



8-26-2011

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CROWDFUNDING MICROSTARTUPS: IT’S TIME FOR THE SECURITIES AND EXCHANGE COMMISSION TO APPROVE A SMALL OFFERING EXEMPTION

Nikki D. Pope*

As social networking websites and crowd-based problem-solving initiatives gain popularity, entrepreneurs have begun to consider them as possible tools in a fundraising method, known as “crowdfunding.” Current federal and state securities regulations, however, limit the ways in which such fundraising methods can be employed by entrepreneurs and early-stage companies. This article focuses on federal securities rules and regulations and recommends changes the Securities and Exchange Commission (the “Commission”) can implement in federal securities rules and regulations to foster such funding initiatives and facilitate capital formation, while achieving its mission to protect investors from fraudulent investment practices.

I. INTRODUCTION

Entrepreneurs often face the challenge of raising sufficient capital to support further development or expansion of their businesses. Those with a good idea or a track record of success may find it easier to secure financing from traditional funding sources like early- and late-stage angel and venture capital funds.¹ Entrepreneurs without a track record or who are not yet certain they have a good idea are likely to find it more difficult to

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1. Venture capital can come from individuals or entities. High net worth individuals also are known as “angels.” Angels sometimes aggregate their investment funds into an “angel fund,” investing to help entrepreneurs grow beyond the idea stage.

secure private equity financing through these funds.² Thanks to the financial crisis, access to bank loans is no longer a viable alternative to bridge the gap between self-funding and venture capitalist funding. Of course, entrepreneurs still can rely on their friends and family for some funding, but in tough economic times, giving or lending money to help your little sister fund her idea for the next college student social networking site may be far down the list of where you would spend your discretionary income—if you have discretionary income. And if the financial crisis were not enough, the recently enacted “financial reform” bill includes provisions that will make it even more difficult for entrepreneurs to get their businesses funded. For example, the minimum net worth for an individual to be deemed an accredited investor now excludes the value of such individual’s primary residence from the net worth calculation, making it harder for an individual to qualify for an accredited investor exemption.³

So, how can an entrepreneur who only needs a small amount of capital to get to the next level of development raise the necessary funds? The success of micro-financing initiatives like Kiva.org suggests there may be money out there, available in small amounts from hundreds or thousands of investors, ready to invest in microstartups in exchange for small equity positions. Unfortunately, the current federal regulatory scheme makes it too costly and often even impossible for entrepreneurs to go after this money.

When it comes to entrepreneurs and microstartups, the Commission’s current rules are too restrictive and choke off nascent businesses with over-regulation, the very antithesis of facilitating capital formation. With nearly instantaneous access to information and the ubiquity of online communities like Facebook and Twitter, the time has come for the Commission to adopt rules that will “facilitate capital formation” among entrepreneurs and microstartups that do not need to attract hundreds of thousands or millions of dollars and reject congressional efforts to further stifle capital formation by small businesses. A few amendments to the Securities Act of 1933, as amended (the “Securities Act”) and the Securities Act Rules will allow entrepreneurs and microstartups to raise much-needed capital to reach the next stage of growth. The advent of crowdfunding and the potential capital that crowdfunding can unlock makes now the right time for the Commission to consider these amendments.

2. *A Special Report on the World Economy: The Cost of Repair*, THE ECONOMIST, October 9, 2010, at 14-15, available at <http://www.economist.com/node/17173933> (quoting Steve Jurevson of venture capital firm Draper Fisher Jurevson as saying that venture capital fundraising has been “harmed immensely” by the recent financial crisis).

3. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413, 124 Stat. 1376 (2010).

II. CROWDFUNDING AND MICROSTARTUPS

A. *What is a “Microstartup”?*

A microstartup is a business in which one or two creative people have an idea for a product or service that can be developed, launched, and marketed for a few thousand dollars. The business is typically too early and too small to attract the attention of venture capitalists or even seed-stage investors like angel funds.

In an essay titled “The Future of Startups,” Jason Calacanis introduced the concept of the microstartup:

The zero cost startup has led to the age of the “microstartup.” It’s no longer two folks in a garage hoping to build a prototype in order to land a huge VC round, then getting millions of dollars to build out an office. Microstartups are sustainable from prototype to launch and on to a core user base, all for around \$5–10,000 in costs.⁴

Eric Reis calls this the “Lean Startup”:

The Lean Startup is a disciplined approach to building companies that matter. It’s designed to dramatically reduce the risk associated with bringing a new product to market by building the company from the ground up for rapid iteration and learning. It requires dramatically less capital than older models, and can find profitability sooner. Most importantly, it breaks down the artificial dichotomy between pursuing the company’s vision and creating profitable value. Instead, it harnesses the power of the market in support of the company’s long-term mission.⁵

Even though these “lean” and “zero-cost” startups require less capital than their forebears, at some point the entrepreneurs behind these businesses will look for capital to continue developing their products and services. Those who seek small amounts of capital have begun to look at crowdfunding as a way to raise a few hundred to many thousands of dollars to take their ideas to the next level of development.

B. *What is “Crowdfunding”?*

To define “crowdfunding,” it is necessary to first understand the concept of “crowdsourcing.” According to Jeff Howe, “[c]rowdsourcing has its genesis in the open source movement in software.”⁶ The open

4. Jason Calacanis, *The Future of Startups*, CALACANIS.COM (Nov. 6, 2008), <http://calacanis.com/2008/11/06/the-future-of-startups/>.

5. Eric Reis, *How to Build Companies that Matter*, O’REILLY RADAR (Mar. 20, 2009), <http://radar.oreilly.com/2009/03/lean-startup.html>.

6. JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE

source movement relies on a community of software developers to continually improve software, adding features and functionality and even spinning off into new applications. Each developer works on problems that interest him or her and their collective efforts improve the software overall.

Launched in May 1999, SETI@home was one of the first crowdsourced projects.⁷ Developed by David Gedye of the SETI (Search for Extraterrestrial Intelligence) Institute, SETI@home was a distributed computing project that sought to harness the power of millions of internet-connected home and office computers during their dormant hours to analyze the millions of bits of data collected by the world's radio telescopes.⁸ The project's 5.4 million participants successfully analyzed all of the radio telescope data. Unfortunately, the project did not yield any evidence of extraterrestrial intelligence.⁹ The original SETI@home project was shut down in December 2005, having been replaced by another crowdsourced distributed computing initiative.¹⁰

It was not long before companies began to follow the SETI Institute's lead and reached out to the masses to help solve product development problems. Notably, Netflix, the DVD rental service, launched a contest in October 2006 to develop a movie recommendation algorithm that could improve upon the performance of its existing recommendation algorithm by a factor of ten percent. The \$1,000,000 prize to the winner was awarded on September 21, 2009.¹¹ What makes this an excellent example of crowdsourced problem-solving is that during the three years of the contest, competitors shared source code information and even joined forces to become teams, not only to win the prize money, but also because they were building communities.¹² As Wired put it, "[b]etter solutions come from unorganized people who are allowed to organize organically."¹³ This sort of organic organization is at the root of crowdsourcing.

Internet-based communities are collections of people with shared interests—sports teams, movies, books, knitting, videogames, photography—web-chatting amongst themselves and acting in concert with

FUTURE OF BUSINESS 8 (2008).

7. *SETI@home Classic: In Memoriam*, SETI@HOME, <http://setiathome.berkeley.edu/classic.php> (last visited Mar. 18, 2011).

8. *The Science of SETI@home*, SETI@HOME, http://setiathome.berkeley.edu/sah_about.php (last visited Mar. 18, 2011).

9. *Current Total Statistics*, SETI@HOME, <http://seticlassic.ssl.berkeley.edu/totals.html> (last updated Jan. 13, 2006).

10. SETI@home, *supra* note 7.

11. Steve Lohr, *Netflix Awards \$1 Million Prize and Starts a New Contest*, N.Y. TIMES, (Sept. 21, 2009, 10:15 AM), <http://bits.blogs.nytimes.com/2009/09/21/netflix-awards-1-million-prize-and-starts-a-new-contest/>.

12. *Id.*

13. Eliot Van Buskirk, *How the Netflix Prize Was Won*, WIRED (Sept. 22, 2009, 11:19 AM), <http://www.wired.com/epicenter/2009/09/how-the-netflix-prize-was-won/>.

each other.¹⁴ Out of these shared interests have come ideas for new products and services. Threadless is a community website that was created in 2000 by two guys who wanted to start a t-shirt business. They found designers to submit t-shirt designs that would then be voted on by Threadless community members. The winning designer would get free t-shirts and the community members could buy the winning shirt from Threadless. Amazingly, this turned out to be a very lucrative business for the two founders, spawning a new generation of entrepreneurs tapping into the crowd to help focus and fund their development efforts.¹⁵

1. Examples of Non-profit Crowdfunding

One of the first organizations to use the crowd to raise funds was Kiva.org. Kiva conflated the concepts of microfinance and crowdsourcing to create an online community where Kiva community members could lend small amounts of money to entrepreneurs in developing countries. Kiva made its first loans in April 2005 and has lent over \$160,000,000 to over 400,000 entrepreneurs in 208 countries.¹⁶ According to Kiva, the average loan size is approximately \$380.¹⁷ Kiva is a non-profit entity and lenders through Kiva receive no guarantee of repayment and no financial return on their loans. More recently, Barack Obama's presidential campaign used crowdfunding over the internet to raise hundreds of millions of dollars in donations of \$200 or less from millions of donors.¹⁸ Crowdfunding by non-profit entities and political campaigns is just a step away from crowdfunding by for-profit entities; however, because of regulatory restrictions, that is a very big step.

2. Examples of For-profit Crowdfunding Without Equity Offerings

A number of for-profit entities are trying to use the crowd to finance their development, but without providing the donors any equity in the business. Websites such as Kickstarter and IndieGoGo provide a one-stop clearing house where entrepreneurs and artists meet potential donors. Independent filmmakers and other entrepreneurs looking to finance their projects present their ideas to the IndieGoGo or Kickstarter community and each community member decides which projects, if any, to support with

14. See HOWE, *supra* note 6, at 14 (“Online communities are at the heart of crowdsourcing, providing a context and a structure within which the ‘work’ takes place.”).

15. *Id.* at 2 (“Threadless generated \$17 million in revenues in 2006 (the last year for which it has released sales figures) . . .”).

16. *Facts & History*, KIVA, www.kiva.org/about/facts (information as of Oct. 18, 2010).

17. *Id.*

18. Michael Isikoff, *Obama's 'Good Will' Hunting*, NEWSWEEK, Oct. 4, 2008, at 8.

donations.¹⁹ At Kickstarter and IndieGoGo, an entrepreneur can submit his or her project to the crowd for a specific minimum funding amount. If enough community members like the idea and are willing, in the aggregate, to donate the minimum funding amount by the fundraising deadline, the project goes forward. The Kickstarter and IndieGoGo communities have funded a variety of ideas including small businesses, independent theater productions, and even an initiative to amend securities regulations to create an exemption for equity financings through crowdfunding.²⁰ Whether funded via IndieGoGo or Kickstarter, the common characteristic of these projects, besides their reliance on the crowd, is they do not offer an equity stake to the people providing the money, because doing so would violate federal and state securities laws.²¹

3. Examples of For-profit Crowdfunding with Equity Offerings

Few microstartups are willing to incur the costs associated with regulatory compliance to use crowdfunding as a way to raise capital in a securities offering. Three such companies, Spring Street Brewing Company (“Spring Street”), Cameesa, Inc. (“Cameesa”), and Audience Productions, Inc. (“API”), each took very different approaches to crowdfunding with an equity offering. Of these three, only API still remains in its original business model.

a. *Spring Street Brewing Company*

In 1996, the now-defunct Spring Street offered shares in an initial public offering (“IPO”) under Regulation A of the Securities Act (“Regulation A”), over the internet, via a direct public offering (“DPO”).²² Spring Street’s goal was to raise \$5 million in its DPO and it managed to raise nearly \$2 million from approximately 3500 investors, an average of just over \$570 per investor.²³ While others considered raising nearly \$2

19. Not all independent filmmakers rely on IndieGoGo or Kickstarter. The producers of the film “Age of Stupid” raised over \$800,000 for production and marketing, from over 600 individuals and groups, offering donors everything from a copy of the finished DVD, to tickets, to screenings, to producer credits, depending on the size of the donation. *See, e.g.*, SPANNER FILMS, <http://www.spannerfilms.net>, formerly <http://www.ageofstupid.net> (last visited on July 28, 2011). *See also* Kristina Dell, *Crowdfunding*, TIME, Sept. 4, 2008, <http://www.time.com/time/magazine/article/0,9171,1838768,00.html>.

20. *Crowdfunding Campaign to Change Crowdfunding Law*, INDIEGOGO, <http://www.indiegogo.com/Change-Crowdfunding-Law> (last visited Mar. 18, 2011).

21. *Id.*

22. A direct public offering does not use an underwriter or broker. Instead, the issuer offers shares directly to the public. *See Definition of Direct Public Offering*, ENTREPRENEUR (last visited July 28, 2011), <http://www.entrepreneur.com/encyclopedia/term/82238.html>.

23. Susan Greco, *The Real Legacy of Spring Street Brewing, Inc.*, Sept. 1, 1999, available at <http://www.inc.com/magazine/19990901/13720.html>.

million in a web-based public offering to be a success, Spring Street's founder, Andy Klein, considered it a qualified success because of the low rate of conversion of people who visited the company's website and read the prospectus into purchasers of shares.²⁴ Klein attributed the low conversion rate to the lack of "an intermediary who's in the business of evaluating the company, doing due diligence, and putting its reputation on the line with the company's reputation."²⁵ The lesson of Spring Street's fundraising success is that the lack of an intermediary should not pose a problem for entrepreneurs with a good business idea looking to raise less than \$1 million. Furthermore, because of the internet, investors have easier access to more information than was available to prospective investors in Spring Street back in 1996.

b. Cameesa, Inc.

Ten years after Spring Street's DPO, Cameesa took the Threadless idea a step further.²⁶ Instead of simply offering t-shirt designers a community in which to present their designs for voting and potential production, the founders of Cameesa offered investors a share in the net proceeds of the crowdfunded t-shirts.²⁷ Once a design was fully-funded, each person who invested money to produce that design would receive a t-shirt with the design on it and share in future profits from the sale of t-shirts with that design.²⁸ Although Cameesa's model did not sell equity in Cameesa itself, under the rubric of *Securities and Exchange Commission v. W. J. Howey* ("Howey")²⁹ discussed in Section III of this article, Cameesa's

24. *Id.* (

[The success] had nothing to do with the appetite for venture capital or investors' interest in beer companies. It was that we had the good fortune of being the first company to raise money using the Internet. And that led to hundreds of stories about the offering as it was occurring, which led, in turn, to, I would say, hundreds of thousands of people on our Web site. The interesting fact was, although we had around 500,000 people who came and saw the prospectus on our site, only 3500 of them invested. Yeah, we raised nearly \$2 million, but the conversion rate—that is, the rate at which people who heard about the offering and looked at the prospectus were willing to buy in a direct offering—was very, very small.

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25. *Id.*

26. See generally ZAZZLE, <http://www.zazzle.co.uk/tshirts> (last visited July 28, 2011) (Cameesa's new website).

27. Josh Lowensohn, *Cameesa: A Threadless Where Customers Are Also Investors*, CNET NEWS, Aug. 15, 2008, available at http://news.cnet.com/8301-17939_109-10018138-2.html.

28. *Id.* See also AJ, *Cameesa*, T-SHIRT MAGAZINE (Feb. 20, 2009, 12:26 PM), <http://t-shirtmagazineonline.com/comeesa/> (posting an interview with Andrew Cronk of Cameesa).

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

scheme was a securities offering that violated the Securities Act of 1933. During the summer of 2010, Cameesa shut down the community.³⁰

c. Audience Productions, Inc.

In October 2009, API filed a registration statement on Form S-1 as a DPO, with an initial offering deadline of October 19, 2010.³¹ Since then, API elected to extend the offering period for six months, ending on April 19, 2011 and an additional three months, ending on July 19, 2011.³² If all of API's shares had not been sold by that date, the company reserved the right to extend the offering period for up to an additional nine months.³³ API sought to raise \$8,000,000 by offering 800,000 shares of Series A Preferred Stock at a price of \$10 per share in minimum sales blocks of two shares and a maximum aggregate investment amount of \$2,500 per investor.³⁴ On January 10, 2011, API launched the website through which it sold shares in its DPO.³⁵

Like Spanner Films,³⁶ API is a movie production company and planned to use the money raised through its DPO to fund the production of "Lydia Slotnick Unplugged." In a conversation with Jay Schwartz, president and a director of API, Mr. Schwartz indicated that crowdfunding is essential to API's business concept to build a broad base of ownership.³⁷ Mr. Schwartz and others believe that crowdfunding not only supports the development of a new business but also builds a market for the products the

30. Kelly Murphy, *TTG Promo Alert – Going Out of Business Sale from Cameesa*, TEE GAZETTE (Aug. 31, 2010), <http://teegazette.com/2010/08/ttg-promo-alert-going-out-of-business-sale-from-cameesa/>. Cameesa's business model underwent various iterations after the shutdown. *See also Cameesa's Resurrection* (Oct. 17, 2010 at 6:58 PM) (indicating that TK Tees of Davis, California offered to purchase Cameesa in the fall of 2010); TKtees message board, *What's Going On?* (Nov. 9, 2010 at 4:45 PM), <http://amber.tktees.com/viewtopic.php?f=9&t=39> (indicating that TK Tees' deal with Cameesa had failed to close and that Cameesa was purchased by Zazzle.com).

31. Audience Productions, Inc., Registration Statement (Form S-1) (Oct. 20, 2009).

32. *Id.*, *See also* Audience Productions, Inc, Prospectus filed pursuant to Rule 414(b)(3) (Apr. 7, 2011) (API's second extension extends the offering period to July 19, 2011).

33. *Id.*

34. *Id.*

35. *See generally* AUDIENCE PRODUCTIONS, <http://www.yourmoneyyourmovie.com> (last visited July 28, 2011) (API's website, providing additional information about API and the initial film project and accepting the online purchase of shares) (password required). *See also* Audience Productions, Inc. Certification for Termination of Registration (Form 15) (July 15, 2011) (API withdrew its registration statement and returned to its investors all funds raised through the DPO).

36. Spanner Films is the production company that produced *The Age of Stupid*, the first crowdfunded feature-length film.

37. Telephone interview with Jay Schwartz, President and Director, API (Oct. 22, 2010) (during which Mr. Schwartz explained that having a broad base of owners helps create an audience for API's film if the investors become champions of the film, telling their friends, family and associates about the film).

new business will create. Furthermore, the broad base of ownership will generate valuable personal endorsements for the products.³⁸

d. What Does This Mean for Microstartups?

API's decision to register its offering and conduct a DPO is not an option available to most microstartups. Fortunately for API, its two principal officers are a licensed attorney and a career banker.³⁹ The costliest services in a public offering, aside from filing fees, are the legal and accounting services related to the various registration statements. So, while the financing method API selected may be a reasonable choice for API, it is not a cost-effective option for most microstartups.

Of the three methods discussed in this section, the financing method chosen by Cameesa is the one most viable for microstartups. Through its website, Cameesa offered individual investors a share in the future profits from sales of t-shirts financially backed by that investor. Although Cameesa investors did not own any equity in the company, under *Howey*, their investment in a Cameesa t-shirt design would be deemed a Cameesa security. Without changes to the current federal regulatory scheme, this financing method violates securities laws. Some microstartups might try crowdfunding with an equity offering in defiance of federal regulation, but they do so at their own risk now that the Commission is on notice of the existence of crowdfunding.

III. FEDERAL SECURITIES REGULATIONS – EXISTING BARRIERS TO MICROSTARTUP FUNDRAISING

A. *The Commission's Mission*

The Commission was created in 1934 with a stated mission “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”⁴⁰ In the context of fundraising by entrepreneurs and

38. *Id.* See also Daniel M. Satorius & Stu Pollard, *Crowd Funding: What Independent Producers Should Know About the Legal Pitfalls*, 28 ENT. & SPORTS LAWYER 15, 16 (2010) (“Those contributors who participate in crowd funding are vested in the project (not legally, but philosophically), and they may become proselytizers for the project, which may be many times more valuable to the project than their contribution.”); see also Steve Strauss, *How to “Crowdfund” Your American Dream*, AOL SMALL BUSINESS (Jan. 23, 2011, 9:00 PM), <http://smallbusiness.aol.com/2011/01/23/how-to-crowdfund-your-american-dream> (stating that “folks become (literally) invested in your success and thus become your cheerleaders”).

39. API Registration Statement, *supra* note 31.

40. SEC, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 11, 2011) [hereinafter *The*

microstartups, the first and last of the Commission's objectives—protecting investors and facilitating capital formation—can be at odds. The rules and regulations adopted to protect investors increase the costs associated with raising capital, making it difficult if not impossible for some entrepreneurs and microstartups to grow beyond the idea stage, effectively interfering with and not “facilitating” capital formation. While protecting investors from fraud is important, “the [Commission] must recognize that fraud prevention sometimes has too high a cost.”⁴¹ In the case of small offerings, such fraud prevention is analogous to killing a mosquito with a machine gun.

In the early years of the Commission's existence, investors' access to information was more restricted than it is in today's internet environment. Before the internet, in addition to a company's periodic reports, investors relied on information doled out by a limited number of sources, primarily brokers and analysts, through home-grown publications distributed to clients of the broker or analyst.⁴² The internet has made this information much more readily and widely available at the click of a mouse. For example, instead of subscribing to industry reports from a brokerage house analyst, an investor can find similar information on the Yahoo!Finance website or subscribe to The Motley Fool's online monthly newsletter. This is not meant to suggest that the decreased cost of information should lead the Commission to be less vigilant, but only that today's investor has access to much more reliable information, from different points of view, upon which to base an investment decision.⁴³ Such quick and easy access to information cuts both ways, however, as those who are intent on committing fraud can also reach millions of people quickly and easily. As a result, the Commission has become ever more vigilant in protecting investors from web-facilitated fraud.

At the same time, through the internet and social networking websites, entrepreneurs and microstartups that do not require large amounts of capital to reach the next level of development have the ability to reach large audiences to raise small amounts of capital. Although twenty-first century investors have access to much more information available to the public through the internet, the Commission seems stuck in the early twentieth

Investor's Advocate].

41. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case of an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 34 (2001) (arguing that the Commission should use other available rules, such as Rule 10b-5, to combat certain types of fraud and offer an unconditional exemption for small offerings under Rule 504).

42. For private companies, the information provided by the company, its investment bankers, accountants and attorneys was the only information generally available to investors.

43. Even for private companies, there is a wealth of information available to investors, from industry analysts to technology reviews such as those provided by Cnet and similar companies.

century, regulating based on an outdated assumption that investors have limited access to restricted information. More than ten years ago, the Commission itself recognized that its rules were outdated for the financial markets of that time, stating through its advisory committee that:

The nature of our securities markets has changed dramatically over the last sixty years. The rate of change has been even more striking in the last two decades. In the Committee's view, the statutory schemes first enacted in 1933 and 1934 were well adapted to the markets of the time. Sixty years ago . . . there were few mechanisms for the general public to make investments other than through the direct purchase of corporate shares in primary offerings.⁴⁴

Today's financial markets and investors' access to information are much changed in the years since the Commission's advisory committee issued its report. It is time once again for the Commission to review its policies and regulations, with respect to regulating the sale of securities, for relevance and effectiveness given the rapidly changing marketplace and the easy access investors have to multiple sources of reliable information. Even if it eases some restrictions on who can sell what to whom, when and via what methods, the Commission still will be able to protect small investors from risking their life savings in a single transaction.

B. The Problem with the Current Regulatory Scheme

The regulation of securities balances the benefits of free-market capitalism on one side and protecting investors against fraud and market manipulation on the other. This trade-off is reflected in the Commission's mission objectives to facilitate capital formation and protect investors from fraud. Which of these components should weigh more heavily in the Commission's mission? When it comes to small offerings, does the Commission even need to choose between these competing objectives?

Capital formation is essential to economic development and job creation in this country. Entrepreneurs create new solutions to existing problems or identify previously unimagined opportunities for new inventions.⁴⁵ They turn these ideas into businesses that employ people and

44. SEC, REPORT OF THE ADVISORY COMM. ON THE CAPITAL FORMATION AND REGULATORY PROCESS, at 11 (July 24, 1996), *available at* <http://www.sec.gov/news/studies/capform.htm>. Although this statement was made with respect to public offerings made by reporting companies and not private companies, the advisory committee's observation about change is relevant to this discussion.

45. According to the Small Business Administration, small businesses produce thirteen times more patents per employee than larger patenting firms. U.S. Small Bus. Admin., Office of Advocacy, *How important are small businesses to the U.S. economy?* (last visited July 28, 2011), <http://www.sba.gov/advocacy/7495/8420>.

increase the tax base of local government.⁴⁶ Investors in successful startup businesses can make millions of dollars which often are reinvested in new startup ventures. Under the current regulatory scheme, this process is a relatively closed one, providing investment opportunities to venture capital firms and high net worth individuals and financing opportunities to select entrepreneurs.⁴⁷ The ultimate result of this closed community system is the concentration of wealth among a select few in limited geographic areas such as Silicon Valley, Boston, Austin and a few others. The creation of a small offering exemption for microstartups will begin to open up this closed community and spread the potential wealth more broadly.

Another problem with the current regulatory scheme is its inefficiency. Once an entrepreneur has a marketable idea, or one that she thinks is marketable, she will spend a good deal of time shopping her idea around to prospective investors. If she is lucky, her idea will be one of the few that interest an angel investor or a venture capital firm and she will raise enough capital to continue on her development path. If she is among the vast majority of unlucky entrepreneurs, her path may come to an end. Given these odds, it is likely that an idea that could have become a good business will never be realized, solely because a few people in this closed community deemed the idea unworthy of financial support.⁴⁸ On the other hand, according to the National Venture Capital Association, for every ten companies in which a venture fund invests, one or two will produce high returns, about four will produce moderate returns, and the rest will fail.⁴⁹ This means hundreds of millions of dollars are invested every year in failing businesses.

A scheme that allows small investors to make small investments in capital formation could give entrepreneurs an opportunity to travel further down the development path by taking incremental steps before approaching venture capitalists. More ideas would be developed and more businesses created, resulting in a more robust job market and local tax base. If the

46. According to the Small Business Administration, sixty-four percent of new jobs created in the past fifteen years were created by small businesses and those businesses account for forty-four percent of private company payroll in the United States. *Id.*

47. See generally Nat'l Venture Capital Ass'n, *2010 Venture Capital Association Yearbook (2010)*, http://growthandjustice.typepad.com/files/nvca_2010_yearbook.pdf (demonstrating the exclusive nature of the venture capital community). See also *infra* Part V.A for a discussion of the current climate for startups.

48. Even a worthy idea that does not need a large capital infusion could be rejected because most venture capital funds, including angel funds, do not make small investments of the size proposed for the small offering exemption.

49. See Nat'l Venture Capital Ass'n, *Frequently Asked Questions About Venture Capital*,

http://www.nvca.org/index.php?option=com_content&view=article&id=119&Itemid=147 (last visited Mar. 22, 2011) (finding that about forty percent of venture-backed companies produce moderate capital returns, forty percent will fail, and up to twenty percent will produce high capital returns).

company continues to grow, early investors should reap some financial rewards for their investments, spreading the wealth creation beyond the usual venture capitalists and high net worth individuals. Additionally, for startups that fail, the loss to any individual investor would not be catastrophic, and unsuccessful ideas would be revealed as unsuccessful before millions of dollars are invested in them.

By design, a small offering poses no risk of catastrophic loss to the individual investor, so in the case of a small offering the Commission's charge of protecting investors against fraud is less important, on balance, than its charge to facilitate capital formation. This is no different from the way the Commission handles investors in large offerings of private companies. In general, the rules require investors to be accredited, meaning the investor meets certain income or net worth thresholds to be able to invest in the offering. The Commission does not confirm that the investor actually meets the threshold. In fact, the company making the offering only confirms that the investor is accredited through a certification form completed by the investor or via representations and warranties the investor makes in the equity purchase agreement. The guidelines exist and all parties are presumed to follow them. Similarly, the Commission should presume that an individual participating in a small offering has the discretionary funds available to make the small investment. Furthermore, since an investment in a small offering would be no more than \$1000, the financial impact of a loss on the small offering investor would be minimal.

The problem with the current regulatory scheme is that it over-regulates small offerings to prevent fraud on the investor where the detrimental effects of such fraud, if fraud were to happen, are virtually non-existent and outweighed by the beneficial effects of the jobs and revenue generated by the startup business.

C. *What is a "Security"?*

In 1946, the U.S. Supreme Court decided *Howey*, which clarified the definition of a "security" under the Securities Act. In *Howey*, an orange grower offered prospective customers an opportunity to own orange trees by purchasing a land contract from Howey coupled with a service contract from Howey or another service provider.⁵⁰ The land contract could not be purchased without a service contract, and Howey retained all discretionary decisions and control over the growing, harvesting, marketing and selling of the oranges.⁵¹ Although Howey technically was selling land contracts to grow oranges, the Court held that it was in fact selling a security, which the Court defined to include any scheme that involves "an investment of

50. SEC v. W. J. Howey Co., 328 U.S. 293, 295 (1946).

51. *Id.* at 296.

money in a common enterprise with profits to come solely from the efforts of others . . . whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.”⁵²

The Court further defined a profit-seeking business as one where “[t]he investors provide the capital and share in the earnings and profits . . . [and] the promoters manage, control and operate the enterprise.”⁵³ Applying this description, almost any enterprise that is selling unregistered securities to such investors, in which the investors are not also officers and employees of the enterprise, would be selling such securities in violation of the Securities Act. The Cameesa model, for example, ran afoul of *Howey* because it gave investors a revenue share of t-shirts sold once a threshold had been reached, irrespective of whether the investors promoted the sale of the shirts. Cameesa might have avoided *Howey* if it had required the investor to promote the supported t-shirt in order to share in the revenue generated from sales of that t-shirt and limited revenue-sharing only to sales for which the investor was directly responsible. In this way, the investor would have shared revenue only from sales she generated and such revenue would not have met *Howey*’s definition of a security. Thus, the transaction would not have been prohibited under *Howey*. If, on the other hand, Cameesa had allowed the investor to share in revenue that both she and others generated, then Cameesa likely would have been relying on the word “solely” in the *Howey* definition of a security to avoid *Howey*’s applicability, because the investor would not be relying *solely* on others’ efforts to generate revenue. However, such a distinction still may not have excluded the Cameesa profit-sharing scheme under *Howey*, as some courts have held that profits that are primarily or predominantly from the efforts of others also would meet the *Howey* test.⁵⁴

D. What is “Registration”?

Registration is the process by which companies disclose important financial information to prospective investors.⁵⁵ The issuer of the securities

52. *Id.* at 301.

53. *Id.* at 300.

54. See Miriam Albert, *The Howey Test Turns 64: Are the Courts Grading this Test on a Curve?* (Hofstra Univ. Sch. of Law, Legal Studies Research Paper Series, Working Paper No. 10-28, 2010), available at <http://ssrn.com/abstract=1666894> (citing to *SEC v. Kosco Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) and *Robinson v. Glynn*, 349 F.3d 166, 170 (4th Cir. 2003), both cases where lower courts interpreted *Howey* to apply to “profits that come ‘primarily,’ ‘substantially’ or ‘predominantly’ from the efforts of others”). Additionally, in its opinion in *United Hous. Found. v. Forman*, 421 U.S. 837, 852 (1975), the U.S. Supreme Court noted the Ninth Circuit’s relaxed interpretation of the word “solely” in *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir. 1973), but it did not opine on the Ninth Circuit’s holding in *Turner*.

55. See *The Investor’s Advocate*, *supra* note 40, at section titled “The Laws That

is required to file a registration statement with the Commission so that investors can make an informed investment decision. For its part, the Commission oversees the filing of the registration statement by reviewing the information being disclosed, to ensure that sufficient information has been disclosed. The Commission is very clear that while it requires the issuer to provide accurate information, it does not guarantee the accuracy of the information provided.⁵⁶ Securities being offered for sale must be registered or must meet the requirements for an exemption from registration.⁵⁷ Only a few exemptions to registration are applicable to small offerings by private companies, and those exempt offerings also must comply with certain other provisions of the Securities Act.

E. Exemptions to Registration

A securities offering by a private company may not need to be registered with the Commission if the offering satisfies the requirements of any one of a number of exemptions.

1. Regulation A

Based on its title, “Conditional Small Issues Exemption,” one would expect Regulation A to be an ideal exemption for entrepreneurs looking to raise a small amount of capital in exchange for a small amount of equity. An entrepreneur must first form a U.S. or Canadian entity and then seek to raise less than \$5,000,000 in the aggregate in a twelve-month period. Unfortunately for the entrepreneur, the issuer has to file a Form 1-A Offering Statement (the “Offering Statement”) with the Commission. If the issuer advertises the offering, a preliminary and/or final offering circular (each the “Offering Circular”) must be available to prospective investors.⁵⁸ There are rules governing the information that must be included in the Offering Statement and the Offering Circular.

When Regulation A was initially introduced in 1936, its objective was to provide an almost unconditional federal exemption for small offerings.⁵⁹ At the time, a small offering was defined as no more than \$30,000.⁶⁰ Eventually, the small offering exemption under Regulation A, and

Govern the Securities Industry” (explaining that registration enables investors to make educated decisions about whether to purchase a company’s securities).

56. See SEC, *The Laws That Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml> (last visited Mar. 22, 2011) (stating that “[w]hile the SEC requires that the information provided be accurate, it does not guarantee it”).

57. See generally *The Investor’s Advocate*, *supra* note 40 (discussing the requirements of the securities issuance process).

58. See 15 U.S.C. §77; see also 17 C.F.R. § 230.251(d).

59. Bradford, *supra* note 41, at 15.

60. *Id.*

subsequently under Rule 257 of the Securities Act (“Rule 257”), was eliminated when the Commission adopted changes in 1992 to Rule 504 of the Securities Act (“Rule 504”) that encompassed the Regulation A small offering exemptions.⁶¹ Unfortunately, the changes in 1999 to Rule 504 eliminated the small offering exemption that had previously been available under Regulation A and later under Rule 257, but the Commission did not reinstate the old small offering exemption.⁶²

For entrepreneurs looking to raise millions of dollars, the costs associated with preparing and distributing the Offering Statement and the Offering Circular and filing the Form 1-A may be justified; but for entrepreneurs looking to raise significantly less capital, the requirements to comply with Regulation A become a barrier to doing business.⁶³ In the case of Spring Street, the offering raised nearly \$2 million and was made exclusively over the internet as a DPO, keeping the aggregate cost of the registration low.⁶⁴

2. Regulation D

The title of Regulation D of the Securities Act (“Regulation D”), “Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933,” and the rules thereunder appear to provide a way to conduct a small equity offering. Rule 504 provides an exemption for offerings of less than \$1,000,000. Rules 505 and 1001 of the Securities Act (respectively, “Rule 505” and “Rule 1001”), provide safe harbor for offerings of up to \$5,000,000. Upon closer look, however, the exemptions under Rules 504 and 505 contain important restrictions that limit their usefulness to entrepreneurs seeking venture capital funding. Rule 1001 applies only to transactions that are exempt under California law.

The original purpose of Rule 504 was to provide an exemption for small businesses to be able to raise small amounts of capital privately without the high costs associated with registering securities.⁶⁵ In 1992, the

61. *Id.*

62. *See id.* at 16 (noting the SEC’s failure to restore Rule 257). *See also* 17 C.F.R. § 230, Securities Act Release No. 33-7644 (Feb. 25, 1999) (explaining that the SEC sought to stop fraudulent secondary transactions in over-the-counter markets for small issuers and noting the SEC’s belief that the changes would not create an undue burden on or barrier to small businesses trying to raise seed capital).

63. *See* Bradford, *supra* note 41, at 23 (analyzing registration costs in general, not specifically registration costs with respect to Regulation A).

64. *See* Stephen K. Gregg, Comment, *Regulation A Initial Public Offering on the Internet: A New Opportunity for Small Business?*, 1 J. SMALL & EMERGING BUS. L. 417, 420 (1997) (noting that the Spring Street “offering raised \$1.6 million without the use of any expensive intermediaries or underwriters”).

65. Bradford, *supra* note 41, at 4.

Commission strengthened the Rule 504 exemption by making it virtually unconditional in support of the Commission's mission of facilitating capital formation by allowing small businesses to raise small amounts of money without having to register the offered securities.⁶⁶ The Commission saw the need to give entrepreneurs the ability to offer securities by "facilitating access to the public market for start-up and developing companies, and . . . lowering the costs for small businesses that undertake to have their securities traded in the public market."⁶⁷

With each amendment of Rule 504, the Commission noted the importance of providing access to capital for entrepreneurs, even going so far as to acknowledge in 1987 the cost burden to entrepreneurs of compliance with federal as well as state securities laws.⁶⁸ In 1999, the Commission amended Rule 504 again, imposing restrictions that eliminated the unconditional nature of the rule's exemption.⁶⁹ It would seem that by 1999 the Commission believed the "cost burden" to entrepreneurs had disappeared.

The present construction of securities regulations leaves very little room for microstartups to raise capital. What room there is comes at a price that may be too high for entrepreneurs to bear, assuming the entrepreneur can even figure out what she has to do to be in regulatory compliance.

F. Compliance

Assuming the entrepreneur already has rejected filing under Regulation A as a fundraising option, what other options are available to her to raise capital by selling shares of her company?

1. Section 3(a)(11) of the Securities Act

Under Section 3(a)(11) of the Securities Act, when an entrepreneur is selling securities in a single State and the business is incorporated in the same State, such sales will be exempt from federal regulation. State regulation, however, may apply.⁷⁰

66. *See id.* at 14 (noting that the SEC increased the cap on unregistered sales from \$500,000 to \$1,000,000 and eliminated the general solicitation and resale restrictions).

67. *See id.* (quoting Small Business Initiatives, Securities Act Release No. 6924, 57 Fed. Reg. 9768, 9768 (proposed Mar. 20, 1992)).

68. *See id.* at 13 (quoting Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Securities Act Release No. 6683, 52 Fed. Reg. 3015, 3018 (proposed Jan. 30, 1987)).

69. *See id.* at 5 ("In 1999, the SEC . . . made Rule 504 offerings subject to Regulation D's ban on general solicitation and advertising and restricted the resale of securities acquired in a Rule 504 offering.")

70. *See* 15 U.S.C. § 3(a)(11) (2010) (stating that the Securities Act shall not apply to

This exemption, while good for capital-raising on a local level, is too restrictive for crowdfunding via web-based social networks and dedicated websites. A central idea of funding by the crowd is the ability for anyone anywhere to support the entrepreneur by investing in her microstartup.

2. Section 4(2) of the Securities Act

Under Section 4(2) of the Securities Act (“Section 4(2)”), an entrepreneur can privately offer to sell shares, but by definition this would not give her access to the crowd. Rule 502(c) of the Securities Act (“Rule 502”) defines the term “general solicitation or general advertising” as it relates to the non-public offering exemption of Section 4(2).⁷¹ An email blast, a banner ad or other web-based solicitations is likely to be deemed general solicitation or general advertising under Rule 502’s current construction.⁷² An interesting exception might be an offering made through an existing social network or closed online group. The social network or closed online group would have to exist apart from the entrepreneur’s offering. In other words, the entrepreneur could not create an online group for the purpose of fundraising because the act of forming the group would likely be deemed a public offering, thereby violating the very exemption she seeks to use.⁷³ Making an offer to an existing social network, such as the entrepreneur’s Facebook “friends” might not be deemed a public offering.⁷⁴ Alternatively, the entrepreneur, long before she seeks to raise funds, could create a Facebook group featuring her microstartup and invite people to join her company’s Facebook group to follow its progress and help build an online audience for its products. Would a subsequent offering to the followers of the company’s group be deemed a non-public offering? At this writing, the Commission has not issued an interpretation or no-action letter about the treatment of existing online communities for the purpose of an offering qualifying for an exemption under Section 4(2).

“[a]ny security which is a part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state or territory.”).

71. 17 C.F.R. § 687 (2010). Rule 502(c) defines general solicitation or general advertising to include but not be limited to activities such as advertising, articles or notices in print, radio, television or any other media for the purpose of making the offering or inviting prospective investors to attend a meeting about the offering. *Id.*

72. *See* SEC Staff Compliance and Disclosure Interpretation No. 656.01, 17 Fed. Reg. 687 (Jan. 26, 2009) (indicating that a brochure that is mailed, handed out at an event and included in a trade journal is a general solicitation).

73. *See* SEC Staff Compliance and Disclosure Interpretation No. 134.02 (Nov. 26, 2008) (explaining that filing a registration statement that is subsequently withdrawn is a public offering and makes a 4(2) exemption unavailable to the issuer for that same offering).

74. This has not yet been tested, and the SEC has no staff interpretation on whether such an offering would be public.

IV. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT – CHANGES AFFECTING VENTURE CAPITAL FUNDS AND ANGEL INVESTORS

A. *Summary of Title IV*

Title IV (“Title IV”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) gives the Commission the authority to regulate private funds.⁷⁵ Although most of the provisions of Title IV affect hedge funds and private equity funds and their advisers, some of the new regulations also will affect venture capital funds, including angel funds.⁷⁶ In most respects, the Dodd-Frank Act exempts venture capital funds from many of its registration and reporting requirements; however, it also gives the Commission the task of defining “venture capital fund,” which will be hotly debated in the venture capital community.⁷⁷ Congress recognized the importance of venture capital funds as facilitators of capital creation through investments in small businesses and startups and noted that such funds do not pose the same systemic risks to the financial system as large private funds.⁷⁸

Prior to the Dodd-Frank Act, the accredited investor standards were (i) an individual income of more than \$200,000 per year for two consecutive years (or \$300,000 joint spousal income) or (ii) individual or joint spousal aggregate net worth of more than \$1,000,000, including the investor’s primary residence.⁷⁹ The Dodd-Frank Act adjusts the calculation of individual or joint spousal aggregate net worth to *exclude* the investor’s primary residence and requires the Commission to review the accredited investor standards every four years to determine whether further adjustments are needed.⁸⁰ Initial versions of the Dodd-Frank Act required

75. Dodd-Frank Act, *supra* note 3.

76. While Section 407 of the Dodd-Frank Act exempts an “adviser that acts as an investment adviser solely to 1 or more venture capital funds” from the registration and reporting requirements of the Dodd-Frank Act, Section 413 requires an adjustment and periodic review of the net worth standard for determining whether a prospective investor is an “accredited investor” under the Securities Act, which will affect who can invest in venture capital funds. *Id.* at §§ 407, 413.

77. Section 407 of the Dodd-Frank Act directs the Commission to “issue final rules to define the term ‘venture capital fund’” no later than one year after enactment of the section. *Id.* at § 407.

78. *See* S. Rep. No. 111-176, at 74-75 (2010) (concluding that losses sustained from venture capital fund activities are borne by fund investors alone); *see also* DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS, Section 1515, CCH (2010) (explaining that Congress does not believe that venture capital funds pose the same risks as larger private funds, noting that their activities and potential losses do not significantly influence the global financial system).

79. 17 C.F.R. § 230.215 (2010).

80. Dodd-Frank Act, *supra* note 3, at § 413. *See also* S. Rep. No. 111-176, at 78

an increase in the income and net worth thresholds for an “accredited investor” under the Act,⁸¹ but after much outcry from the venture capital community, the increases were eliminated in favor of periodic review by the Commission to determine whether adjustments might be needed.⁸²

Congress believed that since the establishment of the accredited investor standards in 1982, inflation and the appreciation of real estate prices have expanded the pool of natural persons who would qualify as accredited investors under the current standards even though such persons may lack the financial expertise that the original standards implied.⁸³ Only a few public comments have been received regarding additional adjustments to the accredited investor standard.⁸⁴ In a letter to the Commission, the North American Securities Administrators Association, Inc. (“NASAA”) reiterated its position in support of the exclusion of the investor’s primary residence in the calculation of individual or joint spousal aggregate net worth, and urged the Commission to incorporate an additional standard of “investments owned” to more accurately assess a prospective investor’s experience in making investment decisions.⁸⁵

For microstartups looking to raise small amounts of capital for

(noting that a beneficiary of a large inheritance may have little or no investment experience but failing to discuss the opposite situation where someone with insufficient net worth to meet the threshold has a wealth of investment experience). Congress did, however, instruct the General Accounting Office to consider whether other factors should be included in the accredited investor standard. Dodd-Frank Act at § 415.

81. Early drafts of the Dodd-Frank Act required annual income of \$450,000 and net worth of more than \$2.3 million. See Rhonda Abrams, *Financial reform legislation may endanger lots of ‘angels’*, USA TODAY (May 7, 2010, 1:54 AM), http://www.usatoday.com/money/smallbusiness/columnist/abrams/2010-05-07-financial-reform-and-small-business_N.htm.

82. See, e.g., John Mauldin, *First, Let’s Kill The Angels*, THE BIG PICTURE (Apr. 20, 2010, 1:00 PM), <http://www.ritholtz.com/blog/2010/04/first-lets-kill-the-angels> (describing the Dodd-Frank Act as an “innovation killer” because of its potential to adversely affect angel investing); see also Andrew Ross Sorkin, *Angels Rebel Against Dodd’s Law*, N.Y. Times: DEALBOOK, THE NEW YORK TIMES (Mar. 29, 2010, 7:17 AM), <http://dealbook.nytimes.com/2010/03/29/angels-rebel-against-dodd-bill> (noting how angel investors oppose the Dodd-Frank Act); see also Robert E. Litan, *Proposed Protections for Angel Investors Are Unnecessary and Will Hurt America’s Job Creators*, HUFFPOST BUSINESS (Mar. 24, 2010, 10:37 AM), http://www.huffingtonpost.com/robert-e-litan/proposed-protections-for_b_511284.html (arguing the proposed provisions in the Dodd-Frank Act which “protect” angel investors are unnecessary and will only hinder new business financing).

83. S. Rep. No. 111-176, at 77 (2010).

84. The Commission had received fifteen comments on the accredited investor standard as of April 15, 2011. See SEC, *Accredited Investor Standard: Title IV Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, <http://sec.gov/comments/df-title-iv/accredited-investor/accredited-investor.shtml#comments> (last updated Jan. 6, 2011).

85. Letter from David S. Massey, NASAA President, to Elizabeth M. Murphy, SEC Sec’y (Nov. 4, 2010), available at <http://www.sec.gov/comments/df-title-iv/accredited-investor/accreditedinvestor-11.pdf> (recommending an “investments owned” standard as a component to the accredited investor test).

development, the old and new standards for accredited investors likely eliminate most of the people who would participate in a crowdfunded offering. Whether the accredited investor standard should apply to a crowdfunded offering should depend on the size of the individual's investment. For example, the investor protections assumed by requiring an investor to be an accredited investor are hardly applicable when the amount of an individual investment in a crowdfunded offering is likely to be much less than what the average American consumer spends monthly on entertainment and dining out.⁸⁶

B. *Potential Impact of Title IV on Microstartups*

The changes that Title IV will impose on securities regulations make it marginally more difficult for some individuals to qualify as accredited investors. When it comes to friends and family investors, however, the Dodd-Frank Act will have little impact on how entrepreneurs go about raising that initial round of funding from their relatives and friends, regardless of whether the fundraising is one-to-one or over the internet.

C. *Recommendation to the Commission*

For crowdfunded offerings, the Commission needs only to create an exemption from the accredited investor thresholds for individuals who make a *de minimis* purchase in a small offering. The definition of "*de minimis*" is an aggregate purchase in an offering or series of related offerings of no more than \$1000. Section V of this article discusses such an exemption in greater detail.

V. PROPOSED AMENDMENT TO FEDERAL SECURITIES REGULATIONS

A. *Summary of Early Stage Financings Since 2007*

According to the Center for Venture Research ("CVR"), angel investment in startups has declined steadily since 2007.⁸⁷ CVR anticipates that unless the downward trend of angel investing in startups reverses itself, the effect will be an ever-widening gap in the source of capital for

86. The average annual expenditures of the average U.S. consumer unit—defined as 2.5 people where 1.3 earn income—on entertainment and dining out is \$5312, which amounts to more than \$800 per month. It is worth noting that these amounts have declined marginally since prior to the economic downturn of 2008. U.S. DEPT. OF LABOR, U.S. BUREAU OF LABOR STATISTICS, CONSUMER EXPENDITURES 2008, at 1-5 (2010).

87. Jeffrey Sohl, *The Angel Investor Market in Q1Q2 2010: Where Have All The Seed Investors Gone?*, CTR. FOR VENTURE RESEARCH, Oct. 26, 2010, available at http://wsbe.unh.edu/files/q1q2_2010_analysis_report.pdf [hereinafter Sohl 2010] (discussing how angels have cut back in seed and start-ups investing).

entrepreneurs and a continued decline in the formation of new businesses and the jobs they create.⁸⁸ CVR further hypothesizes that angels are putting more money into their existing portfolio companies to help the companies survive the current recession instead of investing in new startup ventures.⁸⁹ Furthermore, the industries receiving the largest share of angel investment capital are not likely to be the ones most interested in crowdfunding.⁹⁰

Since 2007, angel investments in startups at the seed stage have declined steadily from forty-five percent in 2008 to a low of twenty-six percent in the first half of 2010.⁹¹ Total angel investments have declined as well—from \$26 billion in 2007 to a low of \$17.6 billion in 2009 (the last full year for which data is available).⁹² 2010 does not promise much improvement as overall angel investments during the first half of 2010 declined 6.5% over the same period in 2009.⁹³

Table 1: Angel Investor Market

| | Q1,2 | | 2009 | 2008 | 2007 |
|--|--------|-----------|---------|---------|-----------|
| | 2010 | 2009 | | | |
| Total Investments | \$8.5b | \$9.1b | \$17.6b | \$19.2b | \$26.0b |
| Total Ventures Funded | 25,200 | 24,450(1) | 57,225 | 55,480 | 57,200(1) |
| Retail & Media (% of angel investments) | 14% | | 9%(2) | 19% | N/A |
| Seed Stage Investments | 26% | | 35% | 45% | N/A |

(1) Estimated based on percentage change data.

(2) Media was not in the top six sectors in 2009 (less than 5%).

Source: Center for Venture Research

Less than three percent of the thousands of entrepreneurs seeking

88. *Id.*

89. *Id.*

90. *See id.* (concluding that healthcare/medical devices, biotech and industrial/energy accounted for fifty-five percent of angel funding in the first half of 2010, while retail and media, the sectors dominated by social networking and other zero-cost startups, together accounted for only fourteen percent of angel funding during the same period).

91. *Id.* *See also* Jeffrey Sohl, *The Angel Investor Market in 2009: Holding Steady but Changes in Seed and Startup Investments*, CTR. FOR VENTURE RESEARCH, Mar. 31, 2010, available at http://wsbe.unh.edu/files/2009_Analysis_Report.pdf [hereinafter Sohl 2009] (finding that although there was a modest decrease in the amount invested in the angel market in 2009, the number of investments remained almost constant); *see also* Jeffrey Sohl, *The Angel Investor Market in 2008: A Down Year In Investment Dollars But Not In Deals*, CTR. FOR VENTURE RESEARCH, Mar. 30 2009, available at <http://www.unh.edu/news/docs/2008AngelReport.pdf> [hereinafter Sohl 2008 and, together with Sohl 2009 and Sohl 2010, collectively “CVR Angel Market Annual Summaries”] (similarly concluding that the angel market contracted considerably in 2008 in terms of amount invested but not in the number of investments).

92. *See* CVR Angel Market Annual Summaries, *supra* note 91.

93. *See* Sohl 2010, *supra* note 87.

funding from angel investors actually get funding, and the average deal size has declined from slightly more than \$1,000,000 in 2004 to approximately \$500,000 in 2009.⁹⁴ Based on an initial submission pool of 20,619 in the past twelve months as of November 3, 2010, only 477 entrepreneurs received angel investment capital.⁹⁵ If the angel investment market continues to tighten, entrepreneurs will find it increasingly difficult to raise the funds they need to expand their businesses and move beyond the idea stage to the next stage of growth. Crowdfunding can fill in this gap by providing much needed seed funding and spreading the risk broadly across the crowd so that the cost of failure to any one investor is minimal—equivalent to the \$1077 the average U.S. consumer spends on entertainment in a year.⁹⁶

B. Petition for Rulemaking Submitted by Sustainable Economies Law Center

1. Description of the Proposed Amendment

In a letter to the Commission, the Sustainable Economies Law Center (“SELCC”) proposed that the Commission create a new exemption for small securities offerings (the “Small Offering Exemption”), noting as a major reason why the Commission should create this exemption the small amount of capital any single investor would risk.⁹⁷ The Small Offering Exemption would exclude from registration:

- any aggregate offering of \$100,000 or less, in which
- any single investor invests no more than \$100, and
- all offerors are natural persons who are U.S. citizens or legal residents.⁹⁸

Additionally, an offeror may have only one offering open at a time and must include a disclaimer in all communications about the offering that clearly states the possibility that the investor might lose his or her total investment and advises investors to carefully evaluate the trustworthiness of the offeror.⁹⁹

94. See ANGELSOFT, INC., <http://angelsoft.net/a/venture-valuation> (last visited July 28, 2011) (supplying data from the past twelve months).

95. *Id.*

96. News Release, Bureau of Labor Statistics of the U.S. Dep’t of Labor, Consumer Expenditures — 2009 (Oct. 5, 2010) (indicating that the average “consumer unit” spent \$2693 on entertainment in 2009), *available at* <http://www.bls.gov/news.release/pdf/cesan.pdf>.

97. Letter from Jenny Kassan, Co-director, Sustainable Economies Law Ctr., to Elizabeth M. Murphy, Sec’y of the Comm’n, SEC (July 1, 2010), *available at* <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>.

98. *Id.*

99. *Id.*

2. Discussion of the Proposed Amendment

Maximum individual investment of \$100. If the maximum amount any individual investor can invest is \$100 and the maximum aggregate offering amount is \$100,000, the issuer will need 1000 investors to reach the offering limit, a number of investors that exceeds the maximum allowed under Section 12(g)(1) (“Section 12(g)(1)”) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).¹⁰⁰ If the issuer reaches the next stage of development without reaching the Section 12(g)(1) total assets threshold and attracts traditional venture financing, it will be only a matter of time before it exceeds such threshold and will be required to register the affected security with the Commission. A simple solution to this problem is to increase the maximum individual investment amount. Limiting the maximum aggregate investment of any one investor to \$1000, an amount that many consumers already spend on items such as laptop computers and tablets, designer footwear and high-definition televisions,¹⁰¹ would decrease the number of investors an offeror would need to reach her aggregate offering amount while remaining a small enough amount that a total loss of the investment would not be catastrophic to any one investor.

Maximum aggregate offering of \$100,000. Based on the Angelsoft data presented above, the average amount of money invested in seed-stage companies by angel investors is approximately \$500,000.¹⁰² If angel investment in seed-stage companies continues to decline, entrepreneurs will need to look elsewhere to fund their ventures. Additionally, the Commission already has set \$1,000,000 as a maximum amount for a small offering exemption.¹⁰³ Limiting the Small Offering Exemption to an aggregate offering of no more than \$250,000 will allow the very small \$100,000 offerings of concern to the SELC an exemption, while filling more of the gap between self-funding and angel funding.

Offeror must be an individual; U.S. citizen or legal resident. SELC’s purpose is to give investors the ability to verify the identity of the offeror

100. Section 12(g)(1) of the Securities Exchange Act and 12g-1 of the Exchange Act Rules require that an issuer with total assets exceeding \$10,000,000 and a class of equity security held by more than 750 persons file a registration statement for such security with the Commission. While it is possible for an issuer to avoid this requirement, a small business without legal resources is unlikely to be able to create the capital structure necessary to do so. 15 U.S.C. § 781(g)(1) (2010); *see also* 17 C.F.R. § 240.12g-1 (2010).

101. A model of the Apple iPad sells for just under \$900, while various pairs of women’s shoes designed by Jimmy Choo or Manolo Blahnik sell for more than \$1000. *See* APPLE STORE, http://store.apple.com/us/browse/home/shop_ipad/family/ipad/select?mco=MjE0OTI0MDI (last visited Mar. 23, 2011); *see also* JIMMY CHOO, <http://www.jimmychoo.com/cruise-11/newton/invt/103newtonlem/> (last visited Mar. 23, 2011).

102. ANGELSOFT, *supra* note 94.

103. *See* Securities Act Rule 504; *see also* 17 C.F.R. § 230.504 (2010).

and minimize the risk of fraud. If the offeror is an individual and not an entity, the offeror is selling to investors shares in the entity that the offeror holds and is reselling. Such resale may not even be permitted under other securities regulations or the entity's bylaws.¹⁰⁴ The entity issuing the securities being offered should be the offeror. To ensure investors have sufficient access to information about the management of the issuer, Regulation S-K requires disclosure of identification and biographical information for officers and directors of an issuer. This information should be available on the issuer's website or provided free of charge as part of the offering materials.¹⁰⁵ Additionally, the relevant corollary for U.S. citizenship or legal residency of a natural person is a requirement that the entity issuing the securities be formed under the laws of one of the States. Requiring that the offeror be an issuer of the securities being offered does not provide the personal liability that SELC wants to attach to the entrepreneurs, but such personal liability can be attached through an officer certification such as that required under Item 601(31) of Regulation S-K to accompany filings of periodic reports with the Commission.¹⁰⁶

Offeror is limited to one offering at a time. Limiting the offeror to only one offering at a time does not adequately protect investors against fraudulent offerings. An aggressive offeror intending to defraud investors can pressure prospective investors to purchase quickly, "before time runs out." Then, as soon as one fraudulent offering closes, the deceitful offeror can initiate another fraudulent offering. Certainly the maximum investment limitation on any individual investor will ensure that no investor will bear catastrophic financial risk; however, there is another troubling issue with a one-offering-at-a-time limitation—integration.

Under Rule 504, the Commission may aggregate sales occurring within a twelve-month period to determine whether Rule 504's \$1,000,000 limitation on the aggregate offering price has been met or exceeded.¹⁰⁷ Additionally, Rule 502(a) provides that sales occurring within a six-month period of each other must collectively meet the requirements of the

104. For example, if the offeror purchased her shares under an exemption to Rule 701 of the Securities Act, 17 CFR § 230.701 (2010), such shares are deemed to be "restricted securities" and can be resold only in compliance with Rule 144 of the Securities Act. 17 C.F.R. § 230.144A (2010).

105. See SEC Regulation S-K Item 401, 17 C.F.R. § 229.401 (2010) (describing information required about directors, executive officers, promoters and control persons of issuers of securities).

106. SEC Regulation S-K Item 601(31), 17 CFR § 229.601 (requiring an issuer's principal executive officer and principal accounting officer certify that the information contained in a periodic report is accurate and contains no material misstatements or omissions). See also *infra* note 114.

107. See Securities Act Rule 504, ex.1, 17 C.F.R. § 230.504 (2010) (explaining how subsequent offerings are integrated into a previous offering to determine aggregate offering price).

applicable Regulation D exemption and describes the five-factor test to determine whether offerings should be integrated for purposes of determining the applicability of any Regulation D exemption. Integration is a source of particular concern for issuers that anticipate an angel round of financing in the near future. Rule 505 and Rule 506 of the Securities Act (“Rule 506”) limit the number of non-accredited investors in an exempt offering to no more than thirty-five. Most offerings made under the Small Offering Exemption are likely to have more than thirty-five non-accredited investors and if integrated with an angel round of financing, would blow the exemption for the angel round under Rules 505 and 506.¹⁰⁸ In such a case, an offeror would have to wait six months after completing a small offering to complete an angel financing round, and those six months could determine whether the business survives. The time limitation on small offerings, therefore, should be based on the aggregate offering price in a six-month period.

3. Additions to the Proposed Amendment

a. Waiver of Accredited Investor Standard

In passing the Dodd-Frank Act, Congress signaled its ongoing concern about protecting inexperienced investors from making bad investment decisions by amending the accredited investor standards.¹⁰⁹ Assuming the Commission agrees that an investment of no more than \$1000 does not pose catastrophic financial risk to the investor, the accredited investor standards should be waived as part of the Small Offering Amendment.

b. Waiver of Non-public Offering Requirement Under Section 4(2) of the Securities Act

The internet and online communities are essential to crowdfunding, as illustrated by the fundraising effectiveness of organizations like Kiva and Kickstarter. Entrepreneurs should have the ability to use online communities and certain web-based communications to conduct offerings under the Small Offering Exemption. For this to happen, the Commission will need to waive the non-public offering requirement of Section 4(2) or define “non-public” to include online communities and some web-based communications for purposes of utilizing the Small Offering Exemption as discussed above in Section III.¹¹⁰ Understandably, such inclusion may need

108. 17 C.F.R. §§ 230.505, 230.506 (2010); *see also* 17 C.F.R. § 230.501 (2010) (excluding accredited investors from the calculation of the number of purchasers participating in an offering).

109. *See supra* Section IV.

110. Email blasts or banner ads should not be included under this waiver. However,

to rely on the facts and circumstances of each offering to determine whether it is public or non-public.

c. Federal Preemption of States' Securities Regulations for Interstate Offerings Under the Small Offering Exemption

States' securities laws, also known as "blue sky laws," are not uniformly pre-empted by federal regulations. Some States do not require separate filings or fees when an issuer files a Form-D Notice with the Commission. Other States, such as Mississippi and Montana, have a separate filing and/or fee requirement. For entrepreneurs, the cumulative costs of such blue sky filings could be prohibitive and use up a large portion of the capital being raised for business development purposes. Although compliance with federal rules for private offerings generally exempts the issuer from blue sky registration requirements, it does not necessarily shield the issuer from subsequent litigation by a State regulatory agency, nor does it exempt the issuer from paying required fees or making any required notice filings.¹¹¹ An issuer who complies with the Small Offering Exemption should be exempt from paying States' filing fees, should be able to file with any State a duplicate of the Form-D Notice filing it filed with the Commission and should be shielded from subsequent litigation by any State regulatory agency.

C. Where to Include the Small Offering Exemption in the Securities Act

1. Include a New Exempted Transaction Under Section 4 of the Securities Act

Section 4 of the Securities Act provides an exemption from registration of securities that meet certain conditions, some of which may

forms of communication such as joining a Facebook group should be included, depending on when and how members are solicited to join the group. For example, if a company creates a Facebook page so its supporters can follow the company's growth and recommend the company's products, it is building a relationship with those supporters. At some future point, the company might decide to launch a crowdfunding initiative through its Facebook page to those supporters. This author suggests that this solicitation be considered a non-public solicitation. Alternatively, if the company first decides to launch a crowdfunding initiative and uses that to generate interest in joining a Facebook group, such an action should not be considered a non-public solicitation. The company presumably would have no prior existing relationship with the people being solicited. The people being solicited may have little or no knowledge of the company or its products, history or performance.

111. The National Securities Markets Improvement Act of 1996 ("NSMIA") amended Section 18 of the Securities Act to create a class of "covered securities" that would be exempt from State regulation. National Securities Markets Improvement Act, sec. 102, § 18, Pub. L. No. 104-290, 110 Stat. 3416, 3417-20 (1996). Section 18(b) of the Securities Act of 1933 defines what may be deemed a covered security. 15 U.S.C. § 77r.

apply to small business issuers, but none of which would exempt crowdfunded offerings. Section 4(2) exempts private offerings by issuers.¹¹² Section 4(5) exempts private offerings of up to \$5,000,000 with an unlimited number of accredited investors.

To ensure the exemption of crowdfunded offerings, this author proposes the addition of the following new exemption to the Securities Act as Section 4(6) that would exclude offerings made by issuers:

(6) transactions involving offers or sales by an issuer, if the aggregate offering amount of an issue of securities offered in reliance on this paragraph does not exceed \$250,000 in any six-month period, if the maximum aggregate purchase per investor is no more than \$1000, if there is no advertising or public solicitation, and if the issuer files such notice with the Commission as the Commission shall prescribe.¹¹³

The Commission can and should require notice and disclosure from entrepreneurs seeking to make use of a Small Offering Exemption. The Commission also can require a statement from the entrepreneur, stipulating that the entrepreneur recognizes she has a fiduciary duty to each of the investors throughout the life of the business,¹¹⁴ recognizing that it is essential to the functioning of capital markets that investors trust the information being provided by those who are offering securities for sale.¹¹⁵

2. Amend Section 18(b)(4) of the Securities Act

To ensure that securities offered under the Small Offering Exemption are deemed covered securities for purposes of State regulation or, in other words, that they would be exempt from State regulation, this author proposes the following amendment of Section 18(b)(4)(B) of the Securities

112. A change to the definition of “public offering” that excludes solicitation via social networks as public offerings could exempt crowdfunded offerings.

113. Here, “advertising” and “public solicitation” would also be defined to exclude solicitations via social networks and crowdfunding websites such as Kickstarter and IndieGoGo, as well as certain web-based advertising such as ad buttons and banners.

114. Theresa A. Gabladon, *Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Businesses*, 2 J. SMALL & EMERGING BUS. L. 259, 263 (in which the author proposes a statement of trust to ensure protection of investor confidence, even when the investors were friends and family of the entrepreneur, explained as “a legally enforceable stipulation that the promoters are assuming the strictest of fiduciary duties with respect to each of the investors . . . [and which] would pertain throughout the formation, operation, and dissolution of the business”). This statement would perform the same function as the principal executive officer and principal accounting officer certifications required under Item 601(31) of Regulation S-K that must be included as exhibits to an issuer’s periodic reports filed with the Commission.

115. *Id.* at 263 (“In the context of capital-raising, the benefits of trust were recognized at the time the current registration system was adopted. Accordingly, one widely recognized purpose of the 1933 Act was the protection of investor confidence.”).

Act: “(B) Sections 4(4) and 4(6);”¹¹⁶

3. Amend Rule 502 of the Securities Act Rules

Amend Rule 502(c) to exclude certain web-based communications from the definition of “general solicitation” or “general advertising” when such communications are in connection with an offering under the Small Offering Exemption. Alternatively, provide that an issuer that meets all of the Small Offering Exemption requirements may engage in general solicitation and advertising of the small offering.

VI. CONCLUSION

The time is long past for the Commission to adopt a small offering exemption that will allow entrepreneurs to use crowdfunding to raise capital for business growth and development. Given the changes in technology, the importance of small business growth in job creation and economic expansion and the declining investment in seed-stage companies by venture capital firms, crowdfunding is a great way to test out new ideas and finance microstartups and weed out bad business ideas at an early stage before millions or tens of millions of dollars have been wasted in their investment.

116. Section 18(b)(4)(B) provides for exemptions in connection with certain exempt offerings and currently states that “[a] security is a covered security with respect to a transaction that is exempt from registration under this title pursuant to . . . (B) section 4(4). . . .” The proposed amendment would include the new Section 4(6) in this definition of covered security, effectively making a security offered and issued in connection with the Small Offering Exemption a “covered security.” 15 U.S.C. § 77r.