Crowdfunding & Investor Education:
Empowering Investors To Mitigate Risk & Prevent Fraud

"I also requested that the staff think creatively about what the SEC can do to encourage capital formation, particularly for small businesses, while maintaining important investor protections."[1]

I. INTRODUCTION

Small businesses are imperative in the United States economy.[2] Small businesses make up 99.7 percent of all employer firms in the United States.[3] These firms employ nearly fifty-five million individuals and provide 42.6 percent of the nation's private-sector payroll.[4] In addition, small businesses are job creators.[5] Between 1993 and 2013, small businesses accounted for 14.3 million net new jobs, sixty-three percent of net new jobs during that period.[6] Further, these firms are responsible for sixty percent of the net new jobs created since the most recent recession.[7] Additionally, in March 2011, about 900,000

1. *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 112th Cong. (2011) (statement of Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/2011/ts051011mls.htm, *archived at* http://perma.cc/29XB-2XP9.

2. *See Frequently Asked Questions*, U.S. SMALL BUS. ADMIN. (Mar. 2014), http://www.sba.gov/advocacy/7495/29581, *archived at* http://perma.cc/H66Y-SZSL (describing prominence of small businesses in United States economy). This Note will use the Small Business Administration's Office of Advocacy's definition of a "small business:" an independent business with less than 500 employees. *See id*.

3. *See Latest SUSB Annual Data*, U.S. CENSUS BUREAU (2011), http://www.census.gov/econ/susb/, *archived at* http://perma.cc/YU42-PBFW (showing 5,666,753 of 5,684,424 United States employer business firms as small businesses). If the nonemployer firms are counted, small businesses account for 99.9 percent of all United States business firms (27,827,930 of the 27,845,166 firms). *See id.*; *Geographic Area Series: Nonemployer Statistics by Legal Form of Organization: 2010*, U.S. CENSUS BUREAU (Aug. 15, 2012) [hereinafter *Geographic Area Series*], http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=NES_2010_00A1&prodType=table, *archived at* http://perma.cc/35P5-Y8PL (listing number of nonemployer firms by legal form of organization). The vast majority of nonemployers are individual proprietorships. *See Geographic Area Series*, *supra* (indicating 86.4 percent of nonemployer firms as individual proprietorships). Nonemployer firms are businesses that have no paid employees, annual receipts of at least $1000, and are subject to federal income tax. Econ. Planning & Coordination Div., *Nonemployer Statistics: Nonemployer Definitions*, U.S. CENSUS BUREAU, http://www.census.gov/epcd/nonemployer/view/define.html (last visited Dec. 11, 2014), *archived at* http://perma.cc/36U8-C7LZ.

4. *See Latest SUSB Annual Data*, *supra* note 3 (listing employment numbers by size of enterprise).

5. *See Frequently Asked Questions*, *supra* note 2 (describing small businesses' share of net new jobs).

6. *See id.* (providing statistics on small business employment and job creation).

7. *See id.* (discussing small business job creation).

self-employed individuals were unemployed the prior year.[8]

Small businesses, despite their prominence in the economy, account for the vast majority of firm failures.[9] One cause of these failures is inadequate capital.[10] The lack of capital is caused, in part, by the small business capital gap.[11] In order to strengthen the small business environment, the United States economy must bridge this gap.[12] One way to address the disparity between small business capital demand and supply is through the further development of crowdfunding.[13]

Crowdfunding is the raising of small amounts of capital from a large number of people, the "crowd."[14] It is a combination of crowdsourcing and microfinancing, and a number of crowdfunding models have emerged:

8. *See Frequently Asked Questions*, U.S. SMALL BUS. ADMIN. OFFICE OF ADVOCACY (Sept. 2012), http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf, *archived at* http://perma.cc/6W5L-4BTQ ("[A] significant number of the self-employed, 5.5 percent . . . had been unemployed in the previous year.").

9. *See Table 765. Firm Births and Deaths by Employment Size of Enterprise: 1990 to 2007*, U.S. CENSUS BUREAU (2012), http://www.census.gov/compendia/statab/2012/tables/12s0765.pdf, *archived at* http://perma.cc/9L4G-NJCQ (reporting small businesses accounted for 99.96 percent of firm deaths from March 2003 to March 2007).

10. *See What Are the Major Reasons for Small Business Failure?*, U.S. SMALL BUS. ADMIN., http://www.sba.gov/content/what-are-major-reasons-small-business-failure (last visited Dec. 11, 2014), *archived at* http://perma.cc/LQH6-AK2B (listing leading causes of small business failure).

11. *See* JOHN K. PAGLIA, PEPPERDINE PRIVATE CAPITAL MARKETS PROJECT: 2013 CAPITAL MARKETS REPORT 76 (2012), *available at* http://bschool.pepperdine.edu/newsroom/index.php/2012/11/pepperdine-2013-capital-markets-report-released/, *archived at* http://perma.cc/95Y4-8ABC (reporting access to capital as number one emerging issue cited by privately-held business owners). Small business owners, as well as investment bankers and private equity groups, report a gap between available capital and firms worthy of capital. *See id.* at 7-12, 15-19. Fifty-one percent of investment bankers and sixty-three percent of private equity groups reported a capital gap for companies with less than five million dollars of EBITDA. *See id.*; *see also* Susan Longworth & Robin Newberger, *Small Business Access to Capital: Alternative Resources Bridging the Gap*, PROFITWISE NEWS & VIEWS 2 (May 2012), http://www.chicagofed.org/webpages/publications/profitwise_news_and_views/2012/pnv_may2012.cfm, *archived at* http://perma.cc/98TC-M8CY (reporting more than fifty-percent decrease in lending to small businesses since late 2007). Some have suggested that angel investors and venture capitalists are only attracted to about one percent of businesses. *See* Sramana Mitra, *Can Crowdfunding Solve the Startup Capital Gap?*, HARV. BUS. REV. (July 24, 2013), http://blogs.hbr.org/2013/07/can-crowdfunding-solve-the-sta/, *archived at* http://perma.cc/WQ86-JP5U (describing opportunities crowdfunding could create).

12. *See What Are the Major Reasons for Small Business Failure*, *supra* note 10 (listing inadequate capital as one reason small businesses fail).

13. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 103-04 (2012) (positing crowdfunding will open new capital sources to small businesses). Crowdfunding opens investment opportunities to individuals who are less likely to engage in traditional investment methods, such as private securities offerings. *See id.* These individuals are less likely to follow traditional paths of investment because of the large amount of capital typically needed to participate. *See id.* Crowdfunding, however, matches businesses seeking capital with investors willing to make smaller investments, and thus, it opens the capital market to new investors. *See id.* at 103-04. Crowdfunding can help bridge the small business capital gap because it connects small businesses often overlooked by sophisticated investors with small investors typically excluded from traditional capital markets. *See id.* at 100-04.

14. *See id.* at 10 (defining crowdfunding); Benjamin P. Siegel, Note, *Title III of the JOBS Act: Using Unsophisticated Wealth To Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 778 (2013) (describing crowdfunding as utilization of large numbers of investors, each contributing small capital amounts).

donation, reward, pre-purchase, lending, and equity.[15] The crowdfunding models are explained below in Part II.A.[16] To date, these crowdfunding models have raised billions of dollars.[17] Equity crowdfunding, however, has been significantly underutilized.[18] This underutilization is due to the lack of certainty concerning crowdfunding and its interplay with current securities laws.[19] The Securities and Exchange Commission's (SEC's) proposed regulations have helped create some certainty and could aid in closing, or at least shrinking, the capital gap.[20] Certainty alone, however, is not enough; the regulations must also find a balance between investor protection and capital formation.[21] This Note discusses how incorporating a stronger investor education mechanism into the regulations could achieve the appropriate

15. *See* Bradford, *supra* note 13, at 14-26 (explaining different crowdfunding models).

16. *See infra* Part II.A (addressing history and models of crowdfunding).

17. *See* Luke Richards, *Crowdfunding in Numbers: Stats*, ECONSULTANCY (June 15, 2012), http://econsultancy.com/blog/10074-crowdfunding-in-numbers-stats, *archived at* http://perma.cc/4PGQ-3VTR (providing crowdfunding statistics from 2007 to 2012). From 2009 to 2011, crowdfunding raised $2.85 billion for various projects and causes globally. *See id*; *see also* Devin Thorpe, *Crowdfunding for Good Now a Growing Global Movement*, FORBES (Jan. 7, 2014), http://www.forbes.com/sites/devinthorpe/2014/01/07/crowdfunding-for-good-now-a-growing-global-movement/, *archived at* http://perma.cc/26S4-LMK5 (stating 2013 "yielded an estimated $5 billion in global crowdfunding").

18. *See* Siegel, *supra* note 14, at 788 (noting equity crowdfunding used internationally but only recently legalized in United States); *see also* Andrew C. Fink, *Protecting the Crowd and Raising Capital Through the Crowdfund Act*, 90 U. DET. MERCY L. REV. 1, 10 (2012) (explaining equity crowdfunding currently limited due to regulatory restrictions). Under the current securities laws and regulations, small businesses can utilize equity crowdfunding, but they must follow certain procedures. *See* Fink, *supra*, at 12-14. For example, Regulation D exempts public offerings from SEC registration requirements if the offering is under one million dollars and only accredited investors are solicited. *See* 17 C.F.R. § 230.504(b) (2014) (outlining conditions for Regulation D offerings). Thus, a small business could use equity crowdfunding if it limits its "crowd" to accredited investors. *See* Fink, *supra*, at 14. Regulation D is not an effective avenue for crowdfunding, however, because the "crowd" is primarily comprised of unaccredited investors. *See id.*

19. *See* Bradford, *supra* note 13, at 24 (explaining equity crowdfunding not common in United States due to regulatory issues).

20. *See* Press Release, SEC, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Us3X-hY1b8s, *archived at* http://perma.cc/H7Z2-J33U (announcing release of proposed crowdfunding rules, to provide needed certainty); *see also* D. Scott Freed, *Crowdfunding as a Platform for Small Business Capital Raising*, MD. B.J., July-Aug. 2012, at 12, 14 (describing how equity crowdfunding could make crowdfunding more effective); *supra* note 13 and accompanying text (discussing how crowdfunding could bridge small business capital gap). "[I]n order for crowdfunding to be truly effective to raise capital for small businesses in the U.S. the offering must offer investors a potential economic return on their investment. Typically, start-up and emerging businesses raise capital by selling equity interests . . . ." Freed, *supra*, at 14.

21. *See* Nickolas C. Jensen, *Fundraising on the Internet: Crowdfunding, Kickstarter and the JOBS Act*, ARIZ. ATT'Y, Mar. 2013, at 22, 24 (positing if SEC fails to find balance, small businesses may not prefer equity crowdfunding); *see also* 158 CONG. REC. S5474, S5474-78 (daily ed. July 26, 2012) (statement of Sen. Jeff Merkley) [hereinafter Merkley remarks] (highlighting considerations for regulations); 158 CONG. REC. S2229, 2231 (daily ed. Mar. 29, 2012) (statement of Sen. Michael Bennet) [hereinafter Bennet remarks] (stating bill strikes balance between capital formation and investor protection); 158 CONG. REC. S2229, S2230-31 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown) [hereinafter Brown remarks] (testifying crowdfunding law balances access to capital and investor protection).

balance.[22]

Part II of this Note will examine the historical aspect of this issue.[23] It begins by describing crowdfunding, its different models, and its evolution in the United States.[24] Part II goes on to discuss the Securities Act of 1933 ('33 Act), including the rationale motivating the adoption of United States securities laws.[25] This discussion will include an analysis of the relevant provisions of the '33 Act.[26] Finally, Part II will culminate with an explanation of the framework for regulating crowdfunding provided by the Jumpstart Our Business Startups Act (JOBS Act) and the SEC's proposed crowdfunding rules.[27]

Part III will discuss how the SEC can balance investor protection with capital formation by strengthening the regulation's investor education component.[28] By strengthening the educational requirements, the SEC could relax other regulations without compromising investor protection.[29] Further, Part III suggests that a regulatory system built on disclosure, such as this, is not meaningful if investors are not provided the education needed to understand and utilize the disclosures.[30] Lastly, Part IV summarizes the major themes in this Note and solidifies the importance of a balanced and responsible approach toward regulating crowdfunding.[31]

II. History

To better appreciate the challenges in regulating crowdfunding, it is important to first develop a basic understanding of the crowdfunding phenomena and the United States securities laws.[32] This section first discusses the evolution of crowdfunding—where it evolved from and the forms it takes today.[33] Next, it will look at the history of the United States securities laws and outline provisions relevant to this discussion.[34] By describing both crowdfunding and the securities laws, this section will highlight the unique challenges that crowdfunding creates for securities regulators.[35]

22. *See infra* Part III.
23. *See infra* Part II.
24. *See infra* Part II.
25. *See infra* Part II.
26. *See infra* Part II.
27. *See infra* Part II.
28. *See infra* Part III.
29. *See infra* Part III.
30. *See infra* Part III.B.
31. *See infra* Part IV.
32. *See* Siegel, *supra* note 14, at 781 (stating understanding evolution of securities law and crowdfunding needed to realize impact of JOBS Act).
33. *See infra* Part II.A.
34. *See infra* Part II.B.
35. *See* Jensen, *supra* note 21, at 24 (emphasizing unique balance SEC must find to meet crowdfunding

A. Crowdfunding

Crowdfunding is the process of raising money from a large number of contributors who typically contribute small amounts through the use of the Internet or social media.[36] It evolved from the combination of two other practices: crowdsourcing and microfinancing.[37] Crowdsourcing is the process of taking on an overwhelming task by farming out small, manageable tasks to the "crowd."[38] Microfinancing is the lending of small amounts of money to an individual or enterprise in need.[39] Thus, together, crowdsourcing and microfinancing create crowdfunding: raising small amounts of money—microfinancing—from a large number of people—crowdsourcing.[40]

While the phenomena has become prevalent in recent years, the underlying concept behind crowdfunding has been around for some time.[41] In fact, crowdfunding theory has its roots in the eighteenth century when Alexander Pope used the basic concept to finance his endeavor to translate ancient Greek poetry into English.[42] Although the idea of crowdfunding is not new, its

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goals).

36. *See, e.g.*, Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTURING 585, 588 (2014) ("Crowdfunding involves an open call, mostly through the Internet, . . . to support initiatives for specific purposes."); Bradford, *supra* note 13, at 5 ("Crowdfunding [] is . . . funding from the crowd—raising small amounts of money from a large number of investors."); David Mashburn, Comment, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 136 (2013) ("Crowdfunding occurs when someone raises small amounts of money from a large group of people, facilitated via the Internet and, particularly, through social media platforms.").

37. *See* Siegel, *supra* note 14, at 785 (recognizing crowdfunding as combination of crowdsourcing and microfinancing); *see also* Belleflamme et al., *supra* note 36, at 2 (explaining crowdsourcing as root of crowdfunding); Ross S. Weinstein, Note, *Crowdfunding in the U.S. and Abroad: What To Expect When You're Expecting*, 46 CORNELL INT'L L.J. 427, 428 (2013) (describing microfinancing as source of crowdfunding).

38. *See* Bradford, *supra* note 13, at 27 (discussing origin and evolution of crowdfunding). Wikipedia is a well-known example of crowdsourcing. *See id.* There, the contributors—the "crowd"—are working together to build an entire encyclopedia composed of articles from the general public. *See id.*

39. *See* Siegel, *supra* note 14, at 785 (detailing history of crowdfunding). The major criticism of microfinancing is that without a system for continued support, many enterprises that receive microfinance funds will fail. *See* Weinstein, *supra* note 37, at 429. For example, in one region of India, only one percent of microfinanced ventures were still in operation three years later. *See id.*

40. *See supra* notes 37-39 and accompanying text (explaining evolution of crowdfunding from crowdsourcing and microfinancing).

41. *See* Bradford, *supra* note 13, at 11 (discussing how politicians have used crowdfunding idea to finance campaigns for years); *see also* Daniela Castrataro, *A Social History of Crowdfunding*, SOC. MEDIA WEEK (Dec. 12, 2011), http://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/#.Us2cwRY1b8s, *archived at* http://perma.cc/6HZW-AP4G (outlining recent history of crowdfunding); *The History of Crowdfunding*, FUNDABLE, http://www.fundable.com/crowdfunding101/history-of-crowdfunding (last visited Dec. 12, 2014), *archived at* http://perma.cc/Z8L7-34Z4 (noting roots of crowdfunding date to 1700s).

42. *See The History of Crowdfunding*, *supra* note 41 (discussing earliest forms of crowdfunding); Justin Kazmark, *Kickstarter Before Kickstarter*, KICKSTARTER (July 18, 2013), http://www.kickstarter.com/blog/kickstarter-before-kickstarter, *archived at* http://perma.cc/N4Y7-MR6K (noting early crowdfunding campaigns employed by Alexander Pope, Mozart, and Joseph Pulitzer). Seven-hundred-fifty individuals were listed in the acknowledgements of an early addition of Pope's book in exchange for pledging two gold guineas each. *See* Kazmark, *supra*. Pope was not the only individual to utilize the crowdfunding theory in the eighteenth century—Mozart also employed the concept to bankroll the performance of three piano concertos. *See id.* The

utilization of the Internet and social media is.[43] The concept moved to the Internet in the mid-1990s.[44] Two of today's more notable crowdfunding sites, Indiegogo and Kickstarter, however, were not launched until 2008 and 2009, respectively.[45]

Crowdfunding has grown significantly since 2009.[46] In 2009, global crowdfunding platforms raised approximately $530 million.[47] Since then, the amount raised through these platforms has grown by nearly 950%.[48] The 2013 estimate for global funds raised through crowdfunding platforms exceeds five

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first campaign in 1783 did not garner the needed support, but a year later Mozart received enough pledges to bring the concertos to fruition. *See id.* Mozart thanked his backers by printing their names in the concertos' manuscript. *See id.* The crowdfunding concept was put to work early in the United States as well. *See id.* In 1885, Joseph Pulitzer initiated a crowdfunding campaign to fund the construction of a pedestal for the Statute of Liberty. *See id.* Pulitzer received pledges from more than 120,000 people to build the pedestal. *See id.* Supporters that pledged a dollar or more were sent a statuette of Lady Liberty. *See id.*

43. *See* Bradford, *supra* note 13, at 11 (highlighting recent development of crowdfunding via Internet and social media).

44. *See History of CrowdFunding*, CROWD FUNDING WORLD SUMMIT, http://www.crowdfundingworldsu mmit.com/crowdfunding (last visited Dec. 12, 2014), *archived at* http://perma.cc/HN3L-6CL4 (providing timeline of important crowdfunding developments since 1996). In 1996, the SEC began allowing companies to post public offerings online. *See* Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Securities Act Release No. 7288, Exchange Act Release No. 37,182, Investment Company Act Release No. 21,925, Investment Advisers Act Release No. 1562, 61 Fed. Reg. 24,644, 24,645 (May 15, 1996). Spring Street Brewery took advantage of the new rule and posted its initial public offering (IPO) on its website, raising nearly two million dollars. *See* Susan Greco, *The Real Legacy of Spring Street Brewing*, INC. (Sept. 1, 1999), http://www.inc.com/magazine/19990901/13720.html/1, *archived at* http://perma.cc/F223-AW2T (detailing Spring Street's campaign). Online platforms for IPOs also began emerging in 1996. *See History of CrowdFunding*, *supra*. Although not crowdfunding as we know it today, these online direct IPOs were a "precursor to [c]rowd[f]unding." *See id.* Many cite a fundraising campaign conducted by a British rock band as the inception of modern day crowdfunding, or at least the first successful modern crowdfunding campaign. *See* Castrataro, *supra* note 41 (describing crowdfunding's development from 1990s to date); *The History of Crowdfunding*, *supra* note 41 (citing campaign as "first recorded successful instance of crowdfunding"). In 1997, the band Marillion raised $60,000 through its website to fund a United States tour. *See* Castrataro, *supra* note 41. Using this concept, ArtistShare became the first successful crowdfunding platform, allowing bands to solicit donations from fans to fund albums. *See History of CrowdFunding*, *supra*. In the mid-2000s, microlending and peer-to-peer lending sites, such as Kiva (2005) and Prosper (2006), emerged. *See* Castrataro, *supra* note 41. The crowdfunding trend most prevalent today really kicked off in 2008 and 2009 with the launch of Indiegogo and Kickstarter, respectively. *See History of CrowdFunding*, *supra*.

45. *See* Chance Barnett, *Donation-Based Crowdfunding Sites: Kickstarter Vs. Indiegogo*, FORBES (Sept. 9, 2013), http://www.forbes.com/sites/chancebarnett/2013/09/09/donation-based-crowdfunding-siteskickstarte r-vs-indiegogo/, *archived at* http://perma.cc/DR2H-K59P (addressing difference between donation and investment crowdfunding). Indiegogo was conceived in 2007 by three individuals who had attempted, unsuccessfully, to raise startup capital through traditional avenues. *See About Us*, INDIEGOGO, http://www.indiegogo.com/about/our-story (last visited Dec. 12, 2014), *archived at* http://perma.cc/MB93-R4BM. Indiegogo, however, was not launched until 2008. *See id.*

46. *See infra* notes 47-49 and accompanying text (discussing growth of money raised through crowdfunding).

47. *See* Richards, *supra* note 17 (providing crowdfunding statistics from 2007 to 2012).

48. *Compare* Richards, *supra* note 17 (noting $530 million was raised through crowdfunding in 2009), *with* Thorpe, *supra* note 17 (stating 2013 "yielded an estimated $5 billion in global crowdfunding").

billion dollars.[49] The phenomenon is excepted to continue to grow; in fact, a World Bank report estimates that crowdfunding in the developing world could raise ninety to ninety-six billion dollars a year by 2025.[50]

Five different methods of crowdfunding have evolved in recent years: donation, reward, prepurchase, lending, and equity.[51] In the donation model, contributors give money to a cause and receive nothing in return.[52] This does not mean the cause needs to be charitable in nature.[53] For-profit ventures can use the donation model to raise funds, but as a practical matter, most donation model activity is from charities and other nonprofit organizations.[54]

The reward and prepurchase models are similar and treated together.[55] In both models, contributors receive something in return for their contribution, but not an interest or share in business earnings.[56] In the reward model, donors often receive a nominal gift, such as a key chain or their name listed as a project contributor, but the reward can be more extravagant, for example, dinner with a celebrity or a trip to see a band play live.[57] The prepurchase model is similar, but instead of receiving a reward, contributors receive the

49. *See* Thorpe, *supra* note 17 (discussing growth of social giving). In 2013, the American Red Cross Typhoon Relief raised $1.2 million and Habitat for Humanity received $5 million through crowdfunding portals. *See id.* Over the past five years, GiveMN (Give Minnesota) has raised $75 million by utilizing crowdfunding, and in 2013, the campaign received $17 million in just one day. *See id.*

50. *See Crowdfunding's Potential for the Developing World*, WORLD BANK 43-44 (2013), *available at* http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf, *archived at* http://perma.cc/4URN-83H7 (discussing opportunity for crowdfunding in developing world).

51. *See* Bradford, *supra* note 13, at 15-27 (reviewing different crowdfunding models).

52. *See id.* at 15 (evaluating donation model). This is a model that has been used to fund political campaigns for years. *See* Siegel, *supra* note 14, at 786; *see also* Tim Kappel, Writing Competition, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 375 (noting Obama's 2008 campaign raised nearly 750 million dollars primarily through small contributions). It is only more recently, however, that crowdfunding has moved towards an Internet-based practice. *See* Bradford, *supra* note 13, at 11 (pointing out Kiva, a leading crowdfunding site, did not exist until 2005). For example, the most popular donation model crowdfunding sites, Indiegogo and Kickstarter, were not launched until 2008 and 2009, respectively. *See* Barnett, *supra* note 45 (tracing origins of Indiegogo and Kickstarter).

53. *See* Bradford, *supra* note 13, at 15 (stating donations granted to business ventures). Some donation sites, however, are restricted to nonprofit organizations. *See id.*; *see also Application Documents & Next Steps*, GLOBAL GIVING, https://www.globalgiving.org/non-profits/join-globalgiving/application.html (last visited Dec. 12, 2014), *archived at* http://perma.cc/W234-V8X9 (requiring documentation showing organization registered as charitable organization).

54. *See* Bradford, *supra* note 13, at 15 (acknowledging donation sites primarily used by charities and non-profits).

55. *See id.* at 16 (observing in both models contributors receive something nonmonetary in return for their contribution).

56. *See id.* (describing reward and prepurchase models).

57. *See id.* at 17-18 (detailing reward offered by Nine Inch Nails on Indiegogo). The band Nine Inch Nails developed a reward crowdfunding campaign to raise money to fund an album. *See id.* at 18. The rewards ranged from a digital download of the album to touring with the band for a few days. *See id.* Rewards offered by other fundraisers have included acknowledgements, invitations to the filming of a movie, and small roles in the film being funded. *See* Joachim Hemer, A Snapshot on Crowdfunding 13 (2011) (Fraunhofer Inst. for Sys. & Innovation Res. ISI, Working Paper No. R2/2011), *available at* http://hdl.handle.net/10419/52302, *archived at* http://perma.cc/QT7N-C2VT (observing principal characteristics of crowdfunding models).

product the business is raising money to manufacture or create.[58]

In the lending model of crowdfunding—sometimes referred to as peer-to-peer lending—contributors give funds with the expectation that they will be repaid.[59] This model takes two forms.[60] In one form, contributors are repaid only the principal amount—the amount they loaned to the recipient.[61] In the other form, contributors receive the principal amount plus interest.[62]

The final crowdfunding model is equity crowdfunding.[63] Here, donors make contributions to entrepreneurs and in turn expect a share in the profits of the business.[64] To date, there are no major equity crowdfunding sites in the United States that are publicly accessible, largely due to the uncertainty over how the practice relates to securities laws.[65] Most crowdfunding models do not raise securities regulations concerns.[66] Securities laws, however, likely have implications on equity crowdfunding and that model will be the focus of this Note.[67]

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58. *See* Bradford, *supra* note 13, at 16 (comparing reward and prepurchase models). The purpose of the prepurchase model is to help the entrepreneurs or artists produce a product. *See* Hemer, *supra* note 57, at 14. In exchange for their financial support, contributors are promised the end product, typically at a discounted price. *See* Bradford, *supra* note 13, at 16. This has been the most widely used crowdfunding model. *See id.*

59. *See* Bradford, *supra* note 13, at 20 (explaining logistics of peer-to-peer lending).

60. *See id.* (describing how some peer-to-peer lending sites offer interest and some do not).

61. *See id.* at 21 (detailing operations of Kiva).

62. *See id.* at 23 (describing how some interest rates determined by auction); Hemer, *supra* note 57, at 14 (stating crowdfunding lending reward normally principal amount with interest).

63. *See* Bradford, *supra* note 13, at 24-25 (noting equity crowdfunding sale of securities through crowdfunding sites).

64. *See* Hemer, *supra* note 57, at 14 (describing model as variant of microfinancing). The return to the contributor can be in the form of "shares of the venture, dividends and/or voting rights." *See id.*; *see also* Chance Barnett, *Top 10 Crowdfunding Sites for Fundraising*, FORBES (May 8, 2013), http://www.forbes.com/sites/chancebarnett/2013/05/08/top-10-crowdfunding-sites-for-fundraising/, *archived at* http://perma.cc/YQ3A-A63G (explaining entrepreneurs sell ownership stakes in business to raise capital).

65. *See* Bradford, *supra* note 13, at 24-25 (noting equity model likely subject to securities laws).

66. *See id.* at 31-32 (analyzing whether donation, reward, and prepurchase models securities under '33 Act). Whether the lending model of crowdfunding is subject to the '33 Act is a more complicated question. *See id.* at 34-35. Securities laws cover both equity and certain forms of debt. *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012) (defining security to include, among other things, "any note . . . bond, debenture, [or] evidence of indebtedness"). It is likely that the noninterest-lending model is not subject to '33 Act registration. *See* Bradford, *supra* note 13, at 35. Those utilizing the model that offers interest, however, are likely offering and selling securities. *See id.*

67. *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 885-907 (2011) (arguing equity crowdfunding likely security subject to registration under '33 Act). Equity crowdfunding campaigns that offer ordinary corporate stock will be treated as securities, and thus, will be required to register under the '33 Act unless the security will fit into an exemption, discussed *infra*. *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012) (defining security as "any . . . stock"); Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) ("[W]hen an instrument is both called 'stock' and bears stock's usual characteristics . . . [we] may assume that the federal securities laws apply."). If the campaign offers something other than stock, but nonetheless still offers the contributor a right to share in the profits, the question becomes more complicated. *See* Heminway & Hoffman, *supra*, at 885-86. In that situation, the profit sharing could still be a security if it is considered an investment contract. *See id.* The investment contract is the catch all in the definition of security and is defined in *SEC v. W.J. Howey Co.* as "a contract or scheme for 'the placing of capital or laying out of money in a way intended to

B. Securities Laws

Following the stock market crash of 1929 and during the ensuing Great Depression, Congress adopted the '33 Act and the Securities Exchange Act of 1934 ('34 Act).[68] In developing these Acts and the regulations that followed, Congress and the SEC had two competing interests in mind: protecting investors and facilitating capital formation.[69] For the purposes of this Note, only the '33 Act is addressed.[70]

The '33 Act, to effectuate its competing underlying policy interests, requires securities issuers to make certain disclosures and creates liability for noncompliance, material misstatements and omissions, and fraud.[71] First, section five prohibits offering or selling securities until such securities are registered with the SEC and the registration statement becomes effective.[72] Certain securities and offerings, however, are exempt from the registration requirement.[73] To register securities, the issuer—the company selling the securities—must submit a registration statement to the SEC.[74] That statement must include operating and financial disclosures about the issuer, information about the securities being offered, and details about the plan of distribution for the securities.[75] The registration process is time consuming and often

secure income or profit from its employment.'" *See* 328 U.S. 293, 298 (1946) (quoting State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920)).

68. *See* Siegel, *supra* note 14, at 782 (describing purpose of Acts as remedying "speculative frenzies" of 1920s, which led to crash).

69. *See* Heminway & Hoffman, *supra* note 67, at 927 (recounting underlying policy considerations of '33 Act); Siegel, *supra* note 14, at 782 (articulating one purpose of '33 Act as "'prohibit[ing] deceit, misrepresentations, and other fraud in the sale of securities'"). The competing policies can be seen in the provisions of the '33 Act. *See* Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c (2012); Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b). In section 3(b) of the '33 Act, the SEC is given authority to exempt certain securities from registration if it determines enforcement against those securities is "not necessary in the public interest and for the protection of investors." Securities Act of 1933 § 3(b)(1), 15 U.S.C. § 77c(b)(1). On the other hand, section 2(b) of the '33 Act directs the commission, in the process of rulemaking, to consider "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b).

70. *See infra* notes 71-75 and accompanying text (discussing '33 Act).

71. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (prohibiting sale of unregistered securities); Securities Act of 1933 § 6, 15 U.S.C. § 77f (providing for registration of securities); Securities Act of 1933 § 7, 15 U.S.C. 77g (outlining requirements of registration statement); Securities Act of 1933 § 11, 15 U.S.C. 77k (creating liability for false or omitted material fact in registration statement); Securities Act of 1933 § 12, 15 U.S.C. § 77l (allowing rescissionary remedy for certain violations of '33 Act).

72. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (declaring sale of securities illegal without SEC registration).

73. *See* Securities Act of 1933 § 4(a), 15 U.S.C. 77d (listing transactions exempt from section five of '33 Act).

74. *See* Securities Act of 1933 § 6, 15 U.S.C. § 77f(a) ("Any security may be registered . . . by filing a registration statement . . . .").

75. *See* Securities Act of 1933 Schedule A, 15 U.S.C. § 77aa (2012) (listing information registration statement must include). The schedule lists thirty-two required disclosures, ranging from the address of the principal office of the business to a copy of an attorney opinion regarding the legality of the offering. *See id.*

extremely expensive.[76] In many cases, the registration costs, which can exceed $100,000, may outweigh the benefit of offering securities, particularly for companies raising limited amounts of capital.[77] Thus, the registration requirements have the effect of excluding small and startup businesses from the public capital market.[78] The practical exclusion of small and startup businesses from the public capital market is why many have advocated for a crowdfunding exemption.[79]

In 2012, President Obama signed the JOBS Act.[80] Title III of the JOBS Act exempts equity crowdfunding from the '33 Act's registration requirement.[81] Under the JOBS Act, public offerings made through crowdfunding portals are exempt from filing a registration statement with the SEC if the amount raised by the issuer does not exceed one million dollars during a twelve-month period.[82] Further, the offering must be made through a broker or funding portal, and the amount each investor can contribute is limited.[83]

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76. *See* Heminway & Hoffman, *supra* note 67, at 908-09 (noting numerous expenses incurred during initial offering).

77. *See id.* at 909. The costs of registration can include "underwriting compensation, a registration fee . . . legal and accounting fees and expenses, printing and engraving costs, a Financial Industry Regulatory Authority filing fee, electronic filing fees . . . and transfer agent and registrar fees." *Id.* at 908.

78. *See* Bradford, *supra* note 13, at 42-43 (opining few small businesses conduct offerings due to expense).

79. *See, e.g.*, *id.* at 44-48 (describing possible exceptions under current SEC regulations); Heminway & Hoffman, *supra* note 67, at 911-21 (describing shortfalls of current registration exemptions for crowdfunding); Weinstein, *supra* note 37, at 431-34 (analyzing existing regulatory exemptions and how exemptions might apply to crowdfunding).

80. *See* Jensen, *supra* note 21, at 22 (answering questions about crowdfunding and JOBS Act).

81. *See* Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d(a)(6) (2012) (amending Securities Act of 1933 § 4, 15 U.S.C. 77d) (exempting certain public offerings made through crowdfunding portals from registration under '33 Act). Although certain crowdfunding offerors are exempt from filing the registration statement required by the '33 Act, issuers must still make certain disclosures to the SEC. *See* Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d-1(b) (amending Securities Act of 1933 by creating and inserting section 4A). Required disclosures include: the name and legal status of the business; names of officers, directors, and persons holding more than twenty percent of the issuers shares; description of the business and the business plan; the issuers financial condition; the intended use of funds; the target amount of the campaign; the price of the securities; and a description of the ownership and capital structure of the business. *See id.*

82. *See* Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d(a)(6)(A) (amending Securities Act of 1933 § 4, 15 U.S.C. § 77d) (listing requirements for crowdfunding exemption).

83. *See* Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d(a)(6)(B)-(C) (amending Securities Act of 1933 § 4, 15 U.S.C. § 77d) (requiring offerings through funding portals or brokers and limiting individual investments). Investors whose annual income or net worth does not exceed $100,000 cannot invest more than the greater of $2000 or 5% of the investor's annual income in any single issue. *See* 15 U.S.C. § 77d(a)(6)(B)(i). On the other hand, an investor who has an annual income or net worth of $100,000 or more can invest 10% of her annual income or net worth in a single issue. *See* 15 U.S.C. § 77d(a)(6)(B)(ii). Their aggregate investment, however, cannot exceed $100,000. *See id.* In addition to the restrictions on how much the issuer can raise in the aggregate, and the limitation on how much each investor can contribute to the campaign, the offering must be made through a broker or a funding portal. *See* 15 U.S.C. § 77d(a)(6)(C). A funding portal is "any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to [the crowdfunding exemption] that does not" engage in certain prohibited activities, such as providing investment advice or soliciting purchases. *See* Jumpstart Our Business Startups Act § 304, 15 U.S.C. § 78c(80) (amending Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c).

In October 2013, the SEC proposed crowdfunding rules under Title III of the JOBS Act.[84] The proposed rules include maximum campaign amounts, limitations for individual investors, and disclosure requirements that mirror those of the JOBS Act.[85] More relevant to this discussion, however, are the proposed rules requiring brokers and funding portals to provide investors with educational materials.[86] Educational materials must include, among other

84. *See* Press Release, SEC, *supra* note 20 (announcing release of proposed crowdfunding rules).

85. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,551-54 (proposed Nov. 5, 2013) (listing requirements for registration exemption); Eric R. Smith & Parker B. Morrill, *Crowdfunding: The Real Thing Is Almost Here*, BUS. L. TODAY (Nov. 2013), http://www.americanbar.org/publications/blt/2013/11/keeping_current.html, *archived at* http://perma.cc/7GYR-64AL (describing proposed rules).

86. *See* Crowdfunding, 78 Fed. Reg. at 66,466 (introducing rules requiring intermediaries provide educational materials to investors). It is important to note that a regulatory system based on disclosures necessarily relies on consumers having the acumen to understand the disclosures. *See* James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 107 (1998) [hereinafter Fanto, *We're All Capitalists*] (positing education materials highlighting risk without explaining how to mitigate risk will discourage investing); Thomas G. James, *Far From the Maddening Crowd: Does the JOBS Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767, 1783 (2013) (opining investors unlikely to utilize disclosures without proper tools and knowledge). Therefore, educated investors are necessary to the efficacy of the disclosure-based crowdfunding regulations. *See* Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 275 (2013) (noting investors who understand investing basics would make better decisions); *cf.* Patrick J. Bayer et al., *The Effects of Financial Education in the Workplace: Evidence from a Survey of Employers*, NAT'L BUREAU ECON. RES. 1 (Jul. 1996), http://www.nber.org/papers/w5655, *archived at* http://perma.cc/XV57-8VEX (suggesting education can improve financial decision-making). Further, decreasing financial literacy, the growing complexity of the financial industry, and the shifting burden of retirement planning necessitate greater investor education. *Cf.* Jayne W. Barnard, *Deception, Decisions, and Investor Education*, 17 ELDER L.J. 201, 226-27 (2010) (explaining lack of financial literacy in America); Barbara Black & Jill Gross, *The Elusive Balance Between Investor Protection and Wealth Creation*, 26 PACE L. REV. 27, 37 (2005) (highlighting lack of understanding among equity investors regarding risk and diversification); James A. Fanto, *Investor Education, Securities Disclosure, and the Creation and Enforcement of Corporate Governance and Firm Norms*, 48 CATH. U. L. REV. 15, 15-16 (1998) [hereinafter Fanto, *Investor Education*] (arguing increased educational efforts needed due to growing number of unsophisticated investors); Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 197 (2007) (explaining small percentage of Americans have skills to compare credit cards or calculate interest). Moreover, studies suggest educated investors make wiser investment decisions. *See* Memorandum from Jerry Carleton et al., Principal, Immix Law Grp., to U.S. Sec. & Exch. Comm'n 6-7 (Oct. 4, 2012), *available at* https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-163.pdf, *archived at* http://perma.cc/J6HJ-YGSK (explaining investors who review educational material make better investment decisions); *cf.* Laurent E. Calvet et al., *Down or Out: Assessing the Welfare Costs of Household Investment Mistakes*, NAT'L BUREAU OF ECON. RES. 4, 12 (2006), *available at* http://www.nber.org/papers/w12030.pdf?new_window=1, *archived at* http://perma.cc/4MAK-7BD7 (stating educated households will more likely invest in risky assets); Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education*, BUS. ECON., Jan. 2007, at 35, 39 (finding those who understand compound interest more likely to plan for retirement); MARK SCHREINER ET AL., SAVING PERFORMANCE IN THE AMERICAN DREAM DEMONSTRATION: A NATIONAL DEMONSTRATION OF INDIVIDUAL DEVELOPMENT ACCOUNTS (Oct. 2002), *available at* http://www.usc.edu/dept/chepa/IDApays/publications/ADDReport2002.pdf, *archived at* http://perma.cc/VJC6-GNXU (detailing findings suggesting education positively effects savings). A number of investment firms understand the need for investor education and have developed educational programs. *See, e.g.*, *Education*, TD AMERITRADE, https://www.tdameritrade.com/education.page (last visited Dec. 12, 2014), *archived at* http://perma.cc/K4NP-GXK4 (employing educational videos and

things, a description of the: offer process, risks associated with securities offered by the intermediary, types of information the issuer must provide in its annual reports, circumstances where the issuer may cancel the issue, and limitations on investors' rights to cancel their investment commitments.[87] Additionally, the proposed rules require brokers and funding portals to ensure investors review the educational materials and positively affirm that they risk losing their entire investment.[88] Investors must also answer questions that demonstrate they understand the general risk associated with investing in startup companies and small businesses.[89]

III. ANALYSIS

A. The JOBS Act, Crowdfunding Regulations, and Proposed Investor Education Measures

Regulating crowdfunding calls for a delicate balancing of the JOBS Act's competing policy considerations.[90] On the one hand, the regulations must protect investors from the potential fraud that may come with investing in securities exempt from SEC registration requirements.[91] Conversely, rules governing crowdfunding must also facilitate capital formation—meaning these rules cannot be overly burdensome on issuers and funding portals.[92]

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webcasts for consumers); *How To Invest*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/retirement_and_planning/how_to_invest (last visited Dec. 12, 2014), *archived at* http://perma.cc/9BCW-NBMW (providing information on investment basics, types of investments, finding investments, etc.); *Planning & Education*, MERRILL EDGE, http://www.merrilledge.com/education (last visited Dec. 12, 2014), *archived at* http://perma.cc/98QR-TAHQ (offering investor education and planning tools for major life events, retirement, and unexpected emergencies). Finally, investors may avoid becoming victims of fraud if they learn how to identify fraudulent investment opportunities. *See Avoiding Fraud*, INVESTOR.GOV, https://www.investor.gov/investing-basics/avoiding-fraud (last visited Dec. 12, 2014), *archived at* http://perma.cc/5Y7U-MFVD (highlighting ways to avoid scams).

87. *See* Crowdfunding, 78 Fed. Reg. at 66,466 (listing requirement in educational materials).

88. *See id.* at 66,470 (detailing investor affirmation requirements). "[I]ntermediaries [must] ensure that each investor: (1) Reviews the educational materials discussed above [and] (2) positively affirms that the investor understands that he or she is risking the loss of the entire investment and that the investor could bear such a loss . . . ." *Id.*

89. *See id.* (requiring investors demonstrate understanding of investment and illiquidity risks associated with startups).

90. *See* Merkley remarks, *supra* note 21, at S5474-78 (providing factors for SEC to consider when drafting rules to implement JOBS Act). Senator Merkley, one of the Senators who drafted what became Title III of the JOBS Act, stated the Act "was guided by two goals: [one], enabling [crowdfunding] to work for startups and small businesses and [two], protecting ordinary investors from fraud and deception." *Id.* at S5475. He also highlighted ways the JOBS Act was designed to simplify the crowdfunding process and protect investors, hoping the SEC would keep those goals in mind while implementing the law. *See id.*; *see also* Bennet remarks, *supra* note 21, at S2231 (stating Senate sought to balance investor protection and flexibility for entrepreneurs); Brown remarks, *supra* note 21, at S2230 (explaining Title III balances ease of access to capital with transparency to protect investors).

91. *See supra* note 90 (explaining interests underlying Title III).

92. *See supra* note 90 (addressing goals and concerns of Title III).

These two policies seem at odds, appearing to require opposite approaches.[93] Sufficient regulations are needed to protect investors.[94] Excessive regulation, however, will hinder the promised capital formation of crowdfunding by increasing compliance costs.[95] Given the nature of crowdfunding—raising relatively small amounts of capital—high costs would render crowdfunding impractical for small and startup businesses.[96]

This section illustrates how the SEC can serve both policy interests.[97] It posits that the SEC could relax regulations that increase the cost and time needed to comply with the proposed rules without sacrificing investor protection.[98] To balance the competing interests underlying the JOBS Act, the SEC should reinforce the front-line defense.[99] That is, the SEC should strengthen the educational requirements and develop a program that empowers investors to identify risk, make intelligent investment decisions, and detect fraudulent offerings.[100]

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93. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,430 (proposed Nov. 5, 2013) (acknowledging over-burdensome regulations hinder crowdfunding while passive rules increase risk and fraud).

94. *See id.* (recognizing Congress also imposed protections for investors engaged in crowdfunding transactions).

95. *See id.* ("Rules that are unduly burdensome could discourage participation in crowdfunding[.]").

96. *See supra* note 36 and accompanying text (drawing definition of crowdfunding from various sources).

97. *See infra* Part III.B (positing investor education can balance capital formation and investor protection).

98. *See infra* Part III.B (suggesting increased education could alleviate certain disclosure requirements). For example, an issuer would not need to include information about certain general risks if investors must complete an educational program that includes, among other things, information on such risks. *See infra* Part III.B (discussing advantages of increased investor education); *see also* Crowdfunding, 78 Fed. Reg. at 66,553 (requiring issuers provide certain disclosures regarding risks associated with minority ownership). The proposed regulations currently require issuers to disclose risks that purchasers may face as minority owners in a closely held corporation. *See* Crowdfunding, 78 Fed. Reg. at 66,553. For example, issuers will need to explain that the corporation may issue additional securities or repurchase securities, which may dilute the purchaser's ownership interest. *See id.* Further, the rules require issuers to disclose that they may sell the company or its assets to another party. *See id.* These are examples of disclosures that could be avoided if a greater investor education component were implemented. *See infra* Part III.B (arguing increased education could relieve certain disclosure requirements).

99. *See infra* Part III.B (explaining how more robust education requirement can help reach balance).

100. *See infra* Part III.B.1 (discussing need for strengthened investor education measures). Another front-line defense is the screening measures instituted by the JOBS Act and the proposed crowdfunding regulations. *See* Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d-1(a)(5) (2012) (amending Securities Act of 1933 by creating and inserting section 4A) (requiring background checks on issuer's officers, directors, and major equity holders); Crowdfunding, 78 Fed. Reg. 66,428, 66,556 (proposed Nov. 5, 2013) (outlining screening requirements intermediaries must undertake prior to listing offeror). Prior to listing an offeror on its crowdfunding platform, a broker or funding portal must have a reasonable belief that the issuer is in compliance with the JOBS Act and Crowdfunding Rules requirements, and that it has the means to keep accurate shareholder records. *See* Crowdfunding, 78 Fed. Reg. at 66,556. Additionally, the intermediary cannot list an offeror if it has reason to believe that any officer, director, or person owning twenty percent or more of the voting stock of the corporation has been the subject of certain criminal convictions, court judgments, or SEC orders relating to securities law violations. *See id.* at 66,556, 66,562-63. The intermediary must, at the very least, conduct background and securities enforcement checks in determining whether an issuer should be disqualified for such violations. *See id.* at 66,556. Finally, the intermediary cannot allow an issuer

The JOBS Act requires funding portals and brokers acting as intermediaries for crowdfunding to provide investors with disclosures about the risks associated with crowdfunding investments and "other investor education materials."[101] It also requires these intermediaries to ensure investors review these disclosures, acknowledge that they risk losing their entire investment, and answer certain questions to demonstrate their understanding of the risks inherent in investing in small and startup businesses.[102] To implement these provisions of the JOBS Act the SEC has proposed two rules.[103]

First, Rule 302 outlines what must be included in the educational materials provided by the intermediaries.[104] Under that proposed rule, the intermediary must provide information that explains: the process it uses for offering, purchasing, and issuing securities under the crowdfunding exemption and the risks associated with purchasing securities offered under the exemption; the types of securities the intermediary offers and each security's associated risks; the restrictions on reselling securities; what information the issuer must disclose, how often the issuer must make such disclosures, and that the issuer's disclosure obligations may terminate; the limitations on how much the investor may invest; the investor's rights to cancel an investment and the limitation on those rights; the circumstances that allow an issuer to cancel investment commitments; the need for the investor to consider whether this is an appropriate investment for himself or herself; and that following an offering, the relationship between the intermediary and issuer may not continue.[105] The SEC proposed that the educational materials include the information listed above because it believed these factors could influence an investor's decision to purchase securities offered under the crowdfunding exemption or to purchase

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on its portal if it believes that issuer presents a potential for fraud. *See id.*

101. Jumpstart Our Business Startups Act § 302, 15 U.S.C. § 77d-1 (a)(3) (describing disclosure requirements for intermediaries). Section 302 of the JOBS Act requires intermediaries in transactions under the crowdfunding exemption to "provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall . . . determine appropriate[.]" *See id.*

102. 15 U.S.C. § 77d-1(a)(4) (outlining what intermediaries must ensure each investor does). To demonstrate their understanding of the risk associated with crowdfunding investments, investors must answer questions about the level of risk these investments carry and the investments' risk of illiquidity. *See id.*

103. *See* Crowdfunding, 78 Fed. Reg. at 66,556-58 (outlining requirements of proposed Rules 302 and 303).

104. Crowdfunding, 78 Fed. Reg. at 66,556-57 (outlining educational materials intermediary must provide investors). In addition to specifying what educational materials intermediaries must provide to investors, Rule 302 also requires intermediaries to ensure that, prior to making an investment, investors open an account with the intermediary. *See id.* at 66,556. As part of an account opening, the investors must also agree to receive all disclosures and information intermediaries are required to provide via electronic communication. *See id.* Rule 302 further requires intermediaries to inform investors that individuals promoting an issuer's offering for compensation must disclose the receipt of such compensation and that they are acting on behalf of an issuer. *See id.* at 66,557. Finally, Rule 302 requires the intermediaries to disclose to investors how the issuer compensates them. *See id.*

105. *See* Crowdfunding, 78 Fed. Reg. at 66,556-57 (specifying educational materials intermediary must provide investor).

particular types of securities.[106]

Second, Rule 303 would require intermediaries to obtain certain representations from investors prior to each investment commitment.[107] As relevant here, the investor would need to affirm that he or she: has reviewed the educational materials; understands that his or her entire investment may be lost; and can bear such loss if it occurs.[108] Additionally, prior to each investment commitment, the investor must complete a questionnaire demonstrating his or her understanding that: the ability to cancel the investment commitment is restricted; reselling the security may be difficult; and investing in crowdfunding securities is risky and should not be done unless he or she can bear complete loss of the investment.[109] The SEC has proposed that investors make these affirmations and complete the questionnaires before each investment commitment to help remind investors of the risks associated with securities offered under the crowdfunding exemption.[110]

B. More Must Be Done To Educate Investors

1. Why Crowdfunding Demands Increased Investor Education

Although the requirements above are an excellent start, this author does not believe the questionnaire and affirmations go far enough.[111] The proposed rules are designed in a manner that requires more disclosure than education.[112]

106. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,466-67 (proposed Nov. 5, 2013) (explaining what included under proposed Rule 302). The SEC felt that information about when an investment commitment could be cancelled was important for helping investors understand the investment process. *See id.* at 66,466. Further, the SEC believed that an understanding that crowdfunding securities could not be resold for the first year after purchase—with limited exceptions—would influence investors' decision to participate in crowdfunding. *See id.* Moreover, the SEC thought it was important for intermediaries to explain the differences among the types of securities it offers and the risks associated with each type because the SEC is not limiting what securities can be sold under the crowdfunding exemption. *See id.*

107. *See id.* at 66,557 (highlighting representations intermediary must receive from investor prior to allowing investment).

108. *See id.* (setting forth confirmations intermediaries must receive from investor). The SEC did not propose or provide a model form in which investors must make such acknowledgements. *See id.* at 66,471. Instead, brokers and funding portals are left to design a model that best fits the securities offered on such sites and the likely investors each will serve. *See id.*

109. *See id.* at 66,470-71 (describing purpose and content of questionnaire). Whether the questions are multiple choice, "Yes" or "No," or "True" or "False" is left to the discretion of the intermediary. *See id.* at 66,471. Intermediaries are required only to ensure the questionnaire is "reasonably designed to demonstrate receipt and understanding of the [educational and risk] information." *Id.*

110. *See* Crowdfunding, 78 Fed. Reg. at 66,471 (describing proposed Rule 303 and its underlying rationale).

111. *See infra* Part III.B (arguing greater emphasis on investor education needed).

112. *See supra* notes 104-05 and accompanying text (explaining what educational materials must include). For example, the educational materials must explain the process used for listing and selling securities. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,556-57 (proposed Nov. 5, 2013). The materials must also explain the types of securities, and the risks associated with each type, available on the intermediary's site. *See id.* These requirements, although providing particular information to an investor, arguably are not an effective means of

Disclosures are important, but if investors are not educated on how to use them, the disclosures will do little good.[113] Thus, the educational material should also include information about the basics of sound investing.[114] This need for a stronger education mechanism stems from a number of considerations.[115]

As a general matter, greater investor education is needed to offset the growing burden on individuals to plan for their own retirement.[116] Employers are increasingly utilizing defined contribution retirement plans that are self-directed.[117] That is, employees, rather than employers, are deciding how their retirement funds are being invested.[118] Further, some argue the growing vulnerability of the Social Security system creates an even greater need for individuals to save for retirement.[119] Finally, the growing number and complexity of available financial products makes deciding among investment options more complicated.[120]

Investor education is particularly important in the crowdfunding context.[121]

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educating the investor on investment or financial basics. *See id.* Further, if the investor does not understand the basics, it is unlikely that he or she will understand the disclosed information. *See* James, *supra* note 86, at 1783. If all the educational materials do is highlight the significant risk that is associated with investing in crowdfunded securities, without providing information on how to mitigate or diversify such risk, the educational materials may do more harm than good. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 107 (positing poorly conducted investor education discourages investment activities).

113. *See* James, *supra* note 86, at 1783 (explaining disclosures do not protect investors if investors do not have acumen to understand them). James argues that meaningful investor protection in the crowdfunding context requires the availability of information about the issuers and securities, as well as ensuring investors understand such information. *See id.*

114. *See* Baritot, *supra* note 86, at 275 (positing "unsophisticated investors" would make better investments if provided materials explaining investment basics); *cf.* Bayer et al., *supra* note 86, at 30 (positing education can improve financial decision making). Studies have discovered a correlation between one's level of education and rate of savings. *See* Bayer et al., *supra* note 86, at 29-30.

115. *See infra* notes 116-25 and accompanying text (outlining need for investor education).

116. *See* Fanto, *Investor Education*, *supra* note 86, at 16 (arguing growing number of ordinary people involved in investing requires increased educational efforts); Fanto, *We're All Capitalists*, *supra* note 86, at 107-08 (noting educational needs due to new, complex financial products and shift towards self-directed investment).

117. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 114-18 (explaining shift from defined benefit to defined contribution retirement plans creates educational need).

118. *See id.* at 114-15 (noting in many defined contribution plans employees specify how funds invested).

119. *See id.* at 112-14 (suggesting Social Security will not even support retirees at minimum level). The decreasing ratio of workers to retirees, coupled with greater life expectancies, may stretch Social Security funds. *See id.* Thus, individuals need to save for retirement outside the Social Security system. *See id.* at 114.

120. *See id.* at 117-18 (explaining financial products have become more diverse and complex). Fanto points out that financial firms are offering more investment options than previously available. *See id.* The growth in investment options helps investors meet their new retirement planning burden but also creates a need for greater education because investors must choose among the various alternatives. *See id.* Much like investors need education to make informed retirement-planning decisions, they also need proper education to effectively participate in crowdfunding. *Cf. id.* In the crowdfunding context, investors will be selecting between different issuers and securities and will need a basic financial and investment literacy foundation to make those selections in an informed manner. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 117 (explaining education helps individuals appropriately and successfully plan for retirement).

121. *See* Siegal, *supra* note 14, at 796 ("[T]he lack of investor education is especially alarming in the context of crowdfunding.").

Here, unlike many retirement plan settings discussed above, investors are left to make investment decisions completely on their own.[122] This is concerning because many investors are unaware of the need to diversify investments and the risks associated with equity investing.[123] Further, only about four percent of Americans have the skills necessary to compare credit card offers.[124] If most Americans do not possess the financial literacy skills necessary to compare and contrast credit card offers, how will they effectively select among crowdfunding offerors?[125]

2. A Stronger Investor Education Mechanism

To address these concerns and to increase the protection of investors, the SEC must incorporate stronger educational requirements in its crowdfunding rules.[126] Greater educational measures will not only help investors make more informed investment decisions but also provide investors with the tools needed to protect themselves from excessive risk and fraud.[127]

A number of studies have demonstrated the positive effects of investor and financial education.[128] One study has shown that employer sponsored seminars on retirement planning have a positive correlation with participation in and contributions to defined contribution plans.[129] That is, employers who offer frequent seminars on retirement planning will often see an increase in the number of employees participating in employer-sponsored retirement plans.[130]

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122. *Cf.* Crowdfunding, 78 Fed. Reg. 66,428, 66,556 (proposed Nov. 5, 2013) (defining funding portals as "any person acting as an intermediary . . . that does not: . . . [o]ffer investment advice or recommendations").

123. *See* Black & Gross, *supra* note 86, at 37 (stating investors lack understanding of diversification and risk associated with equity investments).

124. *See* Loonin & Renuart, *supra* note 86, at 197 (explaining lack of financial literacy in America). Additionally, Barnard says that a similarly small amount of people can calculate interest on home equity loans and probably fewer people can understand investment products and strategies, diversification, and asset allocation. *See* Barnard, *supra* note 86, at 227.

125. *Cf.* Barnard, *supra* note 86, at 227 (explaining only small percentage of Americans understand fundamental investment principles).

126. *See* Black & Gross, *supra* note 86, at 37 (suggesting education provides greatest hope for protecting investors); Fanto, *Investor Education*, *supra* note 86, at 16 (stating education must precede involvement of ordinary people in savings and investment); Fanto, *We're All Capitalists*, *supra* note 86, at 121 (arguing education fundamental component of capital system based on involvement of ordinary people).

127. *See infra* notes 129-34 and accompanying text (discussing studies demonstrating positive links between education and financial and investment behavior).

128. *See infra* notes 129-34 and accompanying text (illustrating correlation between education and investment behavior).

129. *See* Bayer et al., *supra* note 86, at 29 (concluding retirement seminars associated with increased participation in and contributions to retirement plans). The positive effect between seminars and participation and contribution is stronger for nonhighly compensated employees. *Id.* Retirement plans associated with frequent seminars had an average participation rate of nonhighly compensated employees 11.5% higher than plans without seminars. *See id.* at 16. This is significant here because crowdfunding is expected to attract unsophisticated investors, who would typically be similarly situated to nonhighly compensated employees. *See* Siegel, *supra* note 14, at 794.

130. *See* Bayer et al., *supra* note 86, at 16 (reporting frequent seminars increase participation in retirement

The employers may also find that employees increase the amount they contribute to their retirement plans.[131]

In populations over fifty, studies show that those with more financial knowledge are more likely to plan for retirement.[132] Also, financially sophisticated households are more likely to effectively invest in risky assets, such as securities.[133] Further, those with some financial education are more likely to save.[134] Although the effectiveness of investor education has its detractors, the evidence above suggests a more robust educational requirement would help protect investors and increase the success of crowdfunding.[135]

The financial services industry has developed a number of educational programs the SEC could base its requirements upon.[136] This author only suggests a few basic components that should be included and leaves developing the specifics of an educational program to those with the specialized skills to do so.[137] First, and foremost, investors should learn how they can identify their risk preferences and how they can participate in crowdfunding in a manner that comports with those preferences.[138] This is particularly important given that crowdfunding tends to attract financially unsophisticated individuals who may not appreciate the risks associated with investing in small and startup businesses.[139]

Second, investors must be given the tools to understand basic financial and financial product information.[140] For example, crowdfunding investors should be provided the tools needed to understand financial statements, as well as

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plans).

131. *See id.* at 21 (estimating contributions are nearly twenty percent higher in plans associated with frequent seminars).

132. *See* Lusardi & Mitchell, *supra* note 86, at 39 (finding in populations over fifty those understanding compound interest more likely to plan for retirement).

133. *See* Calvet et al., *supra* note 86, at 12 (discussing characteristics of risky asset investors). "[A] household is more likely to participate [in risky asset markets] if it has higher income, higher . . . wealth, higher liabilities or is more educated." *Id.* The authors further posit that educated and sophisticated households may encounter lower learning and startup costs when participating in risky asset markets. *See id.*

134. *See* SCHREINER, *supra* note 86, at 51 (explaining findings suggest even short financial education seminars positively affects savings).

135. *See* Barnard, *supra* note 86, at 203, 214-18 (suggesting investor education ineffective for elderly because of particular characteristics); Lusardi & Mitchell, *supra* note 86, at 43 (cautioning studies may overstate positive effects of education).

136. *See, e.g.*, *Education*, *supra* note 86 (offering educational videos and webcasts to consumers); *How To Invest*, *supra* note 86 (educating investors regarding investment basics, types of investments, finding investments, etc.); *Planning & Education*, *supra* note 86 (delivering investor education and planning tools for major life events).

137. *See infra* notes 138-50 and accompanying text (suggesting components author considers vital).

138. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 132-33 (explaining how identifying risk preferences helps design portfolios consistent with risk tolerance).

139. *Cf.* Siegel, *supra* note 14, at 794 (acknowledging crowdfunding investors likely financially unsophisticated).

140. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 131 (positing investors should understand basic information about investment instruments, investment professionals, and regulations).

intermediary and issuer disclosures.[141] Additionally, investors should understand the basic differences between stocks and bonds to help appreciate the risks and returns associated with each instrument.[142] Developing such an understanding, even at a basic level, will help investors compare and contrast offerings and make more informed selections.[143]

Third, educational materials should equip investors with a basic understanding of finance principles and investment strategies.[144] For example, investors should understand liquidity, the time value of money, and the relationship between risk and return.[145] This knowledge will help investors understand why certain investment instruments are offered and more fully comprehend risks and returns.[146] For investment strategies, an investor should be taught the importance of portfolio diversification.[147] Teaching investors to diversify their portfolios, and the importance of doing so, will help them reduce their risk exposure and caution against excessive speculation.[148]

Finally, the educational materials must highlight the signs of fraud.[149] For instance, investors should be told to be wary of investments that guarantee returns and seem too good to be true.[150]

Materials on the fundamentals discussed above should be added because investor education is critical to investor protection.[151] Further, the disclosures required under the JOBS Act and proposed crowdfunding rules will mean nothing if investors do not have the acumen to understand and use the

141. *See* Baritot, *supra* note 86, at 275 (suggesting investors would benefit from "examples and explanations of common investment documents and their terms"); Fanto, *We're All Capitalists*, *supra* note 86, at 131 (arguing investors should understand basic information).

142. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 131 (explaining such knowledge helps select investment instruments).

143. *See id.* (arguing basic financial literacy critical to mitigating risk).

144. *See* Baritot, *supra* note 86, at 275 (describing how knowledge of basic finance and investing principles helps in investing); Fanto, *We're All Capitalists*, *supra* note 86, at 132 (discussing how understanding basic finance principles leads to better investing).

145. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 132 (suggesting understanding of these basics helps investors comprehend risk and return).

146. *See id.* (outlining investor education).

147. *See id.* (describing advantages of understanding portfolio diversification).

148. *See id.* (explaining diversification reduces risk).

149. *See* Fanto, *We're All Capitalists*, *supra* note 86, at 135 (highlighting importance of providing simple rules to avoid fraud).

150. *See Avoiding Fraud*, *supra* note 86 (noting basic understanding of scams, including red flags to watch for, makes investing safer); *cf.* Baritot, *supra* note 86, at 275 (suggesting examples investors would benefit from). Baritot posits "examples and explanations of common investment documents and their terms, an introduction to basic finance and investment concepts, and an in-depth analysis of the potential risks of similar investments with graphics and statistics" would help investors make better decisions. Baritot, *supra* note 86, at 275 (footnote omitted).

151. *See* Baritot, *supra* note 86, at 275 (noting many crowdfunding investors perhaps unfamiliar with mechanics of investing, making education critical). Informed investors who have received and reviewed the proper educational materials will make better investment decisions. *See* Memorandum from Jerry Carleton et al. to U.S. Sec. & Exch. Comm'n, *supra* note 86, at 6-7.

information.[152] More importantly, if investors are taught how to identify fraud, they can protect themselves and help ferret out fraudsters rather than becoming victims.[153]

These added measures would strengthen investor protection, allowing for relaxation of other requirements in the rules.[154] For example, if information on the risks associated with minority ownership were included in the educational materials, each issuer would not need to discuss such risks as part of its disclosures.[155] Arguably, this would reduce compliance costs—facilitating more capital formation—because the disclosure would only need to be made once, by the intermediary, and not by each issuer.[156] Further, relaxing of the regulations would not come at the expense of the investor because each investor would still be receiving the relevant information through the educational materials.[157] This is but one example of how proper investor education can help reach the balance required by the JOBS Act without sacrificing capital formation.[158]

IV. Conclusion

Equity crowdfunding can be a significant tool to raise capital for small and startup businesses. To reach its full potential, however, it must be implemented in a balanced manner. That is, issuers and intermediaries cannot be over regulated, leading to a compliance cost that removes the benefits of participating in crowdfunding. At the same time, the rules must not be so relaxed that they do not protect investors. As discussed above, one way in which the SEC can balance these competing interests is by implementing a stronger investor education mechanism. The mechanism should teach investors the basics of finance and investment. Such knowledge will empower investors to mitigate their risk exposure and protect themselves from falling victim to fraud.

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152. *See* James, *supra* note 86, at 1783 (arguing meaningful investor protections come, in part, from investors ability to understand disclosed information).

153. *See Avoiding Fraud*, *supra* note 86 (highlighting ways investors can avoid scams and protect investments).

154. *See supra* Part III.A (discussing how increased education can decrease issuer disclosure requirements).

155. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,553 (proposed Nov. 5, 2013) (requiring issuers provide certain disclosures regarding risks associated with minority ownership).

156. *See supra* Part III.A (discussing potential efficiencies associated with intermediary sponsored education).

157. *See supra* note 138 and accompanying text (suggesting educational materials should include information on risk).

158. *See supra* note 98 (providing examples where education can reduce disclosure requirements).