. Pursuant to the SEC, the following are some risks to consider before making an equity-based crowdfunding investment:[40]

- ✗ Speculative risk: Investments in start-up companies are highly speculative. There is no track record of revenue and income. This is because the success of a start-up company usually relies on the development of a new service or product that may or may not find a market.[41] The SEC suggests that crowdfunding investors should be prepared to lose the entire investment.

- ✗ Illiquidity risk: Under the Jobs Act there is a limitation to resell crowdfunding securities for the first year. In addition, there is no organized secondary marketplace to negotiate these instruments. Thus, there is a risk of liquidity since investors would have to locate an interested buyer to resell a crowdfunding security.

- ✗ Limited disclosure risk: Start-up companies looking to raise capital through a crowdfunding platform need to provide only limited information about their business plan and future plans since they do not have to comply with disclosure requirements fully.

[39] U.S. Securities Exchange Commission (SEC), 'Investor Bulletin: Crowdfunding for Investors' (U.S. Securities Exchange Commission, Feb. 16, 2016) para 13 <https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html> accessed on 17 May, 2017.

[40] U.S. Securities Exchange Commission (SEC), 'Investor Bulletin: Crowdfunding for Investors' (U.S. Securities Exchange Commission, Feb. 16, 2016) para 13 <https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html> accessed on 17 May, 2017.

[41] U.S. Securities Exchange Commission (SEC), 'Investor Bulletin: Crowdfunding for Investors' (U.S. Securities Exchange Commission, Feb. 16, 2016) para 13 <https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html> accessed on 12 May, 2017.

✗ Fraud risk: Taking into account that start-up companies may raise funds through crowdfunding, it may be the case that individual opportunities turn out to be money-losing fraudulent schemes[42]. There is no guarantee that crowdfunding investments will be immune from fraud.

On the other hand, from an entrepreneur point of view, some downsides to equity-based crowdfunding are: (i) loss of corporate control (dilution, in the case of issuance of more shares), and (ii) issuance of shares to the public would generate a personal liability for the founder, directors and officers of the company, since the other new shareholders could sue them for any breach of their fiduciary duties, this is a very sensitive topic that might affect the equity crowdfunding industry and it will be further explained in chapter II below.

Individuals and companies involved in a crowdfunding transaction want regulation and instruments that help them to mitigate risks. Yet, those rules have to be flexible in the sense that they promote and allow crowdfunding itself and do not create an excessive amount of requirements that make the business obsolete due to the high costs. Thus, disclosure requirements must be regulated to provide investors with the enough valuable information to take an informed investment decision, but they cannot be too extensive as that might make the crowdfunding transaction quite expensive and unviable. The mentioned risks could be mitigated if further disclosures are required, and some requirements on the destination of the funds are imposed. In any case, investors need to understand the legal and financial risks surrounding the performance of the company before they commit their resources. Disclosure requirements imposed on issuers looking to sell their securities in a crowdfunding transaction is something that investors would pay attention in order to take an informed investment decision and thus it would have an impact on fundraising success.

Under the Jobs Act, issuers must provide some basic information to the market, and some information regarding the financial condition of the company is required. The amount of information varies depending on the amount of money to be raised by the issuer company.[43] The

[42] U.S. Securities Exchange Commission (n39) para 25.
[43] Andrew Schwartz (n26) page 1464.

required disclosures include the offering's purpose, the targeted amount of money to be raised, the deadline for reaching such amount and the offering price.[44]

The Jobs Act disclosure requirements are meant to protect investors from fraud and ensure that information provided by businesses is reliable.[45]As explained by Professor Jason W. Parsont in his paper, *Crowdfunding: The Real and the Illusory Exemption*, in the public context, accurate and complete disclosure is the primary means through which the securities laws seek to protect investors.[46] Furthermore, as stated by the US Supreme Court in the case of *Ralston Purina*, the Securities Act of 1933 was intended to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.[47]

Finally, as per SEC's regulation, crowdfunding electronic platforms must act as gatekeepers to create more elements to protect investors from any fraudulent activity. Companies wishing to be funded through crowdfunding in the US must rely on funding portals. These portals act as gatekeepers to prevent fraud and abuse and they make sure that investors understand investing and the risks associated therein.

3. US legal context

To understand how the existing US regulation may affect the equity crowdfunding industry, it is necessary to briefly explain the US financial regulations and the securities-based crowdfunding regulatory framework.

3.1. US financial regulation: background

As a consequence of the 1929 Great Depression, the US Congress enacted the two primary federal securities laws, (i) Securities Act of 1933 (the Securities Act) and (ii) the Securities Exchange Act

[44] Thomas Lee Hazen, 'Crowdfunding or Fraudfunding - Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure' (2012) 90 UNC School of Law, North Carolina Law Review, 1735, 1755.
[45] Andrew Schwartz (n26) page 1465.
[46] Jason W. Parsont, 'Crowdfunding: the Real and the Illusory Exemption' (2014) 4 Harvard Business Law Review 281, 313.
[47] Darian M. Ibrahim (n38) 593.

of 1934 (the Exchange Act). Both securities laws were enacted to ensure that investors would have sufficient access to the information regarding securities and the companies putting forth those securities in the market.[48]

US Congress' primary goal was to protect investors who were considering putting capital into the country's financial market from abuses by company insiders and market professionals and to safeguard the integrity of the financial markets. As explained by professors Pritchard and Choi in their book, *Securities Regulation: Cases and Analysis*, the securities laws seek to protect investors by encouraging full disclosure and deterring fraud. Securities laws regulate transactions involving financial instruments falling within the definition of security (e.g. shares).[49] Securities laws govern the means by which a company can offer and sell its securities to the public. The goal of these regulations is to balance the need of the company to raise capital against the need to protect investors from potential fraud.[50]

As explained by Joseph Hogan, in his paper, *Like Oil and Water: Equity Crowdfunding and Securities Regulation*¸ the US securities laws derive from a very simple and straightforward concept: all investors, either accredited or unaccredited investors, should have access to certain basic information about an investment prior to buying it, and so long as they hold it. To this effect, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge to all interested investors to use to judge for themselves if to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.[51]

[48] Sharon Yamen and Yoel Goldfeder, 'Equity Crowdfunding a Wolf in Sheep's Clothing: The Implications of Crowdfunding Legislation under the Jobs Act' (2015) 11 International. Law & Management Review 41, 42.
[49] S. Choi and A.C. Pritchard (n19) 1.
[50] Sharon Yamen and Yoel Goldfeder (n48) page 48.
[51] Joseph Hogan, 'Like Oil and Water: Equity Crowdfunding and Securities Regulation' (2014) 18:4 Lewis & Clark Law Review 1091, 1095.

3.2. Securities-based crowdfunding applicable regulations

It is important to note that if a crowdfunding campaign seeks to raise money from the public in exchange for stock of the issuer company, there is an offering of securities and thus, the securities laws apply. [52] Crowdfunding securities (e.g. shares) transacted through crowdfunding funding portals are considered securities, and thus they fall within the scope and regulation of US federal securities laws. The presence of security in a transaction leads to some regulatory consequences under US securities laws.[53] In addition, the presence of security also brings with it the surveillance and enforcement of the Securities and Exchange Commission (SEC).[54]

Crowdfunding securities are subject to the Securities Act of 1933, the Securities Exchange Act of 1934 and fraud litigation with respect to these securities will be subject to federal statutory and common law.[55]

3.3. Crowdfunding securities regulatory framework

The securities-based crowdfunding regulatory framework in the United States comes from the reaction to the 2008 financial crisis, the previous regulation and the unsatisfied consumer demand from the banking system created the perfect scenario allowing new models to take advantage of the uncertainty surrounding the traditional financial market.[56]

In addition, in some OECD countries, such as Australia, the United Kingdom, Ireland, France, and Switzerland, it was possible for entrepreneurs to raise capital by selling equity stakes in their business through crowdfunding portals or open calls to investors over Internet portals.[57] In recognition of these facts, in 2012, under President Obama's administration, the Jobs Act was enacted by the US Congress mainly to democratize capital markets for financing speculative start-up companies and to legalize and facility securities-based crowdfunding with the primary objective

[52] Thomas Lee Hazen (n44) page 1739.
[53] S. Choi and A.C. Pritchard (n19) page 95.
[54] S. Choi and A.C. Pritchard (n19) page 609.
[55] Sherief Morsy (n22) page 1387.
[56] C. Steven Bradford (n25).
[57] Douglas Cumming and Sofia Johan, 'Demand-driven securities regulation: evidence from crowdfunding' (2013) 15:4 Ventura Capital: An International Journal of Entrepreneurial Finance 361, 361.

to promote the access to capital for start-up companies.[58] The Jobs Act was intended to provide start-up companies with access to a wider variety of investment capital.

Title I of the Jobs Act created a new category of companies "emerging growth companies," which are basically those enterprises that have total amount gross revenues of less than USD$1 billion. The Jobs Act was enacted to lessen the restrictions and cost burdens associated with new and emerging-growth companies (i.e. start-up companies), to help those companies stimulate investment, grow their business, and create private sector jobs for Americans.[59] Before the Jobs Act, small enterprises in the US could not solicit investors (i.e. advertise) through crowdfunding platforms by promising equity in return for capital. The federal securities laws forbade this.[60] This changed as of September 2013 when crowdfunding was open for selling securities in the United States to accredited investors and then on May 2016 when it was open for selling securities to non-accredited investors.[61]

Under the Jobs Act, there are at least two main distinct types of securities-based crowdfunding, to wit: (i) accredited crowdfunding, and (ii) retail crowdfunding. The following paragraphs briefly describe each of them.

3.3.1. Accredited crowdfunding: Title II of the Jobs Act

Title II of the Jobs Act was officially passed in September of 2013 with the intent to make it easier for start-up companies and small businesses to raise capital. Yet, Title II places heavy restrictions on who can purchase the securities being offered. Crowdfunding under this title has been known as "accredited crowdfunding" since only accredited investors are allowed to participate. [62] Under this title, issuers must take reasonable steps to verify that purchasers of securities are actually

[58] Andrew Schwartz (n26) 1457.
[59] Sharon Yamen and Yoel Goldfeder (n48) page 55.
[60] Sherief Morsy (n22) page 1377.
[61] C. Green, *Banker's Guide to New Small Business Finance: Venture Deals, Crowdfunding, Private Equity, and Technology* (Wiley 2014)88.
[62] Andrew Schwartz, 'Inclusive Crowdfunding' (2016) 4 Utah Law Review, University of Colorado Law School, Legal Studies Research Paper Series, 661, 662.

accredited investors to avoid sales to non-accredited investors since small and retail investors are expressly barred. [63]

An accredited investor is either an individual with substantial financial means or a certain organization or company. The SEC will consider a person, institution, or company to be an accredited investor if the person or company falls within any of the following categories at the time of the sale of the securities:[64]

- A bank, insurance company, registered investment company, business development company, or small business investment company.
- An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets more than USD$5 million.
- A charitable organization, corporation, or partnership with assets exceeding USD$5 million.
- A director, executive officer, or general partner of the company selling the securities.
- A business in which all the equity owners are accredited investors.
- An individual who has personal net worth, or joint net worth with the person's spouse, that exceeds USD$1 million at the time of the purchase, excluding the value of the primary residence of such person.
- An individual with income exceeding USD$200,000 in each of the two most recent years or joint income with a spouse exceeding USD$300,000 for those years and a reasonable expectation of the same income level in the current year, or
- A trust with assets more than USD$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

[63] Jason W. Parsont (n46) page 310.
[64] Sharon Yamen and Yoel Goldfeder (n48) page 53.

3.3.2. Retail crowdfunding: Title III of the Jobs Act

Title III of the Jobs Act (which finally was adopted and took effect on May 16, 2016) allowed small investors (i.e. unaccredited investors) to make investments that had previously been offered solely to so-called "accredited'' investors. Title III of the Jobs Act created a federal exemption under the US securities laws to allow the use of this method to offer and sell securities in the United States. Crowdfunding under Title III of the Jobs Act is the most inclusive form of securities-based crowdfunding since everyone may invest regardless of who they are. This type of crowdfunding has been known as retail crowdfunding.[65] As of June 16, 2016, exactly one month after the title III was adopted there were a total of 39 active equity crowdfunding campaigns in the US.[66] Retail crowdfunding is open to all investors, meaning more than 300 million Americans.[67]

As explained by Darian Ibrahim, in his paper, *Equity Crowdfunding: A Market for Lemons,* to obtain a true equity crowdfunding situation, the majority of unaccredited investors must be allowed to participate in start-up offerings.[68] Title III of the Jobs Act, (also known as the Crowdfund Act) opened up new opportunities for entrepreneurs, who will now have the ability to raise money from investors without having to comply with the costly federal registration requirements of an initial public offering.[69] Entrepreneurs have benefited from the SEC regulations since they may now raise capital without having to register with the SEC. It helps entrepreneurs and saves considerable money and red tape. As mentioned by Andrew Schwartz *''there is good reason to expect that the crowdfunding of securities will open up a new chapter in the financing of start-up companies, one in which all investors, wealthy or not, have a chance to invest in such speculative assets.''*[70]

The main characteristics of retail crowdfunding pursuant to Title III of the Jobs Act may be summarized as follows:

[65] Schwartz (n62) page 662.
[66] Jack Wroldsen, 'Crowdfunding Investment Contracts' (2017) 11 Virginia Law & Business Review, page 18.
[67] Jason W. Parsont (n46) page 316.
[68] Darian M. Ibrahim (n38) page 571.
[69] Andrew Schwartz (n26) 1460.
[70] Andrew Schwartz (n26) 1476.

(i) Companies seeking to fund from “the crowd’’ may issue up to USD$1 million in securities in any 12-months period to an unlimited number of investors via one of the crowdfunding platforms approved by the Securities Exchange Commission (SEC). The issuing companies must disclose certain information such as name, legal status, organization, physical and website address, directors, etc. Depending on the amount of money to-be-raised, the issuing company has different filing requirements: (i) tax returns for offerings less than USD$100,000; (ii) financial statements reviewed by an independent public accountant for offerings from USD$100,000 to USD$500,000; (iii) audited financial statements for offerings over USD$500,000.[71]

(ii) Anyone can invest in a retail crowdfunding securities offering. Yet, an investor can only invest in a crowdfunding offering through an online platform, such as a website or a mobile app that must be previously registered with the SEC. Hence, crowdfunding transactions cannot be consummated directly between the Issuer Company and investor, but rather must be completed via intermediaries registered with the SEC. These intermediaries can be registered either as a broker-dealer or a funding portal. [72]

(iii) To protect investors, the SEC issued some regulation which limited the amount of money that an investor can invest during any 12-month period in these transactions. All individuals can annually invest up to a tiered threshold, (i) if the investor's net worth plus income is less than USD$40,000, then he or she can only invest up to $2,000; (ii) if his or her net-worth and income combine to less than USD$100,000, then he or she can invest five percent of his or her income in equity crowdfunding endeavors; (iii) if his or her income or net worth is greater than USD$100,000, then the limit is ten percent of his/her income in equity crowdfunding.[73] These crowdfunding transactions have been defined as the sale of unregistered securities over the Internet to large numbers of retails investors, each of whom only invests a small dollar amount.[74]

[71] Garry A. Gabison (n16) page 389.
[72] Andrew Schwartz (n26) 1462.
[73] Garry A. Gabison (n16) page 389.
[74] Andrew Schwartz (n26) 1458.

(iv) Title III of the Jobs Act placed a restriction on transferability of crowdfunding securities. Investors who hold crowdfunding shares are limited in their capability to resell them within the first year of ownership unless the shares are transferred:[75]

- to the company that issued the securities;
- to an accredited investor;
- to a family member;
- in connection with the investor's death or divorce or other similar circumstance;
- to a trust controlled by the investor or a trust created for the benefit of a family member;
- as part of an offering registered with the SEC.

These securities are referred to as "restricted" securities.[76] The purpose of this restriction serves an anti-fraud purpose. Yet, as will be further explained in chapter II below, it ultimately harms investors more than it helps them.[77]

(v) The US Congress enacted a new private antifraud liability provision specifically for retail crowdfunding.[78] Section 4A(c). This provision that applies only to retail crowdfunding offerings pursuant to the Title III of the Jobs Act allows crowdfunding purchasers to recover damages from an "issuer" if the issuer "by any means of any written or oral communication... makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission"[79] Under Section 4A(c), a plaintiff making a claim must show only that the statement in question was false, leaving the defendant to prove that it did not know, and with the exercise of reasonable care could not have known, that it was false. Hence, plaintiffs

[75] U.S. Securities Exchange Commission (SEC), 'Investor Bulletin: Crowdfunding for Investors' (U.S. Securities Exchange Commission, Feb. 16, 2016) para 13 <https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html> accessed on 17 May, 2017.
[76] S. Choi and A.C. Pritchard (n19) 695.
[77] Sherief Morsy (n22) page 1393.
[78] S. Choi and A.C. Pritchard (n19) page 610.
[79] C. Steven Bradford, 'Shooting the Messenger: The Liability of Crowdfunding Intermediaries' (2014) 83 University of Cincinnati Law Review 371, 388.

under this liability provision do not need to prove either (i) scienter, (ii) reliance, nor (iii) loss causation.

3.3.3. Differences: accredited and retail crowdfunding

Having explained both types of securities-based crowdfunding, I would like to emphasize the main differences between them and provide some comments, as follows:

(i) Amounts: retail crowdfunding limits start-up companies to raising just USD$1 million per year, while accredited crowdfunding has no limit on the amount a company can raise so that an unlimited amount can be raised.[80] Hence, retail crowdfunding is less flexible because it will not be an option if the issuer company requires more than USD$1 million in one year.[81]

(ii) Caps: retail crowdfunding imposes a cap on the amount each investor can contribute while accredited crowdfunding has no such limit.[82] Retail crowdfunding has a fundamental advantage over accredited crowdfunding, and it is the value of inclusivity. Under retail crowdfunding, everybody is welcome to invest in early-stage companies.[83]

(iii) Liability exposure:[84] in the accredited crowdfunding context only the Rule 10b-5 antifraud liability provision applies. Rule 10b-5 poses a relatively low liability risk for issuers and other participants since as will be further explained in chapter II below, a plaintiff will need to prove the four elements under Rule 10b-5, to wit: (i) a material misrepresentation (i.e. misstatement), (ii) scienter (i.e. a wrongful state of mind), (iii) reliance (i.e. an investor relied on a misstatement in making an investment decision), and (iv) loss causation (i.e. a causal connection between the material misrepresentation and the loss). Thus, this liability regime creates a difficult challenge for plaintiffs and it makes accredited crowdfunding more attractive for issuers since the exposure of liability is way lower than in retail crowdfunding.

[80] Jason W. Parsont (n46) page 301.
[81] Jason W. Parsont (n46) page 301
[82] Schwartz (n62) page 668.
[83] Schwartz (n62) page 672.
[84] Jason W. Parsont (n46) page 304.

By contrast, retail crowdfunding is exposed to a public-like form of liability included by Section 4A(c) of the Securities Exchange Act of 1934 which is less friendly to issuers since this regime does not require plaintiffs to prove (i) scienter, (ii) reliance, nor (iii) loss causation.[85] This special liability regime which applies to retail crowdfunding will be further explained in chapter II below.

(iv) Disclosure requirements[86]: retail crowdfunding has some mandatory disclosure requirements, such as description of the business, the use of proceeds, risk factors and depending on the size of the offering there could be additional disclosure requirements, such as independent public accountants and audited financial statements. On the other hand, in accredited crowdfunding, there are no such requirements.

(v) Intermediation:[87] in retail crowdfunding, there is necessary to use a broker or funding portal as an intermediary in the conduct of the transaction. This mediation will increase the operation costs. By contrast, in accredited crowdfunding, there is no mediation requirement.

[85] Jason W. Parsont (n46) page 304.
[86] Jason W. Parsont (n46) page 305.
[87] Jason W. Parsont (n46) page 306.

CHAPTER II - REGULATORY ANALYSIS

Under Title III of the Jobs Act, unaccredited investors now have the opportunity to invest in start-up companies through crowdfunding portals and all of the transaction is completed by electronic means. As explained in Chapter I above, the SEC has already regulated retail crowdfunding, and therefore small businesses are now allowed to solicit unaccredited (unsophisticated) investors to invest in these companies as an alternative to raise capital.

Securities-based crowdfunding has been subject to substantial criticism. As per Professor Andrew Schwartz, the principal line of attack has been that most crowdfunding investors will lose most of their money, for one reason or another. Hence, fraud is a driving concern.[88] Beyond fraud, there are a lot of issues that have not been addressed yet. In this chapter, I will analyze how the absence of an organized secondary market along with the US existing regulation on securities-based crowdfunding affect the equity crowdfunding industry and will constrain the growth of this market.

First, to understand how the absence of an organized secondary market affect the equity crowdfunding industry it is necessary to briefly explain in more detail what an organized secondary market is and how it works. Second, once it has been understood the functioning of a secondary market, it will be explained from a commercial, economic and legal point of view how its absence along with the existing US regulation on equity-based crowdfunding will affect this industry and will constrain the growth of this market. Third, an analysis of different issues that also may affect the equity crowdfunding industry, such as, the lemons problem, pump and dump schemes and enforcement matters will be carried out. Finally, some lessons from China, which is the biggest crowdfunding market in the world, will be given.

Role of a Secondary Market

Securities transactions can be divided into primary transactions and secondary transactions. In primary transactions (i.e. primary market), a company offers and sells its securities to investors and the proceeds derived from that sale are for the issuer company’s benefit. On the other hand, in

[88] Andrew A. Schwartz,’ The Nonfinancial Returns of Crowdfunding’ (2014-2015) 34 Review of Banking & Financial Law 565, 570.

a secondary transaction (i.e. secondary market), one investor resells securities of the issuer to another investor. Thus, in a secondary transaction the company which issued the securities does not participate in this transaction, and therefore the proceeds of the sale are for the only benefit of the seller. [89]

Securities (e.g. shares) can be bought and sold in different venues. For instance, a shareholder of a company may sell his shares to a friend. To close the transaction, the seller may transfer the stock certificates in the relevant company to his friend in exchange for cash in a face-to-face transaction.[90] However, these face-to-face transactions are unusual, and most of the securities transactions (either primary or secondary transactions) take place through organized markets and with the assistance of professional intermediaries. [91] The most famous organized marketplaces in the United States are NASDAQ and NYSE (New York Stock Exchange).

As explained by Professor Yannis Bakos in his paper, *The Emerging Role of Electronic Marketplaces on the Internet*, markets (electronic or otherwise) have three primary functions: (i) matching buyers and sellers; (ii) facilitating the exchange of information, goods, services, and payments associated with market transactions; and (iii) providing an institutional infrastructure such as a legal and regulatory framework that enables the efficient functioning of the market.[92] When a market functions well, this also leads to an efficient allocation of productive resources. Hence, markets are the engines and steering system of any economy.[93]

An organized secondary market is a marketplace that matches seller and buyers of securities. By matching demand and supply.[94] Thus, an organized secondary market is where investors buy and sell securities that they already own. Usually, it is a stock exchange, and it serves one essential

[89] S. Choi and A.C. Pritchard (n19) 1.
[90] S. Choi and A.C. Pritchard (n19) 8.
[91] S. Choi and A.C. Pritchard (n19) 8.
[92] Yannis Bakos, 'The Emerging Role of Electronic Marketplaces on the Internet' (1998) Communications of the ACM, page 1.
[93] Yannis Bakos (n92) page 2.
[94] Yannis Bakos (n92) page 2.

function, it makes easier and more efficient for sellers and buyers of securities to find one another and transact, and it provides liquidity to the market.[95]

Most people buy securities as a means of building wealth. Investors make an investment with the hope to receive more money (capital plus profits) in the future when they resell their securities. Under this scenario, an organized secondary market is the best venue to bring together sellers and prospective purchasers of securities. An organized secondary market allows investors to resell securities both quickly and at low cost. Thus, it provides investors with liquidity and transparency.[96] Securities which are bought and sold through an organized marketplace provide liquidity and solvency to the market while those securities which are restricted to be traded on a secondary market are unusual and illiquid.

The restriction imposed by the Jobs Act regarding the transferability of crowdfunding securities for one year and the absence of an organized secondary market affect equity crowdfunding industry from a commercial perspective as will be further explained in the next section.

1. Commercial Perspective (Liquidity)

It is worth mentioning that in the case of crowdfunding securities there is no organized secondary market. These securities are sold in the primary market by means of funding platforms, but there is no organized secondary market in the United States where these securities can be traded. In addition, as mentioned above, in retail crowdfunding (Title III of the Jobs Act) there is a restriction on the transfer of crowdfunding securities that potentially makes resales for investors highly complicated, illiquid and risky.

Professor Andrew Schwarts said that the secondary market for crowdfunding securities is limited for a very simple reason because the number of shares in the marketplace is likely to be orders of magnitude smaller for a crowdfunded issue than a registered one. Publicly traded companies issue millions or even billions of shares, making it easy to find someone else who wants to buy or sell a

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[95] Elizabeth Pollman, ‘Information Issues on Wall Street 2.0’ (2012) 161 University of Pennsylvania Law Review 179, 202.
[96] S. Choi and A.C. Pritchard (n19) page 9.

few. By contrast, crowdfunded companies are likely to have only thousands of securities outstanding, making it challenging and expensive to transact in them since the demand and supply of crowdfunding securities would be lower than any other regular security. For this reason, as per Professor Schwarts, no liquid secondary market is likely to develop in crowdfunded securities.[97]

Being a crowdfunding investor is different from being a shareholder in a publicly listed company. A crowdfunding investor cannot sell his shares at any time since there is a restriction to resell them during the first year of ownership and crowdfunding securities are not traded in an organized secondary market which makes harder to resell these shares than shares of a publicly listed company. The restriction to resell these securities during the first year of ownership and the absence of organized secondary market mean a reduction in the securities value to the investors and it makes these investments less attractive for institutional and more sophisticated investors.

An investment implies a return of some sort. In the case of securities, the investors expect to have the chance to sell the security at a higher rate at some later date. Yet, investing in start-up companies may be difficult from a liquidity point of view. As Professor Dr. Lin Lin has said in his paper *Equity Crowdfunding in China*, the securities-based crowdfunding industry is known for its high risk of illiquidity and limited exit opportunities. If investors are stuck with no liquidity or no means to monetize their investments, they will likely lose all of their investment and suffer losses even if the company has thrived. Having available exit options is thus critical for investor protection.[98]

In particular, it is unlikely that investors in crowdfunding securities transactions would be able to find a liquid market to resell these securities. The absence of an organized secondary market would oblige crowdfunding investors to find alternative suitable trading venues. As a consequence, as explained by the SEC, the potentially high degree of illiquidity associated with crowdfunding securities might prevent investors (including both accredited and unaccredited investors) from investing in crowdfunding transactions, thus limiting potential capital formation in this industry.[99]

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[97] Andrew Schwartz (n26) page 1463.
[98] Dr. Lin Lin (n13) page 24.
[99] Securities Exchange Commission (SEC) (Crowdfunding 17 CFR Parts 200, 227, 232, 239, 240 and 249) page 349 <https://www.sec.gov/rules/proposed/2013/33-9470.pdf> accessed 26 May, 2017.

As mentioned, crowdfunding securities in the US cannot be resold within the first year of ownership. This resale restriction imposed by the Jobs Act reduces the value of the crowdfunding securities to the investors. Without the possibility to resell, investors cannot convert crowdfunding securities into cash. [100] As a general rule, purchasers of these securities must wait one year to have the chance to resale these instruments. This measure was included in the Jobs Act as a deterrent against fraud. Yet, this provision could dissuade institutional investors from purchasing these securities since this restriction would reduce the liquidity of the shares.[101] The resale restriction imposed by the Jobs Act and absence of an organized secondary market severely affects the liquidity and market for crowdfunding securities. Thus, equity crowdfunding may undesirably lock in investors.[102]

Due to the high illiquidity of the securities-based crowdfunding transactions, the SEC appears to have little confidence in the ability of investors to get any return on these crowdfunding investments. As mentioned by Professors Yamen and Goldfeder, in their paper, *Equity Crowdfunding a Wolf in Sheep's Clothing: the Implications of Crowdfunding Legislation*, those choosing to give money to start-up companies should not see their contributions as investments, but rather as donations to the cause of business growth.[103] In addition, liquidity risk can raise an issuer company's cost of capital at the time of a security's sale. Therefore, crowdfunding investors may demand a discount on the price of a share to compensate them for the risk that they will not be able to resell the security at a fair price for cash.[104]

An organized secondary market provides an exit option at the individual level, rather than at the company level as with an acquisition or IPO.[105] In the absence of an organized secondary market, individual investors willing to sell a security may waste time and money trying to find a prospective buyer. Even, if the selling investor finds a potential buyer, the parties (i.e. seller and

[100] S. Choi and A.C. Pritchard (n19) page 610.
[101] Sherief Morsy (n22) page 1393.
[102] Garry A. Gabison (n16) page 370.
[103] Sharon Yamen and Yoel Goldfeder (n48) page 63.
[104] Jason W. Parsont (n46) page 313.
[105] Elizabeth Pollman (n95) page 204.

buyer) have no assurance that they are closing the deal for the right price. [106] By contrast, in an organized secondary market, selling investors can easily find prospective buyer investors. In addition, as will be explained in the next section, an organized secondary market would have an impact on security price since it would reflect all the available information on the market. Furthermore, information on the deals of other investors also flows more easily in an organized market, which will be translated into transparency that allows investors to determine the best price for these transactions.[107]

2. Economic Perspective (Efficient Market Hypothesis)

This section will address from the efficient market hypothesis perspective how the absence of an organized secondary market has an impact on the share price (i.e. crowdfunding securities) and hence in the equity-based crowdfunding industry.

The efficient market hypothesis essentially states that a market in which securities prices always "fully reflect" available information is called "an efficient market."[108] Securities prices reflect a significant amount of available information from many different sources in the stock market. This hypothesis is grounded on the principle that the stock market translates information about the issuer company into the market price for the issuer company's securities.[109] The market incorporates all public information about a security resulting in a price that is an accurate representation of its actual value. Hence, according to this hypothesis, investors do not need to know all public information about the security, but they can rely on the market price as a close approximation of its actual value.[110]

In an efficient market, share prices fully and accurately reflect all public information, then, stocks not only must react to news but must respond in a manner that is consistent with what the news

[106] S. Choi and A.C. Pritchard (n19) page 9.
[107] S. Choi and A.C. Pritchard (n19) page 9.
[108] Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 The Journal of Finance 383, 383.
[109] Marvin G. Pickholz and Edward B. Horahan, 'The SEC'S Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities' (1982) 39:3 Washington and Lee Law Review 943, 956.
[110] Joseph Hogan (n51) page 1106.

says about company fundamentals.[111] However, the efficient market hypothesis depends on certain market characteristics which are absent in the equity-based crowdfunding context. Without an organized secondary market it would not be possible to determine whether equity crowdfunding market is efficient, that is, whether the information is duly reflected in the stock price.[112]

3. Legal Perspective (Fraud Causes of Action)

Securities-based crowdfunding created new investment opportunities but it also created the potential for investment fraud, and it could create new mechanisms to defraud sophisticated and unsophisticated investors.[113] Combining high-risk investments, unaccredited (unsophisticated) investors, and the Internet could be a perfect recipe for fraud. Thus, to analyze this matter, sections 3.1 and 3.2 below explain the two most relevant antifraud liability provisions which apply to securities-based crowdfunding (i.e. Section 4A(c) that exclusively applies to retail crowdfunding and Rule 10b-5 that applies to both retail crowdfunding and accredited crowdfunding). Section 3.3 along with its sub-sections critically analyze these antifraud liability provisions to understand how they may affect the securities-based crowdfunding industry.

3.1. Liability provision: Section 4A(c)

In recognition of the risks involved in securities-based crowdfunding, the US Congress enacted a private antifraud liability provision specifically for retail crowdfunding.[114] Section 4A(c) of the Securities Act of 1933. This Section applies only to retail crowdfunding offerings pursuant to the Title III of the Jobs Act.

Under Section 4A(c), a crowdfunding investor may bring an action against an issuer to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if such investor no longer owns the security.[115]

[111] Bradford Cornell and James C. Rutten, Market Efficiency, Crashes and Securities Litigation (2006).
[112] Sherief Morsy (n22) page 1374.
[113] Sherief Morsy (n22) page 1380.
[114] S. Choi and A.C. Pritchard (n19) page 610.
[115] Securities Exchange Act of 1933-Section 4A(c).

This liability provision allows crowdfunding investors to recover damages from an "issuer" if the issuer “by any means of any written or oral communication... makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission”[116] This liability applies even if the misstatement was merely negligent, not intentional.[117] Under this liability provision, a plaintiff need only prove that an untrue statement or misleading omission occurred and that the defendant did not exercise reasonable care.[118] A plaintiff under Section 4A(c) does not need to prove (i) scienter (i.e. a wrongful state of mind), (ii) reliance (i.e. an investor relied on a misstatement in making an investment decision), nor (iii) loss causation (i.e. a causal connection between the material misrepresentation and the economic loss).[119]

The term ‘‘issuer’’[120] includes any person who is a director or partner of the issuer company, and the CEO or officers, CFO, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function within the issuer company) that offers or sells a security in a crowdfunding transaction and anyone who offers or sells the security in such offering.

3.2. Liability provision: Rule 10b-5

Rule 10b-5 which is the broadest and most important anti-fraud civil liability provision in US securities laws applies to both retail crowdfunding (i.e. Title III of the Jobs Act) and accredited crowdfunding (i.e. Title II of the Jobs Act).[121] As per Professors Choi and Pritchard, the most significant consequence of the application of US securities laws is the use of the “catch-all” antifraud provision Rule 10b-5. [122] Rule 10b-5, enacted under Section 10b of the Securities

[116] C. Steven Bradford, ‘Shooting the Messenger: The Liability of Crowdfunding Intermediaries’ (2014) 83 University of Cincinnati Law Review 371, 388.
[117] David Mashburn (n7) page 131.
[118] David Mashburn (n7) page 127.
[119] Jason W. Parsont (n46) page 304.
[120] Securities Exchange Act of 1933-Section 4A(c).
[121] David Mashburn (n7) page 152.
[122] S. Choi and A.C. Pritchard (n19) page 95.

Exchange Act of 1934, represents the most widely used and relevant antifraud provision for private plaintiffs in the United States.[123] Section 10b and Rule 10b-5 are the principal statutory provisions against fraud. If market participants violate these rules, the SEC can initiate a civil enforcement action against fraudsters. Furthermore, investors would be able to sue the individuals who have defrauded them.[124]

Rule 10b-5 states that “it shall be unlawful for any person, directly or indirectly, to employ any device, scheme, or artifice to defraud, make false statements, omit material information or otherwise to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”[125]

The elements of the Rule 10b-5 cause of action are similar to those required for common law fraud. Plaintiffs bear the burden of showing: (i) a material misrepresentation (i.e. misstatement), (ii) scienter (i.e. a wrongful state of mind), (iii) reliance (i.e. an investor relied on a misstatement in making an investment decision), and (iv) loss causation (i.e. a causal connection between the material misrepresentation and the economic loss).[126]

3.3. Analysis of liability provisions

This section will critically analyze both liability provisions in order to understand how these provisions may affect securities-based crowdfunding industry.

3.3.1. Excessive liability on issuers

First, to understand the extent of both antifraud liability provisions, it is necessary to briefly explain the main differences between them, which may be summarized as follows: (i) the level of culpability required by Section 4A(c) is mere negligence, not scienter as required by Rule 10b-5, (ii) under Section 4A(c), the plaintiff does not have to prove reliance as required by Rule 10b-5 (even if the plaintiff never read or heard the untruth, the issuer could still be held liable under

[123] S. Choi and A.C. Pritchard (n19) page 34.
[124] S. Choi and A.C. Pritchard (n19) page 34.
[125] Securities Exchange Act of 1934 – Rule10b-5
[126] S. Choi and A.C. Pritchard (n19) page 227.

Section 4A(c), and (iii) under Section 4A(c), the plaintiff does not need to prove loss causation as required by Rule 10b-5 (e.g. the share price may have dropped for any reason, and the issuer company may still be liable if a false statement was made).[127]

Section 4A(c) imposes a severe liability on crowdfunding issuers since under this provision a plaintiff need only prove that an untrue statement or misleading omission occurred and that the defendant did not exercise reasonable care.[128] Thus, innocent and unsophisticated start-up companies may fall within the broad scope of this liability provision. Under this context, what initially seems to be a fast and easy form of financing may quickly unravel into costly and time-consuming litigation.[129]

As exposed by David Mashburn, US Congress should rewrite this provision to avoid an excessive liability on crowdfunding issuers and to create a better balance between issuers' accountability and investor protection from fraud. [130] Equity crowdfunding deserves a proper liability provision that addresses the risk of fraud in a crowdfunding transaction and not beginners' reporting mistakes.[131]

As Section 4A(c) does not apply to accredited crowdfunding (i.e. Title II of the Jobs Act), this will make accredited crowdfunding, on this dimension, more affordable for issuers since the liability exposure is lower than in retail crowdfunding. As pointed out by Professor, Jason W. Parsont, from the perspective of the companies seeking to raise capital, accredited crowdfunding would be more attractive than retail crowdfunding.[132]

Section 4A(c) would be more favorable for investors since in the case of legal dispute they would only have to prove that an untrue statement or misleading omission occurred and that the defendant did not exercise reasonable care, even if loss causation, reliance, and scienter are not shown.[133] Therefore, this liability provision is less friendly with issuers and more favorable to investors.

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[127] David Mashburn (n7) page 152.
[128] David Mashburn (n7) page 127.
[129] David Mashburn (n7) page 172.
[130] David Mashburn (n7) page 133.
[131] David Mashburn (n7) page 177.
[132] Jason W. Parsont (n46) page 284.
[133] David Mashburn (n7) page 127.

3.3.2. Loss causation and reliance under Rule 10b-5

Retail crowdfunding securities because anyone (accredited and non-accredited investors) can buy them through online platforms possess a public quality. [134] Investors who buy these securities (e.g. shares) expecting returns should have the option to sell them whenever they want. However, Title III of the Jobs Act contains a provision that places a restriction on the transferability of these crowdfunding securities.

Crowdfunding securities cannot be transferred by the purchaser during the first year beginning on the date of the purchase, unless such securities are transferred to (i) the issuer of the securities, (ii) an accredited investors, (iii) as part of an offering registered with the SEC, (iv) to a member of the family of the purchaser, or (v) in case of death or divorce of the buyer. [135] Furthermore, as explained above, there is no organized secondary market where these crowdfunding securities can be traded. These facts, as will be described in the next paragraphs, make it tough to prove loss causation and reliance under Rule 10b-5.

- **Loss causation**

Loss causation is a result of the markets' realization.[136] There is a link between loss causation and efficient markets. As pointed out by Sherief Morsy, in his paper, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, a robust secondary market is a key factor in determining whether a market is efficient, that is, whether the stock price reflects all the available information.[137] Without an organized efficient secondary market, such as the case of equity crowdfunding, it would be tough to establish that the stock price reflects all the available information, mostly, making harder to prove loss causation in equity-crowdfunding litigation.

[134] Sherief Morsy (n22) page 1392-1393.
[135] Sherief Morsy (n22) page 1392-1393.
[136] Sherief Morsy (n22) page 1398.
[137] Sherief Morsy (n22) page 1374.

Loss causation requires that a plaintiff shows that the economic losses were a direct consequence of the defendant's wrongful conducts and no related with other causes. [138] Plaintiffs would have to prove that the misrepresentation or misstatement by the defendant actually had an effect on share's price.

In *Haliburton Co V Erica P. Johan Fund, Inc.,*[139] the court required securities fraud plaintiffs to prove, loss causation, it is a causal connection between the defendant's alleged misrepresentations and the plaintiffs' economic losses (i.e. injury).[140] As explained by the US Supreme Court in *Dura Pharmaceutical, Inc v. Broudo (2005),*[141] under Rule 10b-5, a plaintiff who claims securities fraud shall have the burden of proving that the act or omission of the defendant caused the economic loss for which the plaintiff seeks to recover damage.[142] That is, a plaintiff will have to demonstrate and explain how the misrepresentation or misstatement caused a drop in the share's price. Therefore, the plaintiff shall have the burden of proving that the act or omission of the defendant caused the economic loss for which the plaintiff seeks to recover damage.[143]

In the US Supreme Court's words, the market serves as the unpaid agent of the investor, informing him that, given all the information available to it, the share price reflects the interplay of supply and demand.[144] That is, making the market efficient. However, the one-year resale restriction along with the absence of an organized secondary market make the market for crowdfunding securities highly inefficient which presents proof problems for plaintiffs to evidence loss causation under Rule 10b-5.[145] In equity crowdfunding, no organized efficient secondary market reflects the stock's price. In this sense, it would be tough to establish that the stock price reflects all available information making it harder to prove loss causation under Rule 10b-5. If investors cannot show loss causation, then they will not have a cause of action under Rule 10b-5.

[138] Sherief Morsy (n22) page 1374.
[139] S. Choi and A.C. Pritchard (n19) page 268.
[140] S. Choi and A.C. Pritchard (n19) page 269.
[141] S. Choi and A.C. Pritchard (n19) page 284.
[142] S. Choi and A.C. Pritchard (n19) page 284.
[143] S. Choi and A.C. Pritchard (n19) page 284.
[144] Bradford Cornell and James C. Rutten, *Market Efficiency, Crashes and Securities Litigation* (2006)
[145] Sherief Morsy (n22) page 1404.

If crowdfunding investors cannot prove loss causation, then their fraud lawsuits will ultimately fail. In this sense, under Rule 10b-5, a crowdfunding investor would not have effective legal mechanisms to secure their interests. Therefore, the restriction on transferability of crowdfunding securities included by the SEC as a measure against fraud in the title III of the Jobs Act and the absence of an organized secondary market would harm investors more than helping them.

- **Reliance**

One of the elements that a plaintiff must plead to state a federal securities fraud claim under Rule 10b-5 is reliance. That is, an investor must prove that he relied on a misstatement in order to make an investment. The US Supreme Court, in its decision in *Basic Inc. v. Levinson* (1988), held that investors could satisfy the reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all available public material information.[146] This has been known as fraud on the market theory.

This theory states that the price of a company's stock is based on all available information about such company. Thus, misstatements about the company constitute fraud even if investors who bought the stock in the company did not directly rely on the misstatements. As explained by Professor Jason W. Parsont, for private enterprises whose shares are not traded in an efficient market, prove reliance under Rule 10b-5 is very hard to do.[147] Without an efficient market, such as the case of crowdfunding securities, plaintiffs must demonstrate that each investor actually relied on the misstatement or omission. Thus, given that crowdfunding securities are not traded on efficient markets, plaintiffs cannot rely upon the fraud on the market theory to bring an action under Rule 10b-5.

In conclusion, the liability regime under Rule 10b-5 creates a difficult challenge for plaintiffs since it would be tough to prove all of its elements due to the current conditions of the equity crowdfunding market. Therefore, this Rule 10b-5 is more favorable for issuers than investors since

[146] Harvard Law School, 'Supreme Court Upholds Fraud-On-The-Market Presumption in Halliburton' (June 24, 2014) <https://corpgov.law.harvard.edu/2014/06/24/supreme-court-upholds-fraud-on-the-market-presumption-in-halliburton/> accessed on 31 May, 2017.
[147] Jason W. Parsont (n46) page 303.

it cannot be easily proved in equity crowdfunding transactions and thus it would be harder to make them liable for fraud.

4. Miscellaneous

The following sections assess from a practical point of view several matters which may affect the securities-based crowdfunding industry.

4.1. Pump and Dump Schemes

As explained by the SEC, one of the most common frauds involves the classic "pump and dump" scheme, by means of which promoters try to boost the price of a stock with false or misleading statements about the company and once the stock price has been pumped up, fraudsters behind the scheme sell their shares at the peak and stop hyping the stock, the price plummets, and investors lose their money. [148] These schemes generally occur over the Internet where it is common to see messages urging readers to buy a stock quickly at a low cost. Fraudsters frequently use this ploy with small companies because it is easier to manipulate a stock when there is little or no information available about the enterprise.[149]

As pointed out by Professor, Yannis Bakos in his paper, *The Emerging Role of Electronic Marketplaces on the Internet*, an essential function of markets is price discovery, that is, the process of determining the prices at which demand and supply “clear” and trade occurs. Furthermore, markets provide the infrastructure (physical or otherwise) that allows transactions between sellers and buyers to take place.[150]

In an equity crowdfunding transaction, an investor may struggle to know whether the stock valuation is correct without traditional market mechanisms. As a consequence, the absence of an

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[148] Securities Exchange Commission (SEC) <https://investor.gov/protect-your-investments/fraud/typesfraud/pump dump-schemes> accessed 31 May 2017.
[149] Securities Exchange Commission (SEC) <https://investor.gov/protect-your-investments/fraud/typesfraud/pump dump-schemes> accessed 31 May 2017.
[150] Yannis Bakos (n92) page 3.

organized efficient secondary market where crowdfunding securities can be traded may create a higher risk that this industry may be vulnerable to dump and pump schemes.

Unaccredited investors in unsophisticated and inefficient markets, such as the equity crowdfunding market, lack basic financial knowledge and they usually do not understand the pricing fundamentals for securities. Therefore, as pointed out by Professor Alan R. Palmiter, in his article, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, this lack of knowledge reduces the ability of retail crowdfunding investors to protect themselves from fraud or to evaluate the risks and price in securities offerings.[151]

4.2. Market for Lemons

Even if securities-based crowdfunding is affordable enough to be viable, it could degrade into a market for lemons since there are high-quality entrepreneurs but also low-quality entrepreneurs in the market.[152] The lemons problem was explained by the Nobel Prize George Akerlof. This is an issue in markets with asymmetric information, that is, markets where sellers know the quality of the goods they are offering, but buyers do not. As a consequence, buyers are aware that some goods are of high quality while the rest are of bad quality, those of bad quality are known as "lemons."[153]

As explain by Professor Jason Parsont in his paper, *Crowdfunding: The Real and the Illusory Exemption*, the annual investment limits imposed by the title III of the Jobs Act, which are intended to protect small investors by limiting their exposure to risky investments, could disincentive due

[151] Alan R. Palmiter, 'Pricing Disclosure: Crowdfunding's Curious Conundrum' (2012) 7.2 Ohio State Entrepreneurial Business Law Journal, 373, 413.

[152] The lemons problem refers to issues that arise due to asymmetric information possessed by the buyer and the seller of an investment or product, regarding its value. The lemons problem was put forward in a 1970 research paper, "The Market for Lemons," written by George Akerlof, an economist and professor at the University of California, Berkeley. The tag phrase identifying the problem came from the original example of used cars that Akerlof used to illustrate the concept of asymmetric information, as defective used cars are commonly referred to as "lemons. "The lemons problem is recognized as existing in the marketplace for both consumer and business products, and also in the arena of investing, related to the disparity in the perceived value of an investment between buyers and sellers. The lemons problem is also prevalent in financial sector areas, including insurance and credit markets. For example, in the realm of corporate finance, a lender has asymmetrical and less-than-ideal information regarding the actual creditworthiness of a borrower (source: www.investopedia.com)

[153] Gmeleen Faye B. Tomboc (n5) page 263.

diligence because they prevent any one investor from having significant “skin in the game’’.[154] Therefore, if investors lack sufficient motivations to perform due diligence on the issuer company[155] and there are no investors with a significant stake, there are no motives to carry out a profound due diligence of the issuer company in order to verify that the securities being offered are well priced. Without due diligence, the information asymmetry problem between the issuer company and the prospective investors may arise, and thus it would tend to give rise to a market for lemons.[156]

Likewise, the relatively small investment caps set by the Title III of the Jobs Act might make retail crowdfunding offering less attractive for institutional investors. Thus, these annual investment limits in retail crowdfunding would discourage sophisticated investors, such as venture capital firms, from doing a due diligence work of the issuer company on behalf of the crowd to prevent a market for lemons.[157] Sophisticated investors would prefer, instead, to invest in accredited crowdfunding in accordance with Title II of the Jobs Act which is not subject to investment caps.

In this sense, if neither a complete set of disclosure requirements is mandatory nor the investors have enough “skin in the game” to carry out a profound due diligence of the issuer, because of the limits on investments, there will be significant information asymmetries in this market. As a consequence, as described by Joseph Hogan, in his paper, *Like Oil and Water: Equity Crowdfunding and Securities Regulation*, investors will not be able to distinguish the good from the bad and the legitimate from the fraudulent. Thus, investors’ confidence will crash and many will flee the market, and consequently “lemons” will dominate the market.[158] The high level of information asymmetry in crowdfunding securities would create a situation ripe for fraud, misappropriation, and the lemons problem.[159]

The absence of an organized secondary market for equity crowdfunding securities may help to intensify the lemons problem, since without an efficient market where the share price reflects all

[154] Jason W. Parsont (n46) page 285.
[155] Jason W. Parsont (n46) page 285.
[156] Jason W. Parsont (n46) page 285.
[157] Jason W. Parsont (n46) page 318.
[158] Joseph Hogan (n51) page 1104.
[159] Gmeleen Faye B. Tomboc (n5) page 267.

the available information, investors would not have certainty about the stock price and entrepreneurs will have more information than investors and only they will know if they have a good or bad product. An organized efficient secondary market would mitigate the information asymmetry and consequently the lemons problem in the equity crowdfunding industry.

4.3. Enforcement issues

Pursuant to Professor Alan R. Palmiter, while the Jobs Act provides a private right of action for crowdfunding investors, recovering damages through litigation would be tough due to the high cost of litigation (particularly class action litigation).[160] Therefore, defrauded investors would face a lot of issues to enforce a liability provision against an issuer.

The small amounts of money involved in a securities-based crowdfunding transaction, mainly because of the investment caps make litigation out of reach for crowdfunding investors. Pursuant title III of the Jobs Act, certain investment caps must be observed by the investors. These caps will restrict investors to have enough "skin in the game." Thus, it would be unlikely that investors, separately, would suffer sufficient damages to warrant bearing the high cost associated with litigation.[161]

5. Lessons from China

Unlike the US, where equity crowdfunding has already been regulated, in China, there is neither a clear definition of equity crowdfunding nor a legal framework. This lack of regulation has contributed to uncertainty about the legitimacy of funding platforms and the legality of equity crowdfunding transactions. In addition, it also has contributed to an increasing in the number of legal disputes around this industry. For instance, on 24 October 2016, the Shanghai Pudong New Area People's Court heard a case where an investor sued an equity crowdfunding platform "Zhongchoujie" and its CEO for misappropriation of funds. Furthermore, 43 Chinese equity-based crowdfunding platforms were closed in the first four months of 2016 due to fraudulent fundraising, misrepresentation, internal conflict and lack of funding.[162] All of these incidents have undermined

[160] Alan R. Palmiter (n151) page 416.
[161] Alan R. Palmiter (n151) page 416.
[162] Dr. Lin Lin (n13) page 4.

investors' confidence in this industry and contributed to the declined growth rate of equity crowdfunding platforms in 2015.[163] Hence, the Chinese case is a concrete example that lack of regulation usually harms investors and entrepreneurs more than it helps them.

However, not all the lessons learned from China are wrong. For instance, there have been some good attempts by China regarding equity crowdfunding industry. As explained by Professor Dr. Lin Lin in his paper *Equity Crowdfunding in China*, to reduce the liquidity risk related to equity crowdfunding industry, regulators have started to provide new channels. The NEEQ (commonly known as the New Third Board) is a new national over-the-counter ("OTC") market launched in 2013, which imposes less stringent listing requirements and has a shorter listing timeline as compared to the other stock exchanges in China (i.e. the Main Boards (Shanghai Stock Exchange and Shenzhen Stock Exchange), the SME Board, and the ChiNext). Although this has been a good attempt to try to provide liquidity to this industry, NEEQ has not yet proven to be an attractive exit channel for equity crowdfunding investee companies. Additionally, a number of Chinese municipal governments including Beijing and Tianjin, have established regional equity trading systems where equity crowdfunding investee companies can legally list their shares. However, as this model is still in its infancy, it has not become a viable model for most investee firms yet.[164]

[163] Dr. Lin Lin (n13) page 5.
[164] Dr. Lin Lin (n13) page 25.

CHAPTER III – CASE STUDY

ASCENERGY: CROWDFUNDING INVESTMENT FRAUD[165]

To expose some of the points discussed above, the following is the analysis of the "first" crowdfunding investment fraud case in the United States. Ascenergy LLC, a Nevada limited liability company, that raised around USD$5 million from approximately 90 investors under the exemption granted by Title II of the Jobs Act. This Chapter proceeds in three parts. Part I provides a summary of the case. Part II analyzes this case from the perspective of the topics already discussed in this thesis. Part III concludes.

Part I: Summary

1. On October 13, 2015[166], the SEC (the "SEC and/or Plaintiff") filed before the U.S. District Court for the District of Nevada, an emergency action (civil action) to stop an ongoing securities offering fraud by Ascenergy LLC and its CEO, Joseph Gabaldon, (jointly the "Defendants") for offering fraudulent oil and gas investments.[167] At the time of the SEC's complaint, Ascenergy had raised approximately USD$5 million from around 90 investors. The investment that Ascenergy offered and sold is a security within the meaning of the Securities Act of 1933 and the Exchange Act of 1934.

2. The SEC stated that the Defendants had been soliciting investors through crowdfunding portals, such as, Crowdfunder, Fundable, EquityNet, and Angel.co, to purchase overriding royalty interest (securities) in undeveloped oil and gas wells, under the Rule 506(c) securities registration exemption in accordance with the Title II of the Jobs Act.

3. Pursuant to the SEC's complaint, Ascenergy spent, at least, USD$1.2 million of the offering proceeds, but only around USD$2,000 were used for oil and gas related expenses. Instead, as was alleged by the SEC, a significant part of the USD$1.2 million were spent on payments

[165] *Note:* All the information included in this chapter, is public official information taken directly from the U.S. Securities Exchange Commission's official website and Justia.com which is a US database.
[166] U.S. Securities Exchange Commission v. Ascenergy LLC, Joseph Gabaldon, Pyckl LLC and Energy LLC (2015), SEC's complaint filed with the United States District Court District of Nevada on October 13, 2015.
[167] U.S. Securities Exchange Commission v. Ascenergy LLC, Joseph Gabaldon, Pyckl LLC and Energy LLC (2015)

to companies controlled by the Defendants or for expenses unrelated to the oil and gas industry, such as foreign travel, restaurants and personal care products, among others.

4. Right after the SEC's complaint was filed and the SEC subpoenaed Ascenergy's CEO and other company employees, Ascenergy shut down public access to its web page and transferred USD$3.8 million (i.e. virtually all of the remaining offering proceeds) to Pyckl LLC, a company that has no apparent connection to the oil and gas business. Ascenergy, its CEO, and his colleagues refused to provide any information to the SEC about the company, the purported investment, or the use of investor funds.

5. The SEC stated that the Defendants by engaging in all of these conducts violated the securities law provisions, including, Rule 10b-5. Defendants did not admit nor deny the allegations included in the SEC's complaint.

6. At the SEC's request, the U.S. District Court for the District of Nevada entered a temporary restraining order halting the offering, as well as an order freezing the Defendants' assets and the assets of relief defendants Alanah Energy, LLC and Pyckl LLC.

7. The U.S. District Court for the District of Nevada by means of final judgment dated 23 May 2017[168] held that the Defendants violated the securities law provisions, including, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by using improper means to obtain investor funds and assets.

Part II: Discussion[169]

Ascenergy has been considered as the first crowdfunding securities investment fraud case in the United States. This company along with its management team made several misleading statements to defraud investors. Ascenergy posted a series of false and misleading statements on its web page and the crowdfunding portals to spur interest in the offering and to inflate the company's value and

[168] Case No.: 2:15-cv-01974-GMN-PAL U.S. Securities Exchange Commission v. Ascenergy LLC, Joseph Gabaldon, Pyckl LLC and Energy LLC (2015) Agreed Final Judgment dated May 23, 2017.
[169] Case No.: 2:15-cv-01974-GMN-PAL U.S. Securities Exchange Commission v. Ascenergy LLC, Joseph Gabaldon, Pyckl LLC and Energy LLC (2015) United States District Court District of Nevada.

credibility. Pursuant to the SEC's complaint, Ascenergy had no known oil and gas revenues or track record of drilling or production. Ascenergy had no publicly identifiable physical offices and appeared to conduct its business online primarily. This company did not have any expertise in the oil and gas exploration industry.

In accordance with the SEC's complaint, Ascenergy's disclosures contained various, material misrepresentations about the company and the nature of the offering. As per the SEC, Ascenergy falsely held itself out as a credible energy company, and it presented the investment as an extremely low-risk investment opportunity when it actually was a high-risk investment.

As per the SEC's complaint, the Defendants knew or were reckless in not knowing, that the statements made by the company were false and/or misleading. Defendants knew that they were misstating or omitting key facts about the nature and integrity of the business, the risk and performance of the investment, and the use of investor funds. By making these statements and omissions to solicit investor funds fraudulently, the Defendants acted with a high degree of scienter. That is, with the intention to defraud investors.

Ascenergy had been soliciting investors under Title II of the Jobs Act, seeking accredited investors to fund the company. This company utilized several, well known, crowdfunding securities platforms to raise approximately USD$5 million.

Start-up companies looking to raise capital through a crowdfunding platform need to provide only limited information about their business plan and future plans since they do not have to comply with disclosure requirements fully. Based on this exemption, fraudsters take advantage to defraud investors. With limited information on the market and without due diligence over the issuer company, as explained in section 4.2 above, the information asymmetry problem between the issuer company and the investors arise, and thus it would tend to give rise to a market for lemons. That is, markets where sellers know the quality of the goods they are offering, but buyers do not.

Part III: Conclusion

Securities-based crowdfunding created new investment opportunities, but it also created the potential for investment fraud. Regrettably, this case is an example, that start-up companies may use the funds in an inappropriate way. Fraudsters took advantage of the Jobs Act. Ascenergy defrauded investors who were convinced that the company was valuable. Investors who relied on the material statements made by the enterprise. This is the securities-based crowdfunding industry's first real fraud case in the United States, and it showed how the lack of disclosure requirements and due diligence might jeopardize the crowdfunding securities industry and how the high level of information asymmetry in crowdfunding securities would create a situation ripe for fraud, misappropriation, and the lemons problem.

This fraud case showed how important enough disclosure and due diligence are to prevent fraud. In addition, this case posed a question. What is the role to be played by the crowdfunding securities platforms? As per SEC's regulation, crowdfunding electronic platforms must act as gatekeepers to create more elements to protect investors from any fraudulent activity. Companies wishing to be funded through crowdfunding in the US must rely on funding portals. These portals act as gatekeepers to prevent fraud and abuse and they make sure that investors understand investing and the risks associated therein. However, in this case, the money was raised through crowdfunding platforms which did not check any information about the issuer company. This case creates a debate about the role of the crowdfunding platforms and how these platforms will take that responsibility seriously. Crowdfunding securities platforms have a duty to check the offerings that appear on their sites.

Finally, another query arises, if this happened to accredited investors, which are supposed to be financially sophisticated investors who require less protection from the public authorities, what will happen to non-accredited investors? The real impact of this emerging industry is still to be seen. In any case, this case is an opportunity for crowdfunding participants to work together to deal with the challenges of this disruptive industry.

CHAPTER IV - CROWDFUNDING IN THE NEAR FUTURE

As predicted by Professor Yannis Bakos almost 20 years ago, in 1998, Internet-based electronic marketplaces leverage information technology to match buyers and sellers with increased effectiveness and lower transaction costs, leading to more efficient, "*friction-free*" markets. As a consequence, the role of intermediaries may be reduced, or even eliminated, leading to "disintermediation."[170]

Communication and transaction costs have declined because of the Internet, and therefore new platforms have emerged, delivering goods and services at a speed and efficiency previously unimaginable.[171] Under this scenario, securities-based crowdfunding has emerged as an online funding alternative for start-up companies in need of capital.

Notwithstanding that securities-based crowdfunding is being consolidated in some countries, such as the case of the United States where this business model has already been regulated, a new technological transformation is approaching which may have a great impact on this emerging industry. Blockchain technology and cryptocurrencies mature and mainstream applications are rising. Under this new wave of technological change, intermediaries will still be able to add value to transactions, but the nature of intermediation will fundamentally change.[172]

A continuous wave of digital innovation is disrupting the world of business. A particular type of disruptive technology is the Blockchain, which experts compare in importance to the emergence of the Internet.[173] Due to the relevance of this matter, in the next paragraphs, I would like to address how this new technology may have an impact on securities-based crowdfunding transactions.

[170] Yannis Bakos (n92) page 12.
[171] Christian Catalini, 'How Blockchain Technology Will Impact the Digital Economy' (University of Oxford, Faculty of Law, 24 April 2017) para 1 <https://www.law.ox.ac.uk/business-law-blog/blog/2017/04/how-blockchain-technology-will-impact-digital-economy> accessed 24 May, 2017.
[172] Christian Catalini (n171) para 2.
[173] Alfonso Delgado, 'Oxford Fintech & SmartLaw Society: A Student-led Initiative to Explore Disruptive Technologies' (University of Oxford, Faculty of Law, 17 January 2017) para 3 <https://www.law.ox.ac.uk/business-law-blog/blog/2017/01/oxford-fintech-smartlaw-society-student-led-initiative-explore> accessed 24 May, 2017.

- **Blockchain**

First, to understand how the Blockchain technology may impact securities-based crowdfunding industry, it is necessary to explain how it works briefly. Blockchain technology is a decentralized distributed public ledger (data structure) where data is being stored inside blocks in forms of transactions. Blockchain technology creates a platform for trust through truth and transparency for parties. The technology increases transparency, while at the same time significantly reducing transaction costs. Remove the dependency on the trusted third party for recording the data in blocks. Blockchain provides an alternative that eradicates agency problems, costs and intermediation. There is no platform; it is peer to peer. The platform is Blockchain.

Blockchain allows the exchange of information and that some traditional transactions can be closed without the participation of intermediaries. Blockchain enables and facilitates, among others, access to finance and stock markets around the globe in a public peer to peer transaction. Blockchain technology dismisses the need to rely on a controlling authority to verify all transactions. Having formalized a contract's provisions into source code, parties can use a distributed database to confirm that an event or condition has occurred without the intervention of a third party.[174]

Professor Erik Vermeulen in his paper named *"3 Reasons Why the Blockchain Revolution Is (Finally) Becoming a Reality"* said that there has been little or no discussion yet about how new technology and particularly Blockchain technology and smart contracts might offer an alternative, and oftentimes better, set of solutions to the problems facing a young entrepreneur or new business.[175]

In this sense, it is important to note that organized securities exchanges have historically had a physical trading floor.[176] Yet, in recent years more and more transactions are completed by electronic means. The decentralized database, computing infrastructure, peer to peer network.

[174] Alfonso Delgado (n173) para 4.
[175] Erik Vermeulen, '3 Reasons Why the Blockchain Revolution Is (Finally) Becoming a Reality!'(Medium.com 5 May 2017) para 10 < https://medium.com/@erikpmvermeulen/3-reasons-why-the-blockchain-revolution-is-finally-becoming-a-reality-63bdd90c89e2> accessed 5 May 2017.
[176] S. Choi and A.C. Pritchard (n19) 9.

Today's marketplaces can efficiently operate without anybody in the middle. Today's capital markets do not rely on traders interacting at a particular trading floor. Instead, online communication allows the parties involved in a securities transaction to be brought together to close a deal. Even soon, there is a chance that the crowdfunding platforms would disappear due to the new era of technology, Blockchain. Blockchain technology and smart contracts offer simple, fast, secure and reliable solutions.[177]

According to a recent report by Bain & Company, 80% of financial market participants say the technology will transform their industry and expect their companies to adopt it by 2020.[178] Understanding how new technologies might be used in a business context seems a good way to move debates on this issue forward.

As Professor Vermeulen has pointed out, emerging countries have a huge incentive to implement and regulate Blockchain technology, since it gives them the opportunity to leapfrog various stages in the development process. For example, fintech leverages technology to improve the quality of, and access to, financial services for individuals in markets that have traditionally been excluded from such opportunities.[179]

Currently, there are some attempts to implement Blockchain technology for financing purposes. For instance, Funderbeam an Estonian platform is building a Blockchain-based "stock exchange" for start-ups. The previous CEO of the Nasdaq Tallin Stock, kaidi Ruusalepp, said, companies used to go to exchanges for growth financing, but looking at the start-up funding trends, like Uber raising €3.5 billion in just one round, plus the cost structure of getting listed and being listed on a traditional stock exchange, it does not make sense anymore. [180]

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[177] Ibid para 12.
[178] Laura Shin, 'Why Nasdaq Is Even More Optimistic About Blockchain Than It Was 3 Years Ago' (Forbes, 21 February 2017) para 3 <https://www.forbes.com/sites/laurashin/2017/02/21/why-nasdaq-is-even-more-optimistic-about-blockchain-than-it-was-3-years-ago/#727efd621a26> accessed 6 May 2017.
[179] Ibid para 35-36
[180] Steve O'Hear, 'Estonia's Funderbeam is building a blockchain-based "stock exchange" for startups' (Techcrunch, October 12, 2017) para 1 <https://techcrunch.com/2016/10/12/funderbeam/> accessed 11 May, 2017.

In addition, she said "Today growth companies look to the equity markets only as a serious option for exits. On top, early-stage and growth funding has grown to unimagined heights, but it is one of the most illiquid assets classes. Once you're in, you hardly get out."[181] Funderbeam Blockchain-based platform would solve the liquidity problem. This would be a transparent and trustworthy platform for the secondary market, and one that can work across borders. It will let shareholders sell their shares in start-up companies, either one that was initially funded via the platform or potentially any that they have permission to trade.[182]

Finally, in 2015, NASDAQ confirmed that an issuer was able to use Nasdaq Link Blockchain ledger technology to complete a private securities transaction. It was the first of this nature using Blockchain technology. [183]

[181] Steve O'Hear (n180) para 5.
[182] Steve O'Hear (n180) para 7.
[183] Will Briganti and Ryan Wells, 'Nasdaq Linq Enables First-Ever Private Securities Issuance Documented With Blockchain Technology' (Nasdaq, December 30, 2015) para 1 <http://business.nasdaq.com/> accessed on 12 May, 2017.

CONCLUSION

This thesis demonstrates the impact of the current US regulation on securities-based crowdfunding industry. The legal restriction to resell crowdfunding securities during the first year of ownership (as explained in Chapter II above) and the absence of a liquid and transparent secondary market for crowdfunding securities truly affect investors who acquire shares of start-ups companies. These investors may be left holding securities that they would be unable to sell due to the absence of an organized secondary marketplace. A developed and viable secondary market that promotes a liquid and transparent environment for crowdfunding securities, a market in which investors can have confidence, it is the best way to protect investors, while promoting the successful expansion of small companies and securities-based crowdfunding industry.

In order for securities-based crowdfunding industry to be actually a success, an organized secondary market is essential. A secondary market will create a real opportunity to provide investors with liquidity and make crowdfunding securities more attractive to prospective investors, including sophisticated and institutional investors. More investors will be attracted to invest in crowdfunding securities if they know that there is a marketplace to resale these securities and that they have the right exit mechanisms to get their money back. The restriction to resell crowdfunding securities during the first year of ownership and the absence of organized secondary market mean a reduction in the securities value to the investors and it makes these investments less attractive for institutional and more sophisticated investors.

An organized and efficient secondary market for crowdfunding securities and a less restrictive resale provision would incentivize institutional investors to transact in crowdfunding securities. The restriction to resell crowdfunding securities was included in the Jobs Act as a deterrent against fraud. Yet, this provision could dissuade institutional investors from purchasing these securities since this restriction would reduce the liquidity of the shares. The high degree of illiquidity associated with crowdfunding securities might prevent investors from investing in crowdfunding transactions, limiting potential capital formation in this industry and thus constraining the growth of this market.

There have been abroad some initiatives to implement crowdfunding secondary market platforms. For instance, Seedrs a UK-based equity crowdfunding platform announced that they are planning to launch a crowdfunding secondary market platform later this 2017 summer.[184] By contrast, in the United States, there have not been initiatives to establish a unified organized secondary market such as NASDAQ where these crowdfunding securities can be traded.

As pointed out by Joseph Dehner and Jin King, the ultimate success of equity-based crowdfunding as a positive force in the world requires more than entrepreneurs with good ideas and willing crowd investors. Hence, there should be a supportive ecosystem and enabling factors, such as flexible and forward-thinking regulations, efficient technology solutions, and cultures that embrace this new investment vehicle. Key factors that facilitate successful equity-based crowdfunding include: (i) a regulatory framework that is transparent, cost-effective, efficient, and scalable for early-stage funding; (ii) strong social media market penetration and effective technological solutions; (iii) a well-regulated online marketplace that facilitates capital formation while providing reasonable disclosure and high education and training for investor protection; (iv) coordinated collaboration among other entrepreneurial players, including business plan competitions, incubators, accelerators, universities and co-working spaces to leverage synergies for opportunity and peer-oversight; and (v) a secondary market providing exit strategies for investors to reap their ultimate investment rewards.[185]

Moreover, as was explained in Chapter II above, the one-year resale restriction along with the absence of an organized secondary market make the market for crowdfunding securities highly inefficient which presents proof problems for plaintiffs to evidence loss causation under Rule 10b-5. If crowdfunding investors cannot prove loss causation, then their fraud lawsuits will ultimately fail. An organized secondary market is essential to determine if a particular market is efficient. That is, whether the all the available information is duly reflected in the stock price. Without an organized efficient secondary market, such as the case of equity crowdfunding, it would be tough

184 Steve O'Hear, 'Equity crowdfunding platform Seedrs to launch secondary market' (Techcrunch, May 7, 2017) para 1 <https://techcrunch.com/2017/05/07/equity-crowdfunding-platform-seedrs-to-launch-secondary-market/> accessed 11 May, 2017.

185 Joseph J. Dehner and Jin Kong (n17) page 443.

to establish that the stock price reflects all the available information, mostly, making harder to prove loss causation under Rule 10b-5 in equity-crowdfunding litigation.

In addition, as explained by Professor Jason W. Parsont, for private companies whose shares are not traded in an efficient market, prove reliance under Rule 10b-5 is very hard to do. Without an efficient market, such as the case of crowdfunding securities, plaintiffs must demonstrate that each investor actually relied on the misstatement or omission. Thus, given that crowdfunding securities are not traded on efficient markets, plaintiffs cannot rely upon the fraud-on-the-market theory in order to bring an action under Rule 10b-5.

In sum, the liability regime under Rule 10b-5 which applies mainly to accredited crowdfunding creates a difficult challenge for plaintiffs (investors) since it would be tough to prove all of its elements due to the current conditions of the equity crowdfunding market. Therefore, this Rule 10b-5 is more favorable to issuers than investors since it cannot be easily proved in equity crowdfunding transactions and thus it would be harder to make them liable for fraud. On the other hand, Section 4A(c) which exclusively applies to retail crowdfunding imposes a severe liability on crowdfunding issuers since under this provision a plaintiff (investor) need only to prove that an untrue statement or misleading omission occurred and that the defendant did not exercise reasonable care. Innocent and unsophisticated start-up companies may fall within the broad scope of this liability provision. Under this context, issuer companies would prefer accredited crowdfunding since it would be less expensive, more flexible and they will have lower liability exposure and fewer marketing restrictions than retail crowdfunding.

In addition, there are still some issues that have not been tested yet. Annual investment limits in retail crowdfunding would discourage sophisticated investors, such as venture capital firms, from doing a due diligence work of the issuer company on behalf of the crowd to prevent a market for lemons.[186] The annual investment limits imposed by the Title III of the Jobs Act, which is intended to protect small investors by limiting their exposure to risky investments, could disincentive due diligence because they prevent any one investor from having significant “skin in the game’’. Even if securities-based crowdfunding is affordable enough to be viable, it could degrade into a market

[186] Jason W. Parsont (n46) page 318.

for lemons since there are high-quality entrepreneurs but also low-quality entrepreneurs in the market. Without due diligence, the information asymmetry problem between the issuer company and the prospective investors may arise, and thus it would tend to give rise to a market for lemons, as was explained in section 4.2 above. Likewise, the relatively small investment caps might make retail crowdfunding offering less attractive for institutional investors. Sophisticated investors would prefer, instead, to invest in accredited crowdfunding in accordance with Title II of the Jobs Act which is not subject to investment caps.

The real impact of this emerging industry is still to be seen. Upon a closer analysis, there are clearly extensive issues that US Congress and the SEC have not correctly addressed. There is no balance between issuers' accountability and investor protection from fraud. Regulators face the challenge of actually balancing access to capital by small businesses and investor protection. Beyond fraud, there are a lot of issues that have not been addressed yet. A secondary market along with regulation which does not jeopardizes the crowdfunding participants is required to ensure securities-based crowdfunding success and to ensure the steady growth of this market.

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