Resolving the Crowdfunding Conundrum: The Experience of the United States and Spain

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RESOLVING THE CROWDFUNDING CONUNDRUM: THE EXPERIENCE OF THE UNITED STATES AND SPAIN

BY: RAFAEL A. Porrata-Doria, JR.*

The phenomenon known as crowdfunding has become an attractive alternative for businesses looking for investors without having to go through more well-established routes or without necessarily having to lure and impress professional investors. However, this new form of raising capital creates a series of issues and problems unique to crowdfunding, which has led to a struggle amongst governments to effectively regulate this new entrepreneurial opportunity. The crowdfunding conundrum government regulators are facing causes them to have to reconcile two contradictory missions: facilitating the acquisition of capital by businesses and protecting investors (and the market) from fraud and manipulation. This Article analyzes this conundrum from a United States (“U.S.”) and Spanish perspective. I first describe the crowdfunding conundrum in general terms by explaining how crowdfunding (both consumer and accredited investor) works in practice and explore the major problems and issues that startup companies, investors, the market, and the state face in crowdfunding, which need to be resolved in a regulatory system. I will then describe and evaluate the current American and Spanish and proposed European regulatory solutions to the crowdfunding conundrum. I then conclude by evaluating whether and how well the United States’ and Spain’s regulations, as well as the European Union’s (“EU”) proposed regulations, have attempted to resolve the conundrum by balancing the risks and problems facing crowdfunding transactions.

I. Introduction ...................................................................................221
II. What is Crowdfunding? ................................................................226
    A. Consumer Crowdfunding ...............................................226
    B. Accredited Investor Crowdfunding ..................................228
III. The Crowdfunding Conundrum ..................................................230
    A. Consumer Crowdfunding – The Company ..............230
i. Investors ................................................................. 232
ii. Intermediaries ...................................................... 233
iii. Markets and Regulators ....................................... 235
B. Accredited Investor Crowdfunding ....................... 236
   i. Companies .......................................................... 236
IV. Crowdfunding in the U.S. Regulatory System .......... 239
   A. The U.S. Regulatory System Before the JOBS Act ...... 239
   B. The JOBS Act ....................................................... 241
      i. Accredited Investor Crowdfunding .................... 242
         ii. Consumer Crowdfunding ............................... 243
            a. Provisions relating to sellers of securities ....... 244
            b. Provisions relating to investors in securities ...... 245
            c. Provisions relating to intermediaries (Platforms) .245
   C. Regulation Crowdfunding ................................... 246
      i. Provisions relating to sellers of securities .......... 246
      ii. Provisions relating to intermediaries and transactions247
   D. The Consumer Crowdfunding Experience in the United
      States .................................................................... 251
      i. Statistics ........................................................... 251
      ii. Reactions to Regulation CF ............................... 251
      iii. The Risk of Loss and Fraud .............................. 252
         a. Investor Vetting and Education ....................... 253
         b. “The Wisdom of the Crowd” ............................. 254
         c. Due Diligence .................................................. 254
         d. Remedies for Fraud or Misrepresentation ............ 255
      iv. Burdens and Costs ............................................. 256
V. Crowdfunding in the Spanish Legal System ............ 260
   A. The Regulation of the Securities Industry in Spanish Law
      .............................................................................. 260
   B. Ley 5/2015 ............................................................ 263
      i. Provisions relating to intermediaries (Platforms) ...... 264
      ii. Provisions relating to sellers of securities .......... 266
      iii. Provisions relating to investors in securities ...... 267
   C. The Spanish Crowdfunding Experience .................. 269
VI. Enter the European Union: The Proposed EU Crowdfunding
    Regulation ............................................................... 272
    A. Provisions relating to Intermediaries (Platforms) ...... 272
    B. Provisions relating to Sellers of Securities .......... 274
    C. Provisions relating to Investors .......................... 275
VII. Conclusion ............................................................ 277
    A. Solving the Crowdfunding Conundrum? ................. 278
I. INTRODUCTION

“Crowdfunding” is generally understood to describe an increasingly widespread fundraising technique by means of which the Internet is used to raise funds for a particular goal from a large number of contributors. Operating through platforms such as Kickstarter and Indiegogo, crowdfunding has been used extensively to raise capital for ventures involving charities, movies, art projects, and new product development. Some of the more unusual crowdfunding attempts have involved funding the Russian rebels’ war against Ukraine and paying off Greece’s debt to the European Central Bank. Although some of these campaigns have successfully raised the funds they sought, many of them have failed to raise

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8. See Jo Becker & Steven Lee Myers, Russian Groups Crowdfund the War in the Ukraine, N.Y. TIMES (June 11, 2015), https://www.nytimes.com/2015/06/12/world/europe/russian-groups-crowdfund-the-war-in-ukraine.html (finding that more than a dozen groups in Russia have raised money in an online campaign to support Russian rebels in the war in Ukraine).

9. See Katie Rogers, A Crowdfunding Campaign Tries to Save Greece, N.Y. TIMES (June 30, 2015), https://www.nytimes.com/2015/07/01/world/europe/a-crowdfunding-campaign-tries-to-save-greece.html (stating that €487,000 was raised through a campaign on Indiegogo to help fund Greece’s debt of €1.5 billion to the International Monetary Fund).

10. See, e.g., Mahita Gajanan, Travel Jacket Breaks Record Raising $9 Million on Kickstarter, THE GUARDIAN (Sept. 3, 2015, 7:00 AM), http://www.theguardian.com/
any funds whatsoever.\textsuperscript{11} This type of crowdfunding, often called “reward-based crowdfunding,” appears to be subject to scant regulation.\textsuperscript{12}

Startup companies have also taken advantage of crowdfunding. Many of such companies have raised capital by selling equity or equity-like participations in the company through an Internet platform to a large number of small investors.\textsuperscript{13} This type of crowdfunding has become known as “equity crowdfunding”\textsuperscript{14} and has been used extensively. Indeed, as of April 2012, startup companies, using thirty-nine Internet platforms mostly located in Ireland, Australia, and the United Kingdom, had raised $88 billion.\textsuperscript{15} As we shall see below, crowdfunding presents a highly attractive funding alternative for startup companies for a number of reasons. First, raising capital through smaller investments, made by many non-professional investors (who are excited by the company’s sales pitch), is more attractive than seeking professional investors because the non-professional investors are unlikely to be as demanding as the professional investors. Moreover, Internet investors are also easier to find than professional investors, since they find the company, and not vice versa. Additionally, crowdfunding allows startup companies to raise capital simply and cheaply, with little or none of the costly formalities currently required.\textsuperscript{16} This last characteristic is critical, since most startup companies lack the knowledge, experience, and assets to hire experts to prepare extensive disclosure documents.\textsuperscript{17}

Crowdfunding investors prefer a system that allows them to invest small


\textsuperscript{12} See Ahlers et al., \textit{supra} note 1, at 957.

\textsuperscript{13} \textit{Id.} at 958; see CROWDFUNDER, https://www.crowdfunder.com/raise-capital (last visited May 1, 2020) (billing itself as a leader in equity crowdfunding that has raised capital for many companies from investors).


\textsuperscript{15} \textit{Id.} at 242 n.141.

\textsuperscript{16} See \textit{id.} at 220.

\textsuperscript{17} See infra p. 232.
amounts easily and with limited costs in companies whose products excite them, to communicate and exchange information with fellow investors, and to cash out their investment in an expeditious manner. At the same time, these investors have a strong desire for the investment system to be trustworthy and protect them from scams and frauds.\(^{18}\) Despite its appeal and apparent ease of use, equity crowdfunding is a risky endeavor, since approximately ninety percent of all startup businesses in the United States fail within the first year.\(^{19}\) Indeed, as we shall see below,\(^{20}\) the crowdfunding phenomenon creates a series of issues and problems that make government regulation extremely challenging.

Crowdfunding presents a difficult conundrum for markets and regulations faced with two contradictory missions: facilitating the acquisition of capital by businesses and protecting investors (and the market) from fraud and manipulation.\(^{21}\) Given the nature of crowdfunding and its actors, fulfilling both missions is very problematic. In order to facilitate the acquisition of capital by startup businesses through crowdfunding, regulators must make the process simple, quick, and affordable. This approach would involve implementing simple forms, limited disclosures, and low fees. Protecting investors and the market from fraud and manipulation, on the other hand, may be achieved by educating investors, requiring full disclosure of all material facts regarding the company and the offering,\(^{22}\) establishing time constraints on sales to give both potential investors and the market time to absorb and evaluate the disclosed information and appropriately price the offering,\(^{23}\) or limiting investments for small investors.\(^{24}\) These tasks may be delegated to the market itself\(^{25}\) or, in the case of crowdfunding, to the intermediary. Unfortunately, utilizing these investor protection mechanisms adds time, cost, and complexity to the capital acquisition process. The easier a regulator makes it for a startup company to raise capital by deregulating

\(^{18}\) See infra pp. 233–34.
\(^{20}\) See infra Part III.
\(^{21}\) See infra pp. 236–37.
\(^{22}\) See infra pp. 236–37.
\(^{23}\) See infra pp. 236–37.
\(^{24}\) See infra Part III.
\(^{25}\) See infra note 118 (discussing how the NYSE Regulations work with the Financial Industry Regulatory Authority to enforce compliance by the companies listed on the New York Stock Exchange with federal rules and exchange rules meant to protect investors).
the process, the less protection investors have against fraud and manipulation. Conversely, the more protection investors have against fraud and manipulation, the higher the cost and difficulty of raising capital. In resolving the crowdfunding conundrum, these two interests need to be balanced so that companies participate in a capital acquisition process that provides them reasonable access to capital, and investors receive an appropriate level of protection against fraud and manipulation.

A number of countries have either recently adopted or are considering adopting legislation or regulations that will permit companies to raise capital through crowdfunding. This Article will examine the attempts of two countries, the United States and Spain, to create a regulatory system that will resolve the crowdfunding conundrum.

In the United States, startup companies seeking to raise capital through crowdfunding before 2012 were unable to do so because the federal securities law prohibited the practice. In December 2012, Congress passed a statute named the “Jumpstart Our Business Startups Act” (“JOBS Act”), which completely eliminated this prohibition.

The JOBS Act permits crowdfunding transactions to be undertaken in two different ways. In Title II, the JOBS Act created an exemption to the 1933 Securities Act, which allows the sale of securities through an Internet platform to consumers, subject to a number of limitations. In order to implement this exemption, the Securities and Exchange Commission (“SEC”) issued an implementing regulation known as “Regulation Crowdfunding” (“Regulation CF”). I will refer to this process as “consumer crowdfunding.” Title III of the JOBS Act also created a different exemption that authorized the creation of Internet platforms, which were authorized to sell securities, as long as the purchasers who utilized such platforms were wealthy individuals. I will refer to this process as “accredited investor crowdfunding.”

26. See infra Part III.

27. See infra note 120.


29. See infra notes 90–103 and accompanying text.


31. Id.

Accredited investor crowdfunding has been in use in the United States since 2013, and reports indicate that 1,929 companies raised $118 billion through Internet offerings between September 2013 and September 2014 alone.\(^\text{33}\) For consumer crowdfunding, the situation has been very different. The JOBS Act’s consumer crowdfunding provisions could not become effective until the SEC issued implementing regulations, which were adopted on October 30, 2015. These regulations, known as Regulation CF were finalized on November 16, 2015 and became effective on May 16, 2016.\(^\text{34}\) Accordingly, consumer crowdfunding is a very recent phenomenon in the United States.

Spain’s legal system, which is based on the civil law tradition, did not permit crowdfunding until 2015.\(^\text{35}\) At that time, Spain enacted a statute known as the “Ley de Fomento de la Financiación Empresarial,”\(^\text{36}\) whose Title V authorizes and regulates the sale of securities through crowdfunding transactions.\(^\text{37}\) Although the Spanish crowdfunding statute resembles its U.S. counterpart, a number of its provisions present different solutions to some of the regulatory problems presented by crowdfunding.\(^\text{38}\) The EU has also recently circulated a draft regulation that seeks to resolve the crowdfunding conundrum by proposing to establish a European crowdfunding regime, which would supplement national crowdfunding regulatory systems and introduce innovative regulatory ideas.\(^\text{39}\)

In Parts II and III of this Article, I will describe the crowdfunding conundrum in general terms by explaining how crowdfunding (both consumer and accredited investor) works in practice and explore the major problems and issues that startup companies, investors, the market, and the state face in crowdfunding, which need to be resolved in a regulatory system. I will then describe and evaluate the current American, Spanish, and proposed European regulatory solutions to the crowdfunding conundrum in Parts IV, V, and VI. Finally, in Part VII, I will draw from this experience...
and offer general conclusions and recommendations.

II. WHAT IS CROWDFUNDING?

Crowdfunding is an “increasingly widespread form of fundraising” where a large number of individuals pool their money (usually through an Internet platform) to support a specific goal.40 It has been used extensively for non-profit fundraising, often with the offer of a non-monetary reward in exchange for a contribution.41 As noted before, crowdfunding has been used extensively to raise capital for ventures involving charities,42 movies,43 art projects,44 and new product development.45

A. Consumer Crowdfunding

Crowdfunding has also become attractive to startup companies as a way to raise general equity capital, as opposed to funding a particular project or product.46 This use of crowdfunding, known as equity crowdfunding, involves an entrepreneur or startup company selling debt, equity, or equity-like participations to a large number of small investors through an open call for funding on an Internet platform.47

As of April 2012, thirty-nine Internet platforms in the United States, United Kingdom, France, Australia, Spain, Belgium, and Ireland had raised eighty-eight million dollars in equity financing.48 Most of this activity took place in Internet sites located in Ireland, Australia, and the United Kingdom.49 In the United States, “consumer crowdfunding” was not available until 2016 because the SEC had not yet promulgated the implementing regulations, which were not approved until November 16, 2015.50

40. Ahlers et al., supra note 1, at 955.
41. See Hurt, supra note 14, at 233 (describing five general categories of crowdfunding that do not invite legal challenges).
42. See Druzin, supra note 4 (detailing crowdfunding efforts for veterans’ charities).
43. See McNary, supra note 5.
44. See ARTHEN, supra note 6 (discussing crowdfunding efforts for art projects).
45. See Pfeiffer, supra note 7.
46. See Howard Marks, What is Equity Crowdfunding?, FORBES (Dec. 19, 2018, 8:00 AM), https://www.forbes.com/sites/howardmarks/2018/12/19/what-is-equity-crowdfunding/#2c75f8163b5d.
47. See Hurt, supra note 14, at 238–39.
48. Id. at 242 n.141.
49. Id.
The Australian Small-Scale Offering Board ("ASSOB") Internet platform provides one example of how consumer crowdfunding works. First, potential investors register with the website, provide certain personal information, and confirm that they are aware of the risks associated with investing in startups.\(^51\) Once registered, the potential investor can look at the platform that provides general information about each investment.\(^52\) Once a registered investor clicks on an individual investment, she can download specific information about the company, located in an offering document, which usually includes investment highlights, business model, market analysis, details and purpose of the project, ownership structure, minimum investment sought, and company management structure.\(^53\) To invest, the investor makes a ten percent deposit, which is retained by the platform.\(^54\) The remaining ninety percent is owed when the minimum number of shares noted in the call is sold.\(^55\) If the minimum number of shares is not sold within the time frame specified in the offer, then the deposit is refunded.\(^56\)

One of the largest consumer crowdfunding sites in the United States, Wefunder,\(^57\) has a very simple investment process. A potential investor seeking to invest no more than $2,000 opens an account online by submitting her name and address and acknowledging that she understands the nature of crowdfunding investments,\(^58\) especially their risk and lack of liquidity.\(^59\) Once she has opened an account, she may browse the website for investment offerings and click to invest.\(^60\)

A typical entry for a crowdfunding offer has a snapshot of the business, a description of its product or products under development, a description of its

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51. Creating Account, ENABLEFUNDING, https://www.enablefunding.com/ (follow "Sign up" hyperlink; then follow “Register as an accredited investor” hyperlink) (last visited May 1, 2020).
52. FAQs, ENABLEFUNDING, https://www.enablefunding.com/faqs/ (follow “I would like to understand more about investing into unlisted potentially high-growth opportunities. Are there seminars or presentations I can attend” hyperlink) (last visited May 1, 2020).
53. Invest, ENABLEFUNDING, https://www.enablefunding.com (follow “Invest” hyperlink to browse the different companies looking to raise funding).
54. Ahlers et al., supra note 1, at 964.
55. Id. at 964–65.
56. Id. at 965.
57. See WEFUNDER, https://wefunder.com/ (last visited May 1, 2020) (stating there has been over $132.5 million raised by 560,469 investors).
59. Id.
60. See id. (discussing the investment process).
management team and principal investors, a description of the principal risks associated with the investment, and a link to Form C that the company filed with the SEC.61

B. Accredited Investor Crowdfunding

A second crowdfunding alternative, used in the United States since 2012, when the JOBS Act specifically permitted the practice, is what is often referred to as “accredited investor crowdfunding.”62

Accredited investor crowdfunding has been described as a cyber-version of the traditional “angel investor” network, where a small group of investors, in addition to providing money, provide expertise, experience, advice contracts, handholding, and empathy, often through repeated contact with the startup.63 Within traditional “angel networks,” there is usually an individual or a small group that provides most of this assistance.64 The rest of the group usually relies on the judgment and research of the lead investor, and its participation in the venture is essentially limited to furnishing capital.65

Only “accredited investors” may participate in this type of crowdfunding investment.66 As used in the United States, the term “accredited investor” is defined as including individual investors with a minimum net worth of one million dollars (excluding her primary residence) or an investor with annual income of over $200,000 a year (or $300,000 a year if married), as well as certain institutions with assets in excess of ten million dollars.67

Approximately 1,929 companies reported using accredited investor crowdfunding between September of 2013 and September of 2014.68 These offerings, made through platforms like AngelList and FundersClub, raised approximately $118 billion during that time.69

63. See Ibrahim, Equity Crowdfunding, supra note 1, at 575, 582–83.
64. See Darian M. Ibrahim, The (Not So) Puzzling Behavior of Angel Investors, 61 VAND. L. REV. 1405, 1418 (2008) (stating that angel investors provide 80 percent of early-stage funding).
65. See id. at 1424 n.89.
66. See Ibrahim, Equity Crowdfunding, supra note 1, at 585 (stating AngelList “only allows accredited investors who can help a startup in tangible ways”).
68. Hobey, supra note 33.
69. Id.
How does accredited investor crowdfunding work? This process can be illustrated by examining two of the more well-known accredited investor crowdfunding platforms, FundersClub and AngelList. For both of these platforms, the SEC has concluded that, given their organization and operations, they were not operating as broker-dealers and were, therefore, not required to register as such under the securities laws. This finding relieves accredited investor crowdfunding sites from the extensive cost and regulatory burden that broker-dealers are subject to, giving them a substantial competitive advantage.

Only accredited investors may invest through AngelList and FundersClub. These investors must first register with the website. Both platforms will take affirmative steps before completing the registration of a potential investor to confirm her accredited investor status. On both platforms, the investor will invest through vehicles that will hold all of the ownership and control rights in the investment completed through the website.

Both FundersClub and AngelList have major differences in process and structure. FundersClub has an investment committee that performs a due diligence on potential investments. AngelList uses a more automated process with a focus on transparency and accessibility.

73. Ibrahim, Equity Crowdfunding, supra note 1, at 603.
75. See AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013) (showing how in a similar manner, the FundersClub website asks if you meet one or more of the requirements of an accredited investor); see also FAQ, FUNDERSCLUB, https://support.fundersclub.com/hc/en-us/articles/204968777-How-do-I-start-investing-with-FundersClub- (last visited May 1, 2020) (informing potential investors that if they do not meet the requirements of accredited investor status, then they will not be able to invest in fundraising campaigns listed on FundersClub); FundersClub, Inc. and FundersClub Management LLC, SEC No-Action Letter, 2013 WL 1229456 (Mar. 26, 2013); 15 U.S.C. 77d-1(a)(4) (2018) (requiring that intermediaries take steps to positively affirm that each investor understands the various risks involved in such an investment).
76. Compare FundersClub, Inc. and FundersClub Mgmt. LLC, SEC No-Action Letter, 2013 WL 1229456 (Mar. 26, 2013) (explaining that members may submit a non-binding interest inquiry on the website that allows members to withdraw until the fund closes), with AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter, 2013
This investment committee also provides “angel services” to the companies whose offerings it lists. AngelList, on the other hand, uses a “lead angel” who performs the due diligence examination, vets investors, and advises the company. Angel List refers to this type of transaction as an “angel-advised” transaction. AngelList investors can also invest in an “angel-followed” transaction. In this transaction, the lead angel does not take an active role with respect to advising the company and may not be aware that he or she is being followed. In short, an investor can invest in a transaction in which another individual (such as Marissa Mayer, CEO of YAHOO) is investing merely because that investor thinks that this particular individual is a knowledgeable investor.

III. THE CROWDFUNDING CONUNDRUM

Crowdfunding presents a series of issues and problems that affect startup companies seeking financing, as well as potential investors and the state, acting as regulator of the investment markets. In this section, I will consider these issues and problems for consumer crowdfunding transactions and for accredited investor crowdfunding transactions in that order.

A. Consumer Crowdfunding – The Company

Startup companies face a number of problems and issues in raising capital. First, the principals of startup companies usually do not have sufficient

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79. See id. (noting that a lead angel is an accredited investor).
80. Help: Syndicates, ANGEL INVESTORS, https://angel.co/help/syndicates/angellist-advisors (last updated Dec. 22, 2018) (mentioning that mentoring might be a better fit for a startup company because they can conceivably get the “right angel” with the “right” set of experience, skills, and contacts to advise them; however, this lead angel might not have as much experience as an investment committee that has vetted many different proposed transactions).
81. AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter, 2013 WL 1279194 (Mar. 28, 2013) (explaining that the lead angel investor does not need to advise the Investment Vehicle or Portfolio Company).
experience raising money, and they and the company have little or no access to bank credit. 84 When these companies start seeking funding, they are relatively small in size and do not necessarily want to raise large amounts of money. Some of the traditional methods of raising capital, such as bank loans or public offerings, are not available in this early stage. 85 Even if they were, these methods would generally be cost-prohibitive for a startup. 86 Moreover, startup companies are unlikely to have most of the financial and operational documentation required by professional investors or underwriters, such as audited financial statements. 87

Since the majority of startup firms fail in the short term, 88 professional investors, such as venture capitalists, are unlikely to be interested in a small company unless the investment really looks like a “sure thing.” Even if the professional investors would choose to invest in a startup, they are likely to underprice the company’s stock in order to account for the risk associated with the investment. This underpricing would be unattractive to the company, since it would provide fewer funds than the company is seeking.

Since startup companies are unlikely to attract the interest of professional investors, they are also unlikely to be able to raise the amount of capital they need through financing techniques that do not involve a public offering, such as a private placement. 89 Crowdfunding therefore presents a highly attractive funding alternative for startup companies for a number of reasons. First, raising capital through smaller investments made by many non-professional investors (who are excited by their company’s sales pitch) is more attractive than seeking professional investors because these non-professional investors are unlikely to be as demanding. 90 Moreover, Internet investors are also easier to find than professional investors since they find the company, and

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86. See Hurt, supra note 14, at 224–25.


88. MARMER ET AL., supra note 19.


90. See Hurt, supra note 14, at 224–25 (“[C]rowdfunding could be an alternative to angel investing and venture capital investing that can cost founders managerial control.”).
not vice versa. Additionally, crowdfunding allows startup companies to raise capital simply and cheaply, with little or none of the costly formalities currently required. This last characteristic is critical, since most startup companies lack the knowledge, experience, and assets to hire experts to prepare extensive documentation.

i. Investors

Potential investors who have little or no experience in the markets are in a very different position from the companies that seek their funding and face a number of distinctive problems and risks. First, these investors are generally not financially sophisticated and do not have the expertise to evaluate an investment of their own. Moreover, they also face information asymmetry: inexperienced investors lack the resources and information tools that professional investors utilize to evaluate investments. For inexperienced investors, the cost and difficulty of acquiring this information may be very high; even if they could acquire the information necessary, they may not have the knowledge and experience to adequately evaluate the potential investments. Because of this information, knowledge, and experience asymmetry, retail investors are at a disadvantage and cannot expect to have the same opportunities and returns as more sophisticated and resourceful investors. When investing through Internet platforms, investors are therefore highly susceptible to fraud.

Investors interested in consumer crowdfunding offerings are not likely to be high-net-worth individuals, and, therefore, they generally cannot afford to invest a substantial amount of money. Any loss on these investments will disproportionately affect these investors more than others since their loss will be a larger part of their assets, and the loss is a real possibility for these investors because investments in startups are very risky. Crowdfunding

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91. The Benefits of Crowdfunding, supra note 85.
92. Cable, supra note 87, at 2297–98.
93. See id. at 2279–80.
94. Ahlers et al., supra note 1, at 957, 968.
95. Tom C.W. Lin, Reasonable Investor(s), 95 B.U.L. REV. 461, 484–86 (2015) (recommending that retail investors should not try to invest in individual securities but instead should invest passively over the long term using low-cost index funds and mutual funds that track the market widely because retail investors both have knowledge and experience limitations).
97. See Hurt, supra note 14, at 251–52.
investors also lack a convenient exit channel for their investment because they are more likely to need their money in the short term. The lack of liquidity for most startup investments makes the question of how an investor gets her money back if she wants to leave a very difficult one to answer.

On the other hand, crowdfunding enthusiasts point out that being part of the investment crowd has at least two advantages. First, being part of a large number of investors makes the analysis of information easier (the “wisdom of the crowd”) and resolves some of the information asymmetry issues. Second, the crowd could be very effective in identifying and stopping fraud since a large number of individuals with diverse skills and backgrounds are all looking at the same data and communicating with each other. A downside of the wisdom of the crowd, however, is the so-called “herd effect,” where all members of the crowd only hear and internalize one point of view, ignoring conflicting opinions.

It appears that crowdfunding investors would prefer a system that would allow them to invest small amounts easily and with limited costs, to communicate and exchange information with fellow investors, and to liquidate their investment in an expeditious manner. On the other hand, it seems that these investors have a strong desire for the investment system to be trustworthy and protect them from scams and fraud. This protection would require a substantial (and costly) effort to vet these investments.

**ii. Intermediaries**

Potential intermediaries, the websites that set up and manage the Internet platforms for equity crowdfunding transactions, also face several problems, the most critical one being profitability. How will the platform generate revenue, and will this revenue be sufficient to cover all costs and generate a

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98. Ahlers et al., supra note 1, at 971.
99. Id. at 963–64.
100. See Hurt, supra note 14, at 252 n. 207.
102. The Herd Effect in Financial Markets, QUANTDARE (Feb. 11, 2017), https://quandt.dare.com/the-herd-effect-in-financial-markets/ (explaining that although investors are aware of the actions of their predecessors, each investor ultimately makes their own decisions and can sometimes ignore signals from their predecessors).
103. E.g., Hurt, supra note 14, at 241 (explaining that these institutions tried to avoid regulation by registering with the SEC).
104. Id. at 237.
profit? Possible sources of revenue include listing fees for sellers, subscription fees, commissions, and equity stakes in firms whose securities are listed. However, given the typical small size of crowdfunding offerings and transactions, these fees and commissions are likely to be small. Therefore, increasing the volume of listings and transactions and keeping all costs (including regulatory costs) down is essential. Intermediaries are unlikely to tolerate high levels of regulation, since high levels of regulation will increase compliance costs.

Given the inexperience and information asymmetry of both sellers and buyers in a crowdfunding market along with the high rate of failure of startup companies, it is more than likely that many crowdfunded investments will be unsuccessful. In fact, some critics claim that crowdfunding could help bad businesses get off the ground before they inevitably fail. There is also a real risk of fraud in a market full of unsophisticated investors. This situation presents potential liability to an intermediary, which could find itself the target of litigation by an unhappy investor, who may think that the listing of a company’s offerings in the platform represents some guarantee of solvency or stability.

Careful vetting of all potential listings by the intermediary may minimize this risk, so that only the “least risky” and “safest” offerings are listed on the site. This vetting process is costly and may result in the listing of fewer investments, reducing the profitability of the platform. Another possible risk-reduction technique would include careful vetting of all potential investors using the platform by its intermediary, to ensure that the investors

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105. See generally 17 C.F.R. § 227.503(a) (2015) (detailing disqualifying provisions); id. § 227.100(b)(1) (describing the applicability of the crowdfunding exception); id. § 227.300(b) (providing requirements for intermediaries).
106. Heminway & Hoffman, supra note 84, at 930 (stating that regulatory schemes may have too remote of benefits for crowdfunding investments because of the small number of units and the small aggregate dollar value).
107. See id. at 930.
109. Cortese, supra note 108 (stating that both startups and crowdfunding present high risks of fraud and failure).
110. Eaglesham, supra note 96 (reporting a study from the National Association of Securities Administration, which found that 9,000 website names containing the word “crowdfunding”, and of the 2,000 that were reviewed, 200 merited further investigation to determine if they were fraudulent).
understand the general risks of investing in the stock market and the particular risks of investing in startup companies. Investor vetting is also likely to be costly, and online investor vetting may be ineffective in reducing the risk of disappointed investor litigation.

A potential crowdfunding intermediary will therefore be entering a business with potentially high costs, low profit margins, and a high risk of potential liability. This business model is not a very attractive one. However, investment banking firms may be natural candidates for crowdfunding intermediaries. Since they are experienced in the securities business and have an established online, sales, regulatory, and compliance infrastructure, they will have much lower setup and operation costs. Crowdfunding would open up a previously unserved additional market niche, which may, in the long term, expand a firm’s business into other areas. It may also, however, increase a firm’s exposure to liability, given the riskiness of crowdfunding investments.

iii. Markets and Regulators

Markets and their regulators, on the other hand, face a tough situation. They are faced with two contradictory missions: facilitating the acquisition of capital by businesses and protecting investors (and the market) from fraud and manipulation. Given the nature of the crowdfunding process and its actors, fulfilling both missions is very difficult. In order to facilitate the acquisition of capital by startup businesses through crowdfunding, regulators must make the process simple, quick, and low cost. This approach would involve implementing simple forms, limited disclosures, and low fees. Protecting investors and the market from fraud and manipulation, on the other hand, may be achieved by educating investors, requiring full disclosure of all material facts regarding the company and the offering, and establishing time constraints on sales to allow both potential investors and the market time to absorb and evaluate the disclosed information and appropriately price the offering, or limiting investments for small

112. See id. at 245–46.
113. See id. at 222.
115. Securities Act of 1933 § 5.
116. See id. (requiring the issuer make the following information available to the potential investor within twenty-one days of the sale: administrative, financial condition and offerings, use of the proceeds, target amounts, the price of public securities, and ownership).
investors. These tasks may be delegated to the market itself or, in the case of crowdfunding, to the intermediary. Unfortunately, utilizing these investor protection mechanisms adds time, cost, and complexity to the capital acquisition process. The easier a regulator makes it for a startup company to raise capital by deregulating the process, the less protection investors have against fraud and manipulation. Conversely, the more protection investors have against fraud and manipulation, the higher the cost and difficulty of raising capital. These two interests need to be balanced, so that companies can partake in a capital acquisition process that provides them reasonable access to capital, and investors have an appropriate level of protection against fraud and manipulation. Unfortunately, the devil is in the details.

B. Accredited Investor Crowdfunding

Investing in startup companies that seek capital from accredited investors through crowdfunding is also a risky endeavor. These companies face a number of issues that are different from those companies seeking capital through consumer crowdfunding.

i. Companies

As noted above, a company seeking capital through accredited investor crowdfunding would list its securities on an Internet platform set up for that purpose. Under the U.S. securities laws, it is the company’s responsibility

118. See NYSE Regulation, N.Y. STOCK EXCHANGE, https://www.nyse.com/regulation (last visited May 1, 2020) (explaining that certain federal securities rules are enforced by the financial industry itself, in addition to compliance with the rules of any exchange that a company is listed on; NYSE Regulation, for example, works with the Financial Industry Regulatory Authority to enforce compliance by the companies listed on the New York Stock Exchange with federal rules and exchange rules meant to protect investors).
119. See Heminway & Hoffman, supra note 84, at 911 (discussing the costliness and timeliness of registration).
120. See id. at 936–37 (highlighting the potential for fraud in unregulated markets, even though it would be easier to raise capital with fewer regulatory barriers).
121. See Ibrahim, Equity Crowdfunding, supra note 1, at 573–74 (explaining that the risks of accredited investor crowdfunding generally involve lack of capital, extreme levels of uncertainty because of the nature of the startup itself and information asymmetry, lack of experience, and large agency costs).
122. See supra notes 74–76 (describing online platforms for accredited investor crowdfunding).
to verify an investor’s accredited status.\textsuperscript{123} In crowdfunding transactions, the company has to rely on the work done by the platform to verify that all investors are accredited investors.\textsuperscript{124} This means that the company must take “reasonable steps” to ensure that the platform is appropriately determining that its investors are accredited.\textsuperscript{125}

A company seeking to raise capital through accredited investor crowdfunding in the United States must also determine whether or not the platform through which it lists its securities for sale is required to register as a broker-dealer under the securities laws.\textsuperscript{126} A company that sells securities through an unregistered broker-dealer, whether through the Internet or not, gives its buyers the right to buy back their shares at the price for which they were sold.\textsuperscript{127} This outcome may be a source of economic disaster for the company.\textsuperscript{128}

On the other hand, accredited investor crowdfunding is an attractive option for a startup company. As discussed above, the company does not have to incur the costs, in regards to both time and money, of disclosing information to individual investors, issuing stock to them, and managing the relationship.\textsuperscript{129} Instead, they deal with either an investment committee or a sophisticated and experienced investor whose hand they do not have to hold and who will provide valuable mentoring and networking.\textsuperscript{130} Moreover, since the individuals who invest in accredited investor crowdfunding tend to be wealthy and/or sophisticated, the likelihood of litigation from an unhappy investor who may not have understood the nature of the risks which he was undertaking might be less than in consumer crowdfunding.

Accredited investors who participate in crowdfunding are also investing in highly risky ventures that are highly illiquid and long-term investments.\textsuperscript{131}

\begin{thebibliography}{99}
\bibitem{124} See Young, \textit{supra} note 123, at 588.
\bibitem{125} See id.
\bibitem{126} See id. at 592.
\bibitem{127} See id. at 591–92.
\bibitem{128} See id. at 601–05 (detailing the Neogenix Oncology, Inc. case in which a startup’s issuance of common stock through unregistered dealers, and the threat of rescission by its investors, resulted in enough risk to prevent the startup from raising sufficient capital and forced it into bankruptcy).
\bibitem{129} See Ibrahim, \textit{Equity Crowdfunding, supra} note 1, at 585–86.
\bibitem{130} \textit{Id.} at 583; see \textit{supra} Part III.A (discussing the factors making crowdfunding — though not necessarily accredited investor crowdfunding — attractive to startups).
\end{thebibliography}
Indeed, the investor receives a return at some point (usually determined by someone else) and, if she is lucky, will obtain a profit. She generally does not have the ability to dispose of her individual interest and has little or no say on the timing of this disposal. Moreover, information asymmetry is also a problem for the investor regarding the nature of the investment. These are opaque investments held by an intermediary that does not provide the kind of information or analysis typically available for other types of investments. A more serious issue, as many commentators in the United States have noted, is the fact that even accredited investors are often unable to understand the risks involved in investing in a startup.

In U.S. securities law, the accredited investor concept is based on the assumption that, because certain investors are “sophisticated” (a term that lacks a clear definition), they are thus able to understand the nature of the risk. Therefore, since they are wealthy, and able to assume the risk of failure, they do not need the protection of securities law. This concept has evolved from one where the investor needed to be both wealthy and sophisticated to one where the investor has to be wealthy alone.

Currently, an accredited investor is an individual with a net worth of over

132. See id. at 3410, 3428 (discussing the lack of investors’ right to sell and the risk of potentially losing everything).

133. See id. at 3408 (accentuating concerns about information asymmetries arising in these markets because “buyers and sellers may have vastly different levels of information”).

134. See id. at 3405, 3428.

135. See id. at 3422–23 (pointing out that wealthy does not necessarily equate with sophisticated).


137. See id. at 125; see also Robert B. Thompson & Donald C. Langevoort, Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising, 98 CORNELL L. REV. 1573, 1583 (2013).


139. See 17 C.F.R. § 230.501(a) (2013). One commentator has noted that several flaws exist with a wealth-based test for financial sophistication. Net wealth itself may not be an accurate indication of the investor’s sophistication or ability to bear the risk. Wealth alone is not a guarantee that an investor will be able to avoid opportunistic brokers or fraudulent schemes. Furthermore, the current accredited investor definition is both over- and under-inclusive in scope. Otherwise financially knowledgeable investors are deemed unaccredited because they do not meet the minimum wealth requirements, and, conversely, financial novices may be deemed accredited merely by the possession of wealth. See Wallis K. Finger, Unsophisticated Wealth: Reconsidering the SEC’s “Accredited Investor” Definition Under the 1933 Act, 86 WASH. U.L. REV. 733, 748 (2009).
$1,000,000 or who has over $200,000 in yearly income,\textsuperscript{140} and the amounts have not been adjusted for inflation. So, upper middle-class investors, including senior citizens with large pension funds, may meet the asset or income requirement of the rule and be able to be classified as “wealthy” and thus accredited investors.\textsuperscript{141} Unfortunately, wealth alone does not necessarily indicate that an investor has the ability to appreciate the nature of the risk.\textsuperscript{142} Moreover, given the complicated nature (or opacity) of some investments,\textsuperscript{143} anecdotal evidence suggests that the ability of most “accredited investors” to be able to fend for themselves is a fiction.\textsuperscript{144}

This distinction is especially critical since, as a condition of being exempted from registration as a broker-dealer, accredited investor crowdfunding platforms are not allowed to give any investment advice to their investors.\textsuperscript{145} Moreover, the wider the solicitation and the larger the number of passive investors, the greater the possibility of active-investor opportunism or fraud at the expense of passive investors.\textsuperscript{146}

## IV. CROWDFUNDING IN THE U.S. REGULATORY SYSTEM

### A. The U.S. Regulatory System Before the JOBS Act

Under federal securities law, the general rule is that any sale or offer of a

\textsuperscript{140} 17 C.F.R. § 230.501(a)(5)–(6).

\textsuperscript{141} Thompson & Langevoort, supra note 137, at 1611–12, 1618 (discussing the SEC’s “wealth alone” requirement — which was promulgated on the assumption that wealthier investors are more familiar with financial risks — and explaining how seniors with retirement savings meeting the regulatory thresholds are particularly vulnerable).

\textsuperscript{142} See id. at 1161.

\textsuperscript{143} See The Con of the Century, THE ECONOMIST (Dec. 18, 2008), http://www.economist.com/node/12818310 (discussing the Madoff scandal in which many extremely wealthy investors — indeed, even some banks, such as Santander and HSBC — invested without much complaint in what turned out to be an enormous Ponzi scheme); see also Kurt Eichenwald, Scandal’s Cost to Prudential Tops $1.4 Billion, N.Y. TIMES (Apr. 22, 1995), https://www.nytimes.com/1995/04/22/business/scandal-s-cost-for-prudential-tops-1.4-billion.html (discussing the Prudential-Bache Securities scandal in which limited partnerships were fraudulently sold to hundreds of thousands of people).

\textsuperscript{144} See Thompson & Langevoort, supra note 137, at 1617.


\textsuperscript{146} See Thompson & Langevoort, supra note 137, at 1617 (“[A]s distributors of securities move from bargaining with a small group of buyers to mass marketing directed at a large, dispersed group of well-off retail investors, the likelihood of successful opportunism grows . . . the presence of a critical mass of sophisticated buyers will reduce the likelihood of opportunism even if we assume some unsophisticated buyers.”).
security (a very broadly defined term)\textsuperscript{147} in interstate commerce may not be made unless the issuer registers these securities with the SEC by filing a registration statement.\textsuperscript{148} The registration statement requires disclosure of a substantial amount of information about the company and the offering in a highly stylized form, including audited financial statements.\textsuperscript{149}

The purpose of this requirement is multifaceted: to allow the investor to make an informed decision on an investment by giving her all material information about the company; to allow the market to make an accurate pricing decision based on the disclosed material information; and to prevent fraud.\textsuperscript{150} At the same time, issuers are trying to raise capital as cheaply, quickly, and simply as possible.

For most startup companies, registration is not feasible for a number of reasons. First, the stock distribution method in the United States generally requires the services of one or more investment banks as underwriters in initial offerings of registered securities.\textsuperscript{151} Since underwriters take a substantial financial risk in these transactions, they tend to be quite selective in choosing companies, and they exclude most applicants.\textsuperscript{152} Second, the process is extremely expensive and includes numerous fees and commissions, so it is not the most cost-effective approach for raising small amounts of money.\textsuperscript{153}

There are a number of exemptions to the registration requirements that can be used to sell securities without the filing of a registration statement.\textsuperscript{154} These exemptions tend to be considerably more cost-effective and require less formalities.\textsuperscript{155} However, these exemptions are generally not feasible for startups that are not financed by professional investors.\textsuperscript{156} Some exemptions are still costly and complicated and therefore not feasible for a startup to use.\textsuperscript{157} Most exemptions are also limited to a small number of sophisticated

\textsuperscript{148} See Securities Act of 1933 § 5(a)(1).
\textsuperscript{150} H.R. REP. NO. 73-85, at 4–5 (1933).
\textsuperscript{151} See Hurt, supra note 14, at 225.
\textsuperscript{152} See id. at 225–27.
\textsuperscript{155} See Bradford, supra note 153, at 48.
\textsuperscript{156} See id.
\textsuperscript{157} See 17 C.F.R. § 230.251–63.
investors.\footnote{158}{See 17 C.F.R. § 230.506.} Other exemptions limit the number of investors or forbid general solicitation or advertisement, which would preclude the sale to a large number of investors or the use of an Internet platform.\footnote{159}{See id.} Intermediaries involved in the sale of securities are generally required under federal securities laws to register as an investment advisor or investment company,\footnote{160}{See 15 U.S.C. § 77d-1(a)(1)(2019); see also Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80) (2019).} which would make them subject to a substantial regulatory framework and would bring additional costs and potential liability.\footnote{161}{See id. § 227.300, 227.400 (2018).} The anti-fraud provisions of the securities laws also create a substantial amount of risk, both to the intermediaries and the sellers. Some of this potential liability becomes criminal in certain situations.\footnote{162}{See, e.g., Securities Exchange Act of 1934 § 20(b), 15 U.S.C. § 78t(b) (2018); Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff(a) (2018); Securities Act of 1933 § 24, 15 U.S.C. § 77x (2018).}

### B. The JOBS Act

The JOBS Act was passed by Congress in late 2012.\footnote{163}{See Jumpstart Our Business Startups (JOBS) Act, H.R. 3606, 112th Cong. (2012).} It created two different types of crowdfunding: one (“Section 506C crowdfunding”) would apply only to wealthy individuals who qualify as accredited investors (referred to in this Article as “accredited investor crowdfunding”),\footnote{164}{Id. §§ 302(a)(6)-(b)(5).} and one that can be used for crowdfunding from individuals who have a lower annual income or net worth (referred to in this Article as “consumer crowdfunding”).\footnote{165}{Id. § 602.} The SEC, in accordance with a mandate set forth in the statute,\footnote{166}{See Crowdfunding, Jumpstart Our Business Startups Act Release Nos. 33-9974 and 34-76324 (Oct. 30, 2015).} has issued regulations to implement its consumer crowdfunding provisions.\footnote{167}{Compare Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313–15 (2012) (codifying accredited investor rules), with Jumpstart Our Business (JOBS) Startups Act, Pub. L. No. 112-106, §§ 302(a)(6)–(b)(5), 126 Stat. 306, 315–18 (2012) (codifying exceptions to those rules).}

One question that arises is why the JOBS Act creates two different crowdfunding systems instead of one.\footnote{168}{Id. § 201.} I believe that the statute tried to
solve the crowdfunding conundrum in two different ways because it
responds to two different sets of problems. In the case of accredited investor
crowdfunding, there was already a system in place that allowed individuals,
perceived to be sophisticated investors, the ability to invest in startups
through the private placement mechanism. The problem was that they were
not allowed to do so through the Internet. The Act therefore created a
technical fix to allow private placement investments to be offered to
accredited investors through the Internet.169 With consumer crowdfunding,
Congress understood that there was no mechanism in place allowing non-
sophisticated investors to invest in startups through the Internet.170 In order
to do so, a new market and its underlying infrastructure needed to be created.

In the section below, I examine the statutory and regulatory framework
that has enabled the creation of accredited investor and consumer
crowdfunding.

i. Accredited Investor Crowdfunding

Title II of the JOBS Act permits the use of general solicitation (including
the use of the Internet) to raise capital through private placements, as long as
the investments are offered to accredited investors.172 In addition to
permitting the use of general solicitation in private placements, Title II of the
JOBS Act provides relief from the requirement that an online platform
register as a broker-dealer under the securities laws.173 This exemption
applies to private placements made under Regulation D of the 1933
Securities Act if:

(a) that person maintains a platform or mechanism that permits the offer,
sale, purchase or negotiation of or with respect to securities, or permits
general solicitations, general advertisements or similar or related activities
by issuers of such securities, whether online, in person or through any
other means; (b) that person, or any person associated with that person,
co-invests in such securities, or (c) that person or any person associated

169. See Crowdfunding, Jumpstart Our Business Startups Act, Release Nos. 33-9974
and 34-76324 7 (Oct. 30, 2015) (eliminating rules for the sale of securities that would
have required the seller to register as a broker).
170. See id. at 7–8 (explaining the background of the new rules).
171. Id.
§ 230.501(a) (2019) (stating accredited investors are individual investors with a
minimum net worth of one million dollars excluding primary residence, or an investor
with annual income of over $200,000 ($300,000 joint income for married couples) as
well as certain institutions with assets in excess of five million dollars).
173. Id. § 201(b)(1).
with that person provides ancillary services in connection with those securities.\textsuperscript{174}

The exemption only applies if:

(a) such person and each person associated with it does not receive compensation in connection with the purchase or sale; (b) that person does not possess customer funds or securities in connection with the purchase or sale of such a security; and (c) the person is not statutorily disqualified under Section 3(a)(39) of [the Act].\textsuperscript{175}

As noted above, companies seeking capital through accredited investor crowdfunding face two regulatory risks, which require that they ascertain that investors participating in the offering qualify as accredited investors and that the platform through which they are seeking to list their securities for sale is not required to register as a broker-dealer under the securities laws.\textsuperscript{176}

Moreover, a serious issue arises regarding investors in accredited investor crowdfunding transactions. These are risky investments that are also highly illiquid, complex, and opaque. Given the complexity of these investments and the large number of individuals who qualify as accredited investors under current law, investors may not, by their wealth alone, have the ability to appreciate the nature of the risk they are undertaking or determine whether a potential investment is unsuitable for them.\textsuperscript{177} I, therefore, believe that the definition of “accredited investor” in Rule 501 of the Act\textsuperscript{178} should be amended to provide that, in order to be considered an accredited investor, a person should, either by herself or through the help of an advisor, have sufficient knowledge and experience to understand the nature of the potential investments that she is considering.

\textit{ii. Consumer Crowdfunding}

Title III of the JOBS Act creates a new exemption from the registration requirements in the 1933 Act (Section 4(6)) for transactions by an issuer that meet a number of criteria.\textsuperscript{179}


\textsuperscript{175} Id. §§ (c)(2)(A)–(C).

\textsuperscript{176} See, e.g., Crowdfunding, Jumpstart Our Business Startups Act, Release Nos. 33-9974 and 34-76324 7 (Oct. 30, 2015) (eliminating rules for the sale of securities that would have required the seller to register as a broker and discussing the regulatory requirements of accredited investor crowdfunding).

\textsuperscript{177} See supra notes 139–146 (discussing the risks associated with the definition of accredited investor).

\textsuperscript{178} 17 CFR § 230.501(a) (2019).

a. Provisions relating to sellers of securities

Sellers of securities (“issuers”) who seek to utilize this exemption may not currently crowdfund more than one million dollars in securities sold in a twelve-month period.\(^{180}\) They must also file certain categories of financial and business information with the SEC and provide it to investors and brokers, or the funding platform. Financial information required to be disclosed includes: for solicitations of $100,000 or less, the last two tax returns and financial statements certified by the chief executive officer; for offerings of $100,000 to $500,000, financial statements reviewed by an independent certified public accountant; and for offerings over $500,000, audited financial statements.\(^{181}\) Additional information that must be disclosed includes the stated purpose and intended use of the proceeds, the target offering amount, the price of the security and the method for determining the price, and the description of the ownership and capital structure of the issuer.\(^{182}\) Issuers may not advertise the terms of the offering in any way, except through notices directing investors to an offering platform or broker.\(^{183}\)

Issuers engaging in crowdfunded offerings are also required to file operational reports and financial statements as the SEC determines by regulation, at least annually.\(^{184}\) The issuers may be subject to administrative, civil, or criminal liability for any fraud, material misstatements, or omissions in any disclosed information.\(^{185}\) Investors may also recover damages from the issuer in a crowdfunded offering for material misrepresentations and omissions made by the issuer.\(^{186}\)

Securities issued pursuant to a crowdfunding transaction are restricted and may not be transferred for a year unless they are transferred to the issuer, an accredited investor, as part of a registered offering, or to a family member or equivalent, in connection with a death or divorce.\(^{187}\)

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\(^{182}\) Id. §§ (b)(1)(E)–(H).

\(^{183}\) Id. § (b)(2).

\(^{184}\) Id. § (b)(4).

\(^{185}\) Id. §§ (c)(1)-(2).

\(^{186}\) Id. §§ (c)(2)(A)-(B).

\(^{187}\) Id. § (e).
b. Provisions relating to investors in securities

Title III limits the aggregate amount of securities that may be sold to any investor in a crowdfunded offering to not exceed in a twelve-month period either the greater of $2,000 or five percent of the annual income or net worth of an investor whose income or net worth is less than $100,000, or the lesser of ten percent of the annual income or net worth (not to exceed $107,000) if the investor’s annual income or net worth exceeds $100,000.\footnote{188}

Each investor in a crowdfunded offering is required by the statute to review certain investor education information set forth in the offering platform. The investor will affirm that she is aware of the risk of losing the entire investment and that she can bear such a loss and answer questions showing an understanding of risk generally, and the risk of illiquidity in particular.\footnote{189}

c. Provisions relating to intermediaries (Platforms)

The statute also provides that any person acting as an intermediary in a crowdfunding transaction must register either with the SEC as a broker or a funding platform or with an applicable exchange or self-regulatory organization.\footnote{190} The statute further imposes several additional responsibilities on an intermediary.\footnote{191} First, the intermediary must ensure that each investor reviews the investor education information and affirms that she is aware of the risk of loss of the entire investment and that she can bear such a loss, and answers questions showing an understanding of risk generally, and the risk of illiquidity in particular.\footnote{192} Furthermore, the intermediary must provide to its clients any information provided by the issuer no later than twenty-one days before securities are sold.\footnote{193} Intermediaries are also required to take a number of steps to reduce the risk of fraud in crowdfunded transactions.\footnote{194} Intermediaries must ensure that all offering proceeds are provided to the issuer only when the aggregate capital raised is equal to or greater than a target offering amount and allow the

\footnotesize


190. Id. § 77d-1 (a)(1).

191. Id. §§ 77d-1(a)(4)–(7), (9)–(11).

192. Id. § 77d-1(a)(4).

193. Id. § 77d-1(a)(6).

194. Id. §§ 77d-1 (5), (9)–(11).
investors to cancel their investment.195

C. Regulation Crowdfunding

The JOBS Act required the SEC to issue regulations to implement the consumer crowdfunding provisions of the JOBS Act no later than 270 days from the date of its enactment in April 2012.196 In meeting this legislative mandate, the SEC issued draft regulations on November 5, 2013 (“the proposed regulations”).197 In accordance with U.S. administrative law, comments on these draft regulations were solicited from interested parties.198 These draft regulations were finalized and published on November 16, 2015.199 They are known as Regulation CF and became effective on May 16, 2016.200 These regulations appear in Title 17, Part 200 of the Code of Federal Regulations.201

i. Provisions relating to sellers of securities

Regulation CF is quite extensive and greatly expands the statutory requirements relating to issuers. For example, issuers are required to file the information under Title II of the JOBS Act (and additional categories of information added by the regulations) with the SEC and with its funding platform in an Offering Statement filed on a new SEC Form C.202 The issuer is required to amend this Offering Circular whenever there is a material change, update, or addition and must file progress reports after completing 50 percent and 100 percent of its intended funding target.203 Moreover, issuers must continue to file annual reports of their operations and financial statements on a yearly basis until the company becomes public, repurchases all of the crowdfunded shares, or liquidates the business.204

Regulation CF also spells out the content of the notices that issuers may

195. Id. § 77d-1(7).
198. Id.
201. See id.
204. Id. § 227.202(b).
use in directing investors to the intermediary’s platform.\textsuperscript{205} As set forth therein, the information that may be disclosed in these notices is very limited.\textsuperscript{206}

The crowdfunding exemption also does not apply to issuers, officers, directors, shareholders with over twenty percent ownership stakes, or their partners or paid solicitors, who have violated or failed to comply with federal securities, banking, and bankruptcy regulations or who have been barred from a registered national securities exchange or national securities association.\textsuperscript{207} The regulations also make it clear that consumer crowdfunding exemptions do not apply to issuers who are not organized under the laws of a state or territory of the United States, therefore limiting the availability of crowdfunding only to U.S. companies.\textsuperscript{208}

Lastly, issuers of securities sold through a crowdfunding platform may not transfer them for one year after purchase, unless the securities are transferred to the issuer, to an accredited investor, as part of a registered offering, or to a family member under certain circumstances set forth in the proposed regulations.\textsuperscript{209}

\textit{ii. Provisions relating to intermediaries and transactions}

The regulation imposes a number of requirements and responsibilities on crowdfunding intermediaries. First, each crowdfunding platform must either register as a broker under the Securities Exchange Act of 1934, or as a funding platform in accordance with the regulation.\textsuperscript{210} The intermediaries must also become members of a national securities association, which means that they would be subject to the disciplinary and dispute resolution practices of that association, which might include an obligation to arbitrate disputes.\textsuperscript{211}

Foreign entities may register as a funding platform under certain conditions. First, there must be an information-sharing agreement in place between the SEC and the competent regulator in the jurisdiction in which the proposed foreign platform is registered. Second, the platform must appoint

\textsuperscript{205} See Crowdfunding, 80 Fed. Reg. at 71390.
\textsuperscript{206} 17 C.F.R. § 227.204(a) (2019).
\textsuperscript{207} Id. § 227.503(a).
\textsuperscript{208} Id. § 227.100(b)(1).
\textsuperscript{209} Id. § 227.501(a).
\textsuperscript{211} See 17 C.F.R. § 227.300(a); see, e.g., FINRA, Rule 12100-01 https://www.finra.org/arbitration-mediation/printable-code-arbitration-procedure-12000#12100 (defining terms used).
an agent for the service of process in the United States and certify that it is authorized, under the law of its jurisdiction, to provide the SEC with access to its books and records, submit to onsite inspections and examinations, and then must in fact permit such inspections and examinations by SEC representatives.212

Regulation CF also requires that intermediaries must deny access to the site to issuers in three different situations.213 First, the intermediaries must deny access if they have a reasonable basis for believing that they or their principals are subject to disqualification under the regulations.214 At a minimum, they must conduct a background and securities enforcement regulatory history check on each issuer and its principals.215 Second, the platform must deny an issuer access to the platform if it has a reasonable basis for believing that the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.216 Last, the platform must deny access if it believes that it is unable to adequately or effectively assess the risk of fraud of the issuer or its potential offering. If the intermediary, after the offering, becomes aware of information that causes it to believe that the issuer or the offering present the potential for fraud, then the intermediary must remove and cancel the offering from its platform and refund any investor funds.217

Individuals wishing to invest in a crowdfunded offering must open an account with the intermediary prior to investment. As part of the account-opening process, the intermediary must give potential investors information that explains the investment process, the restrictions on resale of securities, the information issuers are required to provide, investment limitations, as well as risk and suitability criteria.218 The intermediary may not, however, offer investment advice or recommendations to any potential investors.219

The regulation is quite specific with regard to the issue of intermediaries holding financial interests in the securities of the companies they list.

212. See 17 C.F.R. § 227.400(f).
215. See id.
216. See id.
217. See 17 C.F.R. § 227.301.
218. See id. § 227.302(b)(1).
219. See id. § 227.402(a).
Officers, directors, or partners of an intermediary may not have a financial interest in any issuer selling securities on the website or receive a financial interest in the issuer as compensation for services provided to the listed company. An intermediary may, however, compensate a third party for referring a person to the funding platform, as long as the third party does not provide the intermediary with personally identifiable information of any potential investor and the compensation is not based, directly or indirectly, on the purchase or sale of a security offered on or through the intermediary’s platform. An intermediary may also pay or receive compensation to or from a broker or dealer for services provided in connection with the offer or sale of securities by the intermediary. It may receive a financial interest in the entity whose securities are listed for sale on its website if the interest consists of securities of the same class as those being sold, which are given as compensation for services provided to the listing company in connection with the offer.

Prior to listing an offering on the website, intermediaries are required to have a reasonable basis for believing that an issuer seeking listing on the website complies with the requirements of the securities laws and regulations. The intermediaries must also have a reasonable basis for believing that the issuers listing on the website have established means to keep accurate books and records of the holders of the securities that it would offer and sell. The regulations do provide that intermediaries may rely on issuers’ representations about these facts. Intermediaries must post on their website all information required to be submitted by the issuer under the statute and regulation for a period of twenty-one days before any securities are sold and retain it until the offer is either completed or cancelled.

The regulations also require intermediaries to have a reasonable basis for believing that the investor satisfies the investment requirements established by the statute. In order to do so, they must obtain the following from the

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220. See id. § 227.300(b).
221. See id. § 227.402(b)(6).
222. See id. §§ 227.402(b)(6)–(8).
223. See id. § 227.300(b).
225. See id.
226. See 17 C.F.R. §§ 227.301(a)–(b).
227. See id. § 227.303(a).
228. See SEC, supra note 224.
investor: (1) a representation that the investor has reviewed the educational materials delivered as part of the account opening process, understands that the entire amount may be lost, and that the investor is in a financial condition to bear such a loss; and (2) a completed questionnaire that demonstrates the investor’s understanding of the restrictions on his or her ability to cancel an investment commitment and obtain a return of his or her investment, the difficulty of reselling the investment, and of the nature of the risks involved in the transaction.\textsuperscript{220}

An intermediary must also provide on its platform a communications channel through which investors can communicate with each other and with representatives of the issuer about offerings made available on the platform. It may not participate in this channel other than to establish posting guidelines and remove abusive or fraudulent communications.\textsuperscript{230} An intermediary may apply objective criteria to limit the securities offered through its platform as long as those criteria meet the requirements of the regulation.\textsuperscript{231} It may also provide search functions on the website that will allow potential investors to search, sort, or categorize potential investments, as long as those search functions operate according to the objective criteria set forth in the regulation.\textsuperscript{232} As noted above, an intermediary may not give investment advice or recommendations about investments listed on its website, solicit offers to buy the securities offered, or compensate any person for doing so.\textsuperscript{233}

An investor in a crowdfunded transaction may cancel an investment commitment for any reason until forty-eight hours prior to the deadline identified in the issuer’s offering materials.\textsuperscript{234} An investor may also cancel an investment later than that if there is a material change to the terms of the offering or to the information provided by the issuer.\textsuperscript{235} In such a case, the intermediary must send a notice of the material change and state that the investment commitment will be cancelled unless the investor reconfirms it.\textsuperscript{236}

The regulation also imposes substantial compliance and recordkeeping

\textsuperscript{229} See 17 C.F.R. § 227.303(b).
\textsuperscript{230} See id. § 227.303(c) (outlining communication channels).
\textsuperscript{231} See id.
\textsuperscript{232} See id. § 227.402(b)(3) (outlining criteria).
\textsuperscript{233} Id. § 227.402(b)(3)(a). As noted above, there are some exceptions to this prohibition. See supra notes 216–21 for the rules on intermediaries advising investors.
\textsuperscript{234} 17 C.F.R. § 227.304(a).
\textsuperscript{235} Id. § 227.304(c)(1).
\textsuperscript{236} Id. §§ 227.304(a), (c)(1).
obligations on the funding platforms.\textsuperscript{237} For example, the platforms must implement written compliance policies to ensure that the platform is in compliance with federal securities law, money laundering regulations, and privacy laws.\textsuperscript{238} They must also make and preserve for five years a large number of records relating to their operations, including all records relating to investors, issuers, and transactions, educational materials, and notices, agreements, monthly and quarterly transaction summaries, and copies of all communications that occur on or through its platform.\textsuperscript{239}

\textbf{D. The Consumer Crowdfunding Experience in the United States}

\textit{i. Statistics}

The SEC statistics show that, in the first year of Regulation CF’s operation (from May 2016 through May 2017), 105 consumer crowdfunding campaigns were reported to the SEC as completed after having successfully met their minimum fundraising goal.\textsuperscript{240} These successful Regulation CF campaigns raised more than thirty million dollars.\textsuperscript{241} Non-SEC sources have since reported 292 successful campaigns, which raised $92,055,260.\textsuperscript{242} They further added that the average number of investors per closed offering in 2016 was 331, with an average commitment of $833 per investor.\textsuperscript{243}

\textit{ii. Reactions to Regulation CF}

The reaction to the consumer crowdfunding experience in the United States since 2016 has not been positive. There appears to be a consensus

\begin{itemize}
\item \textsuperscript{237} See id. § 227.403(a).
\item \textsuperscript{238} See id.
\item \textsuperscript{239} Id. §§ 227.404(a)(1)–(3), (5)–(8).
\item \textsuperscript{241} Id. at 9 (stating that the average investment raised was $289,000, the median amount raised was $170,000, the highest amount raised was $1,070,000, and the lowest amount raised was $11,800).
\item \textsuperscript{242} The Current Status of Regulation Crowdfunding, WEFUNDER, https://wefunder.com/stats (last visited May 1, 2020). Other sources report different figures. For example, commentators analyzing data from Crowdfund Capital Advisors reported 186 consumer transactions from May through December 2016. Zachary J. Robins & Timothy M. Joyce, How to Crowdfund and Not Fall Flat on Your Face: Best Practices for Investment Crowdfunding and the Data to Prove It, 43 MITCHELL HAMLINE L. REV. 1059, 1073 (2017).
\item \textsuperscript{243} Robins & Joyce, supra note 242, at 1076–77.
\end{itemize}
among commentators that crowdfunding transactions are inherently risky and that these risks cannot be totally eliminated. They also agree that crowdfunding transactions bear a substantial and disproportionate risk of fraud and abuse. The general question these scholars pose is whether a crowdfunding regulatory regime can be crafted where the benefits to issuers and investors outweigh these inherent risks. More specifically, the question that these commentators are considering is whether the consumer crowdfunding regime created by the JOBS Act and Regulation CF reasonably regulates and facilitates the raising of capital by startup entrepreneurs and minimizes the risks to investors. The response is that they do not. Two general criticisms elicit a negative response to this question. The first is that the statutory and regulatory provisions meant to protect investors from fraud are not very effective. The second is that the costs and burdens imposed on issuers and platforms by the statute and regulation do not facilitate these transactions.

iii. The Risk of Loss and Fraud

Proponents of consumer crowdfunding have argued that Regulation CF provides investors with adequate protection from the risks of loss and fraud in several ways. First, investor vetting and education provided by the crowdfunding platforms ensures that potential investors who buy

244. See, e.g., Bradford, supra note 153 (asserting that although a crowdfunding exemption could be structured to provide investor protection, many crowdfunding investors would still lose money as the risks associated with crowdfunding cannot be completely eliminated); Garry A. Gabison, Equity Crowdfunding: All Regulated but Not Equal, 13 DEPAUL BUS. & COM. L.J. 359, 369 (2015) (discussing the unique fraud risks presented by crowdfunding); Dylan J. Hans, Rules Are Meant to be Amended: How Regulation Crowdfunding’s Final Rules Impact the Lives of Startups and Small Businesses, 83 BROOK. L. REV. 1089, 1101 (2018); Arthur McMahon, It Takes a Village to Fund a Startup: How an Electronic Community for Early-Stage Investments Can Bring Democracy Back to Equity Crowdfunding, 84 U. CIN. L. REV. 1269, 1275–76 (2016).

245. See, e.g., Melissa S. Baucus & Cheryl R. Mitteness, Crowdfrauding: Avoiding Ponzi Entrepreneurs When Investing in New Ventures, 59 BUS. HORIZONS 37, 37, 39 (2017); Bradford, supra note 153, at 105; Gabison, supra note 244, at 369; McMahon, supra note 244, at 1282.

246. See Bradford, supra note 153, at 115–16. See generally McMahon, supra note 244, at 1277 (asking what kind of crowdfunding regime is feasible for small issuers and whether the level of risk such a regime would present to investors was acceptable).

247. See Hans, supra note 244, at 1092.


249. See McMahon, supra note 244, at 1310.
crowdfunded securities understand the nature and risks of the investments that they are about to make, allowing them to make informed decisions. Second, the communication channels established by the platform for the use of potential investors and issuers unleashes the “wisdom of the crowd”: investors will use this mechanism to identify fraudulent or risky transactions and educate each other about investment risks and benefits. Last, platform vetting and disclosure of issuer and transaction information will ensure that potential investors have sufficient trustworthy information to make informed investment decisions. Most scholars who have written about the Regulation CF experience seem to think otherwise.\(^{250}\)

\textit{a. Investor Vetting and Education}

Investors interested in equity crowdfunding investments have been described as unsophisticated investors from different economic classes who have very different investment motivations.\(^{251}\) Unfortunately, a significant portion of the American public seems to lack the basic financial knowledge required to understand investment risks.\(^{252}\) Even expert investors acknowledge that they often make poor decisions when evaluating proposed startups whose issuers provide them with far more information than is generally provided in consumer crowdfunding transactions.\(^{253}\)

Unfortunately, the statute and the regulation do not really provide any guidance to platforms on how potential investors should be vetted or educated,\(^{254}\) and this falls outside of the core functions and expertise of most platforms.\(^{255}\) As a result, it appears that the “educational” portions of U.S. consumer crowdfunding sites are somewhat limited.\(^{256}\) For example, Wefunder, one of the most active U.S. consumer crowdfunding sites,\(^{257}\)

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250. \textit{But see} Robins & Joyce, \textit{supra} note 242, at 1074 (stating that 2016 investment statistics show that “the wisdom of the crowd” rejected 58 percent of the 2016 crowdfunding offerings, and claiming that “[t]he crowd, in its infinite wisdom, is deciding who is worthy of capital”).


252. Bradford, \textit{supra} note 153, at 110–12 (discussing a 2005 study in which only 17 percent of adults scored an “A” on a twenty-four-question financial literacy quiz).

253. \textit{See} Baucus & Mitteness, \textit{supra} note 245, at 47.

254. \textit{See} McMahon, \textit{supra} note 244, at 1321.

255. \textit{See} Baucus & Mitteness, \textit{supra} note 245, at 39, 45; Bradford, \textit{supra} note 153, at 42–43 (stating that government entities are not equipped to guard against investor fraud).


discloses risk information through a “Frequently Asked Questions” page with an e-mail address for additional questions.\(^{258}\) It does not appear that a potential investor has to read this disclosure prior to investing.\(^{259}\) Therefore, the likelihood that consumer crowdfunding platforms are providing investor vetting and education sufficient to make the average non-sophisticated investor understand the risks and complexities of crowd-funded investments, as these commentators conclude, is not great.

\textit{b. “The Wisdom of the Crowd”}

The “crowd,” as described by the JOBS Act and Regulation CF critics, is not very wise.\(^{260}\) It is a heterogeneous group of unsophisticated investors whose investment motivations vary greatly.\(^{261}\) They are bound to act emotionally and are subject to the tendency to follow the advice of someone deemed to be an expert or an authority figure. Another weakness of the crowd is that, because of its lack of sophistication, it does not generally know the right questions to ask in order to ascertain risks or uncover fraud.\(^{262}\) Even if the crowd were able to act rationally, the communication channels mandated by the statute and the regulation are not as effective as they could be, as they are only open to investors registered with the platform and closed to outside individuals who might have dealt with the company and might have relevant information to share.\(^{263}\) Moreover, the communication channel among investors is closed once the transaction is completed, eliminating the investor’s ability to communicate post offering.\(^{264}\)

\textit{c. Due Diligence}

The statute and the regulation place substantial due diligence responsibilities, burdens, and potential liabilities on the platform, which include investor education and screening of issuers and the documentation that they post on the website.\(^{265}\) Unfortunately, the regulations neither

\begin{itemize}
  \item 259. \textit{See id.} (showing information about investment risks and other issues).
  \item 260. \textit{See} Baucus & Mitteness, \textit{supra} note 245, at 42 (explaining that the “crowd” is made up of a large amount of unsophisticated investors).
  \item 261. \textit{Id.}
  \item 262. \textit{Id.} at 42; \textit{supra} notes 65–66 and accompanying text.
  \item 263. Bradford, \textit{supra} note 153, at 134–35 (arguing that communication amongst investors should be facilitated by crowdfunding websites because, currently, communication between investors is difficult and can make it easier to miss flaws in the business model).
  \item 264. \textit{See id.}
  \item 265. \textit{See} McMahon, \textit{supra} note 244, at 1318–19; \textit{see infra} Part IV.B and
require nor empower the intermediary to have the necessary tools to do the job.\textsuperscript{266} Moreover, due diligence is costly and time-consuming, and the platforms’ compensation for the largest crowdfunding transactions, which typically average between $50,000 and $70,000, will not be sufficient to underwrite the due diligence and other costs.\textsuperscript{267} “All of this results in a situation where the extent of due diligence by the platforms themselves will vary widely, which creates opportunities for fraudulent ventures to use them.”\textsuperscript{268} Due diligence will vary depending on the number of personnel, procedural templates used, and time spent. This discrepancy creates opportunities for fraudulent ventures to use sites which are known for light vetting.

\textit{d. Remedies for Fraud or Misrepresentation.}

As we have seen, the JOBS Act contains a provision that subjects issuers to liability for losses resulting from material misrepresentations and omissions in connection with a crowdfunding transaction.\textsuperscript{269} This remedy, which gives investors the right to file an action to recover their losses, may be difficult to enforce.\textsuperscript{270} Since the amount of crowdfunding investments is capped by the statute, a scholar notes, each investor’s loss will be relatively small and the costs of litigation will generally exceed any possible recovery, making an individual action for damages unfeasible.\textsuperscript{271} Moreover, the maximum amount allowed in a crowdfunding transaction is so low that it renders the possibility of class action litigation against the issuer unlikely to succeed.\textsuperscript{272} Because of the small amounts involved and limited government entity enforcement funding, crowdfunding fraud cases are unlikely to be a high enforcement priority.\textsuperscript{273} Lastly, even if the investors were to successfully sue the issuer, given most startups’ limited amounts of cash, it is doubtful that a defrauded investor would be able to enforce a judgment.

\footnotesize{accompanying text.}
\textsuperscript{266} See McMahon, supra note 244, at 1321.
\textsuperscript{267} McMahon, supra note 244, at 1322.
\textsuperscript{268} Baucus & Mitteness, supra note 245, at 45.
\textsuperscript{269} See 17 C.F.R § 227.402 (2019).
\textsuperscript{270} Steven Bradford, Online Arbitration as a Remedy for Crowdfunding Fraud, 45 FLA. ST. L. REV. 1169, 1169 (2018).
\textsuperscript{271} Id.
\textsuperscript{272} See id. at 1169 (arguing for the establishment of an arbitration remedy as an appropriate remedy for the resolution of crowdfunding fraud cases).
\textsuperscript{273} See id. at 1182–83 (arguing that, if crowdfunding transactions become popular, the SEC would not have sufficient resources to keep up with demand for enforcement action against fraudsters).}
iv. Burdens and Costs.

Another criticism of the U.S. consumer crowdfunding regime is that it imposes burdens and costs on issuers and intermediaries that make it prohibitively expensive and impractical. For the intermediaries, these costs include SEC and Financial Industry Regulation Authority (“FINRA”) registration and compliance costs, as well as the costs involved in fulfilling the issuer vetting and investor education requirements set forth in statutes and regulations, costs which exceed the $50,000–$70,000 in compensation the intermediaries receive for their services. For issuers, these costs include intermediary fees, preparation and compliance costs for the offering statement, costs of accounting review or audit of financial statements, and the cost of ongoing SEC reporting. These costs, estimated by the SEC at between $72,800 and $168,500 for a one million dollar offering (approximately ten percent of funds sought) are substantial for a startup company and constitute a significant deterrent to issuers. For this reason, the suggestion has been made that the statute be amended to increase the maximum amount of consumer crowdfunding offerings from the current $1.07 million to $5 million per twelve-month period. In May of 2017, a bill was introduced in the Senate that would allow “crowdfunding vehicles” to invest an unlimited amount in crowdfunded transactions. This bill had not become law at the time of publication. On March 4, 2020, however, the SEC, as part of a major restructuring of regulations dealing with exempt transactions, proposed an amendment to Regulation CF that would increase the maximum amount of consumer crowdfunding offerings to five million dollars per twelve-month period. This proposal would also amend the

274. McMahon, supra note 244, at 1310; Hans, supra note 244, at 1106–07.
275. See Hans, supra note 244, at 1094–95.
276. See id. at 1104 (stating that in addition to the costs involved in a crowdfunding transaction, issuers are also subject to significant publicity and advertising restrictions during the offering process).
277. See id. at 1104–05 (discussing the costs that correspond with issuer requirements); see also McMahon, supra note 244, at 1312–16 (providing examples of the several financial burdens on issuers).
278. Hans, supra note 244, at 1104–05 (noting that the deterrent effect stems from the issuing costs making smaller offerings less expensive).
280. Id. § 2(b) (defining a crowdfunding vehicle as a company whose purpose is limited to acquiring, holding, and disposing of securities issued by a single company in one or more transactions made pursuant to § 4(a)(6) of the Securities Act of 1933 and which meets a series of noted conditions).
regulations under the Investment Company Act of 1940 to allow the creation of crowdfunding vehicles.282

The statute and the regulation further constrain investors in consumer crowdfunding in two ways. First, the regulation’s split limit on individual investments in crowdfunded issues constrains the efficiency of capital formation and prevents investors from diversifying their investments in crowdfunded securities.283 Solutions to this problem range from changing the investment cap in crowdfunded securities to maximum investments per issuer284 to amending the statute and regulation from a “lesser of both metrics” system to a “greater of both metrics” standard, similar to that of Regulation D.285

Second, U.S. crowdfunding norms limit the sale of, and do not permit a secondary market for crowdfunded securities.286 These restrictions make investments in crowdfunded securities less attractive because their lack of liquidity prevents the investor from having access to her funds by selling her security.287 Furthermore, the investor’s inability to resell crowdfunded securities prevents the investor from realizing a gain or minimizing a loss in the value of her investment.

The answer to the question of how well the JOBS Act and Regulation CF resolve, or at least balance, the crowdfunding conundrum is mixed. Issuers might argue that Regulation CF crowdfunding is not an attractive proposition because of the limitation on the amount of funds that are crowdfunded,

282. Id. § 270.31-9, p. 329.
283. See Hans, supra note 244, at 1102–03 (explaining that the regulation means that an investor who meets the accredited investor status under Regulation D, which uses the higher of both metrics to test for eligibility, would be able to purchase an unlimited amount of securities in a private placement, but no more than $107,000 in a crowdfunded issue); McMahon, supra note 244, at 1311–12 (providing a numeric example of a consequence created by the split limit); see also Robins & Joyce, supra note 242, at 1070 (noting that the limitation on yearly investments by a given investor is new to securities).
284. McMahon, supra note 244, at 1332 (providing that Regulation AGORA would set the maximum investment per issuer at $500 per year).
285. Hans, supra note 244, at 1110.
286. See Louise Lee, The Missing Piece that Could Hold Back Equity Crowdfunding, WALL ST. J. (May 1, 2016, 10:16 PM), https://www.wsj.com/articles/the-missing-piece-that-could-hold-back-equity-crowdfunding-1462155373 (arguing that the lack of a secondary market deters buyers); see also supra note 207 and accompanying text (noting that under the statute and regulations, purchasers of crowdfunded securities may not resell their investments for at least a year after purchase and there is no provision in the statute or regulations for a secondary market for crowdfunded securities); infra Part V (discussing crowdfunding in the Spanish legal system).
287. SEC, REPORT ON REGULATION CROWDFUNDING (2019) [hereinafter REPORT ON REGULATION CROWDFUNDING].
coupled with its high costs, substantial regulatory requirements, and potential for liability. The response to this argument is simple. Because of the risky nature of startup investments and the lack of investor sophistication, the regulatory requirements imposed on the issuer are reasonable and appropriate. Cost is likely the principal issue for issuers. Raising the maximum amount that can be crowdfunded from one million to two million dollars, as is the case in Spain, is a reasonable accommodation that would increase the issuer’s ability to raise capital and would lower their costs. However, increasing the maximum amount to five million dollars is not a good idea, given the unsophisticated nature of offerees in consumer crowdfunding offerings.

The treatment of consumer crowdfunding intermediaries in the JOBS Act and Regulation CF is problematic. Intermediaries are not required to have minimum capital, insurance, or experience and expertise, which can result in the registration of less than adequate firms as platforms. The vetting of investors, issuers, and their principals imposes substantial compliance obligations, and is essentially outsourced to intermediaries without indicating how it must be done, and what and how much vetting by the intermediary will protect the investor from liability.

Given this lack of regulatory clarity and the intermediary’s low profit margin on the crowdfunded issues, these firms will, as a matter of economic necessity, engage in the least (and cheapest) amount of vetting possible. This approach greatly increases the risk of fraud liability. Since intermediaries are not required to have minimum capitalization or insurance and are not likely to be large firms, it is likely that an intermediary’s liability for its involvement in a fraudulent transaction will bankrupt the firm. The SEC should consider imposing minimum capitalization and insurance requirements as additional protection for investors. Moreover, regulatory clarity should be imposed by amending Regulation CF to clarify how the required vetting of investors and transactions must be undertaken. This clarification must balance the interest of sufficient protection with the cost and effectiveness of the requirements to be imposed.

288. See id. at 23–26 (discussing the types of costs incurred by issuers).
290. See REPORT ON REGULATION CROWDFUNDING, supra note 287, at 27 (noting that there are 45 funding platforms registered with FINRA yet the 3 largest platforms completed the majority of offerings, and that smaller platforms may have to exit the market if they fail to attract a sufficient flow of deals).
291. See id. at 29 (discussing intermediaries’ gatekeeper function regarding issuer compliance).
The protection of investors in Regulation CF is inadequate. Its sliding investment limits (which currently permit investments of up to $107,000) and its prohibition on diversification may cause unsophisticated investors to suffer a massive loss on extremely risky investments and prevent them from minimizing their risks and losses. The SEC should consider adoption of the Spanish regulatory system. It creates a set (and relatively low) investment cap for all unsophisticated investors and allows for the diversification and resale of crowdfunded investments, which offers better protection for investors.

As the Article discusses above, the investment cap on consumer crowdfunded investments for accredited investors does not make sense and does not exist in the context of accredited investor crowdfunding. Accredited investors, as is the case in Spain, should be allowed to invest the same amount in both types of crowdfunding. In fact, the SEC’s proposed amendments to Regulation CF offer just that. As currently practiced, crowdfunding investor education is highly inadequate. As articulated above, educational materials are placed in a Frequently Asked Question section on the website, and the only action potential investors have to take in order to invest is “point and click” to affirm that they have read and understood these materials. Given most consumers’ experience with e-commerce, it is highly unlikely that most participants will have done so. Requiring a potential investor to interact with the educational materials or engage in a computer simulation of the potential results of her investment represents a preferable approach, because it increases the probability that a potential investor has read and understood the educational materials provided.

Lastly, the limitation of the online communication channels to registered potential investors only imposes a limit on the amount and nature of the information exchanged among potential investors and therefore creates a risk that the “wisdom of the crowd” will be adversely affected by the lack of potentially important information. The SEC should consider opening a

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292. See generally id. (providing background information regarding the impact of Regulation CF on investor protection, including a discussion on requirements, direct feedback from intermediaries, potential investor protections, and special purpose vehicle structures).

293. See id. at 6–7 (noting that investment limits depend on investors’ net worth).

294. See infra note 390 (explaining the yearly cap for U.S. investors).


296. See WEFUNDER, supra note 258 (providing an example of an FAQ section containing educational materials).

297. See Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers,
portion of this communication to non-registered potential investors who might have highly relevant information to share. Since the intermediary provides the infrastructure and monitors this channel, it can take steps to prevent non-registered potential investors from abusing the channel.

V. CROWDFUNDING IN THE SPANISH LEGAL SYSTEM

A. The Regulation of the Securities Industry in Spanish Law

The securities industry in Spain is primarily regulated by the Ley del Mercado de Valores (“LMV”), which was originally enacted in 1988.298 Another statute, Real Decreto 13/10/2005, supplements the LMV’s provisions regarding public and private offerings.299 A third statute, the Ley de Sociedades de Capital, (“LSC”) also has provisions that are applicable to the securities market.300

The LMV is meant to regulate all Spanish entities involved in the negotiation, sale, and registration of “financial instruments.”301 The term “financial instruments” is broadly and extensively defined and is meant to cover a wide range of negotiable securities.302

The LMV establishes the Comisión Nacional del Mercado de Valores (“CNMV”) as the principal regulator of the securities industry.303 Its members are appointed by the executive branch of the government from individuals with recognized competence and experience in matters involving the securities markets.304

The CNMV is also charged with advising the executive and legislative branches of the government on issues related to the securities markets.305

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298. Stock Market Law (B.O. E. 2015, 255) (Spain) (noting the original adaptation of this law as Ley 24, 2988 de 28 de Julio, BOE-A-1988-18764 with a number of amendments, the last being on December 20, 3017).


301. Stock Market Law art. 1.

302. See id. arts. 2, 7 (“The LMV provides that all negotiable securities that are publicly traded must exist only in book entry.”).

303. See id. art. 198 (establishing the role of the CNMV).

304. See id. arts. 23–32 (describing appointees and the internal organization ad operations of the CNMV).

305. See id. art. 17 (“Its broad jurisdiction includes the supervision, regulation and inspection of securities markets and all participants therein; oversight over the
The CNMV has the power to issue interpretative regulations and technical guides explaining its interpretation of the law and regulations and has extensive powers to supervise, inspect, and sanction all principal actors involved in the securities markets.

The LMV also imposes an extensive number of obligations and duties for securities professionals towards their clients. These professionals have a general duty of due diligence and transparency to their clients, and are required to provide them with clear, impartial, and accurate information related to their investments. They must know their customers, evaluate their investment knowledge, experience, financial condition and investment objectives, and provide them with appropriate information and warnings about their potential investments and investment strategies. The LMV further prohibits market manipulation and insider trading.

Issuers seeking to sell securities in a public offering must prove to the CNMV that the securities they wish to sell are suitable for sale to the public. Issuers must obtain the CNMV’s approval prior to commencing sales. In order to prove its suitability for entry into the market, the issuer must file certain corporate documents accrediting its compliance with all applicable legislation, as well as two or three years of audited annual financial statements. It must also establish that the securities intended to be sold meet certain requirements and must submit to the CNMV a document containing all information relating to the issuer, the securities, and the transaction that investors need in order to properly evaluate the proposed investment. The CNMV then has ten business days to approve the document. Once it is approved, the document will be registered and the

306. See id. art. 21 (explaining the scope of powers).
307. See id. arts. 233–313 (describing the CNMV powers in detail).
308. See id. arts. 209–10 (identifying the duties of the professionals).
309. See id. arts. 210, 212–13 (describing the scope of duties to the clients).
310. See id. arts. 225–32 (explaining the permissible actions under the LMV).
311. See id. arts. 33–40, 205 (identifying limited exceptions to this requirement and defining accredited investors).
313. See id. art. 9 (“These requirements include, inter alia, that the securities are validly issued, that they are sold in book entry form, and that the minimum value of the securities being sold is three million euros for equity securities and 200,000 Euros for debt securities.”).
314. See id. arts. 16–23 (defining document structure and detailing requirements for organization and structure).
transactions involving certain types of securities, such as those offered to employees, are exempt from the information document and above requirements, and certain transactions are not considered public offerings. The CNMV has broad regulatory powers to require the issuer to provide additional information, or the CNMV can prohibit or suspend an offering.

As is the case in the United States, the LMV also requires domestic and foreign issuers of securities traded in Spain to file periodic reports with the CNMV. Securities that have been previously issued may be sold in a secondary market, such as a security exchange, as long as several conditions are met. First, the issuer must file with the CNMV copies of its constituent documents and financial statements prepared and audited in accordance with applicable legislation. The issuer must also prepare and file with the CNMV an information statement relating to the securities to be sold. Second, the issuer must comply with all listing requirements and conditions set forth by the secondary market in which the securities are to be traded. Last, the issuer must comply with all regulations that may be issued with the CNMV, which cover the market, industry, issuer, or type of security. Issuers whose securities are traded in secondary markets are required to file

315. See id. arts. 24–26 (contending that the issuer may legally use documents pending registration).
316. See id. at art. 26 (defining exemptions to document requirements).
317. See id. arts. 38–40 (stating that “[t]hese include, inter alia, offers made exclusively to accredited investors, offers made to less than 100 offerees, and offers for less than 2,500,00 Euros a year” and defining an accredited investor).
318. See id. art. 44 (identifying regulatory powers of the CNMV).
319. See, e.g., Stock Market Law arts. 118–21 (B.O.E. 2015, 255) (Spain) (describing some limited exceptions to this requirement); see also Secondary Market of Negotiation of Stocks Law art. 5.1 (identifying requirements for domestic and foreign issuers).
320. See Stock Market Law art. 43 (establishing that secondary markets are defined and listed).
321. See id. arts. 36(a)–(b) (listing duties of the issuer).
322. See id. arts. 36(c), 37(1), 37(3)–(4) (“The information statement must contain enough information to permit potential investors to make an evaluation of the issues, its business and the securities being sold. At a minimum, the statement must include, inter alia, a concise summary, drafted in non-technical language, of the information that investors need to determine whether to invest, a brief description of the issuer’s assets, liabilities, and financial condition, as well as a description of the general conditions and terms of the offer and of the risks associated with investment.”).
323. See id. art. 36 (describing the requirements for admission to securities negotiations in the secondary market).
324. See id. arts. 76(1)–(2) (listing duties of issuers).
quarterly and annual financial reports.\textsuperscript{325}

The second important securities regulation statute in Spain is the LSC, a statute that was meant to codify and harmonize separate legislation regulating different types of business entities.\textsuperscript{326} It applies to Sociidades Anónimas (corporations), Sociedades de Responsabilidad Limitada (limited liability companies), and Sociedades Comanditarias por Acciones (limited partnerships).\textsuperscript{327} It also creates, as a subset of the limited liability company, an entity known as “Sociedad Nueva Empresa” (startup company), an entity with minimum capitalization and vastly simplified operating norms.\textsuperscript{328} Under the LSC, only corporations may sell their securities in a public offering.\textsuperscript{329} They may do so as part of their organizational process or thereafter.\textsuperscript{330} The LSC also exempts publicly traded corporations from certain operational requirements and creates numerous other rules that apply only to these entities.\textsuperscript{331} None of these statutes authorize the use of crowdfunding for investment purposes.\textsuperscript{332} As was the case in the United States before the JOBS Act, none of these statutes authorize the use of crowdfunding for investment purposes.

\textbf{B. Ley 5/2015}

In April of 2015, Spain enacted Ley 5/2015, which was intended to present a package of regulatory provisions meant to stimulate alternate financing for businesses, especially small- and medium-sized ones.\textsuperscript{333} Title V of this law specifically created a legal framework that authorized and regulated

\begin{flushleft}
\textsuperscript{325} Id. arts. 118–19.
\textsuperscript{326} Capital Companies Law art. 1 (B.O.E. 2010, 161) (Spain).
\textsuperscript{327} See id. art. 1.
\textsuperscript{328} See id. arts. 443–54.
\textsuperscript{330} Capital Companies Law arts. 41–47 (explaining that a corporation wishing to make a public offering as part of its organizational process must submit a business plan, a technical report attesting to the viability of the business plan, and other documentation).
\textsuperscript{331} See id. arts. 495, 523 (exempting the corporation temporarily from public disclosure requirements).
\textsuperscript{333} See id. at preamble I (explaining that the government has launched a strategic twist of regulations to make financing more available and developing alternative means of financing).
\end{flushleft}
crowdfunding. This statute is Spain’s attempt to resolve the crowdfunding conundrum.

Ley 5/2015 starts this framework by specifically authorizing the creation of Internet platforms (“Plataformas de Financiación Participativa” or “PFP’s”) to serve as electronic intermediaries between individuals or entities that solicit financing for a crowdfunding project (“issuers”) from individuals or entities that wish to invest (“investors”). The statute specifically defines a crowdfunding project as one where an issuer solicits financing for an entrepreneurial project on its own behalf from investors who are seeking a monetary profit. Crowdfunding projects may involve the sale, without a prospectus, of securities or a request for a loan.

Unlike the JOBS Act and Regulation CF in the United States, which Ley 5/2015 resembles, Ley 5/2015 does not have a separate regulatory template or process for accredited investor crowdfunding. It does, however, provide for the investment in crowdfunded transactions by accredited investors, under looser requirements and without investor limits.

i. Provisions relating to intermediaries (Platforms)

Platforms under Ley 5/2015 receive, select, and publish proposals for crowdfunding projects; they further develop, establish, and operate communications channels that facilitate investments in these projects. They are permitted, but not required, to provide additional services but are

334. See id. art. 46.
335. See id. arts. 46–47 (explaining that intermediaries who serve as intermediaries in crowdfunding transactions involving donations, the sale of goods and services, and interest free loans are specifically excluded from coverage, as well as crowdfunding transactions involving Spanish residents using foreign Internet platforms).
336. See id. art. 49 (elucidating that the project may not involve investments or loans to third parties, the purchase of publicly traded securities or investments in firms dedicated to investment).
337. See id. art. 50 (explaining that unlike the LSC, Ley 5/2015 allows limited liability companies to sell their securities to the public in a crowdfunding transaction).
338. See McMahon, supra note 244, at 1316–18.
340. Id. art. 51.
341. See id. (confirming that these additional services include giving advice to issuers regarding the publication of the project on the platform, especially information technology and design; analyzing submitted crowdfunding projects, as well as engaging in risk analysis or other research relating to these projects; providing model documentation; transmitting information received about the issuers and the project; developing communication channels that permit issuers and investors to communicate directly with each other about the project; as well as representing investors with judicial or nonjudicial claims).
forbidden from engaging in practices reserved for investment firms or banking or financing entities.\textsuperscript{342}

In order to engage in crowdfunding projects, all platforms must apply for registration with the CNMV and, once approved, will appear in a public registry.\textsuperscript{343} Registered platforms must file periodic reports with the CNMV.\textsuperscript{344} If a registered platform fails to conduct or interrupt its operations for more than twelve months, its registration may be suspended.\textsuperscript{345}

Entities seeking registration as PFPs must meet certain non-financial and financial prerequisites. Unlike the JOBS Act and Regulation CF,\textsuperscript{346} Ley 5/2015 requires that candidates show that their administrators are “honorable”\textsuperscript{347} and possess adequate and appropriate knowledge and experience that will enable them to adequately perform their duties. The applicant must also show that it has good administrative, accounting, and internal control organization and procedures, as well as adequate mechanisms that guarantee the security, confidentiality, and reliability of its electronic systems.\textsuperscript{348} Moreover, the applicant must have an adequate internal mechanism to deal with conflicts of interest and the appropriate conduct of all employees in dealing with proposed crowdfunding projects.\textsuperscript{349}

Financially, the statute requires that platforms have, at all times, a minimum capitalization of €60,000, as well as professional liability insurance with a minimum coverage of €300,000–€400,000.\textsuperscript{350}

Once an application is filed with the CNMV, it must be approved or denied within three months after receipt or, if further documentation is required, no

\textsuperscript{342} See id. (acknowledging that these entities are subject to substantial regulation elsewhere).
\textsuperscript{344} Law of Promoting Business Financing art. 91.
\textsuperscript{345} Id. art. 59.
\textsuperscript{346} See McMahon, supra note 244, at 1331–32 (recommending a new SEC program which would include biographies of officers and company holders to reveal any “bad actors”).
\textsuperscript{347} See Law of Promoting Business Financing art. 55(e) (explaining that “honorable” is defined through an author’s translation in the statute as “having shown personal, commercial and professional conduct that do not raise concerns about their capacity to engage in a prudent and honest management of the enterprise”).
\textsuperscript{348} Id. arts. 55(f)–(g).
\textsuperscript{349} Id. art. 55(h).
\textsuperscript{350} Id. arts. 56(1)(a)–(c) (stating that the minimum capitalization requirements progressively increase once the platform has raised more than two million euros in a calendar year).
more than six months from receipt. If the CNMV has not acted within this
time period, the application will be deemed denied. The CNMV has
 substantial supervisory and regulatory power over registered platforms and
has the power to impose penalties on them for a number of offenses.

Ley 5/2015 also imposes a code of conduct for registered platforms. Under this code of conduct, platforms must conduct their operations in a
neutral, diligent, and transparent fashion, and have a duty to serve the best
interest of their clients. As is the case in the United States, websites
must warn potential investors, inter alia, about the risks surrounding
crowdfunded investments, including the risk of investment loss, illiquidity,
and dilution. They must also clearly disclose their operational procedures,
fees, conflict of interest policies, antifraud policies, the identity of their
auditors, and their mechanisms for investigating and resolving investor
complaints.

Under the conflict of interest policy, platforms must disclose all potential
conflicts and protect confidential information entrusted to them. Moreover,
they are barred from giving investors any personalized advice regarding any
potential investments offered in the platform. Platforms may not purchase
more than ten percent of the amount being sought for any investment they
own or by any issuer advertising in the site or of the amount being sought
and must clearly disclose this investment.

ii. Provisions relating to sellers of securities

Issuers must be registered in either Spain or another EU member state, and
neither they nor any of their principals may be in bankruptcy, reorganization,
or previously convicted of any crimes involving fraud, embezzlement, tax
evasion, or money laundering.

Crowdfunding projects may not raise funds in more than one platform and

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351. Id. art. 53.
352. See id. arts. 53, 57–58 (describing the documentation required for the
application).
353. Id. arts. 89–93.
354. Id. arts. 60–64.
355. Id.
356. See supra Part IV.
357. Law of Promoting Business Financing arts. 61(b)–(d).
358. Id. arts. 61(e)–(n); see infra Part IV.
359. Law of Promoting Business Financing art. 62(b); see Hurt, supra note 14, at 244.
360. Law of Promoting Business Financing art. 63(1).
361. Id. art. 67.
may not raise more than a total of two million euros ($2,248,000). Platforms are required to ensure that each project has a financing target and a schedule for reaching it. Should the financing target not be achieved as scheduled, all invested funds must be returned.

Any issuer seeking to raise capital is required to provide the platform with sufficient information, presented in non-technical language, about itself and the projects for which funding is being sought to enable a reasonable investor to make an informed decision regarding the investment. Although the issuer is responsible for the completeness and accuracy of the information furnished to the platform, the platform is responsible for conducting a due diligence review of both the issuer’s qualifications for listing as well as the completeness and accuracy of the information provided by the issuer.

Any issuer who participates in a crowdfunding transaction must amend its constituent documents to recognize shareholder’s rights to participate in shareholder meetings through electronic means, grant shareholders the right to vote by proxy, and require the disclosure to all shareholders of any shareholder agreements that may affect the right to vote or transfer ownership of its securities. Any contrary provisions set forth in the issuer’s constituent documents are null and void. Any securities issued in a crowdfunding transaction are subject to regulation under the appropriate sections of the LMV and the LSC.

iii. Provisions relating to investors in securities

Provisions of Ley 5/2015 that relate to investors are set forth under the heading of “Investor Protection.” They include provisions on investor qualification, investing limits for crowdfunding transactions, information

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362. Id. art. 68 (stating that crowdfunding projects directed exclusively at accredited investors may raise up to five million euros).
363. Id. art. 69 (highlighting that there are also exceptions to this rule).
364. Id. arts. 70, 78–89 (stating that certain specific information about the issuer and the offer be included).
365. Id. art. 73.
366. Id. arts. 66, 71–72 (stating that the platform is also responsible for the publication of this information in its website and for ensuring that the information transmitted between the issuer and any investors through its communication channels is easily accessible to any other potential investors, and that the platform must retain any information transmitted through this channel for at least five years).
367. Id. art. 80.
368. Id. art. 77.
369. Id. arts. 81–88.
requirements, and other legal protections.370

Investors in crowdfunding transactions, as they are in the JOBS Act,371 are first categorized as either accredited or unaccredited investors. Accredited investors are individuals with assets of over €100,000 or a yearly income of over €50,000.372 Accredited investors must specifically request this status from the platform,373 which must then determine that the investor has sufficient investment knowledge, skills, and experience to make informed investment decisions and understand the risks of investing in crowdfunding transactions.374 All other investors in crowdfunding transactions are considered unaccredited investors. Accredited investors are not subject to any investment limits.375

Unaccredited investors may not invest more than €3,000 ($3,412) in an individual crowdfunding transaction and may not invest more than €10,000 ($11,376) a year in transactions listed on a single platform.376 Prior to accepting an investment from an unaccredited investor, the platform must obtain a specific representation from the investor that he has been warned of the risks of investing in a crowdfunding project and that he has not invested more than €10,000 ($11,376) in other crowdfunding projects during the previous year.377

Unlike the JOBS Act and Regulation CF, Ley 5/2015 does not have an express prohibition against the resale of crowdfunded securities.378 Indeed, it seems to suggest that these securities may be resold.379 Further, unaccredited investors, certain issuers and platforms are subject to certain consumer protection norms.380

370. McMahon, supra note 244, at 1294.
371. Id.
372. Id.
373. Law of Promoting Business Financing art. 81(1).
374. See id. art. 81(2)(c) (explaining that individuals who may not meet the minimum assets and income set forth in the statute may nevertheless apply for and be considered accredited investors as long as they can establish that they are represented by an appropriate investment advisory firm).
375. See id. art. 82 (discussing only limits to non-accredited investors).
376. Id. arts. 82(a)–(b).
377. Id. art. 82(b).
378. See id. art. 77 (discussing crowdfunding regulation but failing to mention anything regarding the prohibition of crowdfunded securities).
379. See id. (noting that the provision states that securities sold in crowdfunded offering are subject to the provisions of the CNMV and LSC; the former authorizes and regulates the sale of securities in the secondary market).
380. Id. arts. 85–88.
C. The Spanish Crowdfunding Experience

Although a recent phenomenon, equity crowdfunding in Spain is part of a vibrant crowdfunding sector and has been the subject of academic commentary. The principal issue involving the regulation of crowdfunding, an author noted, was striking a balance between overregulation of the crowdfunding sector, which would make it impossible for small firms to raise capital through this mechanism, and under-regulation, which would fail to protect investors and the market. This balance is extremely hard to achieve and may involve either adapting crowdfunding to the current system of Spanish corporate and securities law or creating new legal norms to regulate the phenomenon. Other scholars, in a 2016 report on crowdfunding in Spain, have noted challenges involving crowdfunding activity that included fraud, an overly restrictive statute, lack of data regarding completed crowdfunded projects, and financial sustainability issues involving crowdfunding platforms. The issues resulting in fraud noted in the report included insufficient emphasis on risk mitigation and conflicts of interest, inadequate post-completion communication, lack of conflict resolution mechanisms between issuers and investors, lack of knowledge of industry best practices, and delays in the completion of commitments. The report also notes that the current legislation is too restrictive to properly incentivize the development of the crowdfunding sector.

Although Ley 5/2015 creates a regulatory framework similar to that of the JOBS Act and Regulation CF, there are some notable differences in its

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381. UNIVERSO CROWDFUNDING ET AL., FINANCIACIÓN PARTICIPATIVA (CROWDFUNDING) EN ESPAÑA-INFORME ANUAL 2016 4–5, 13 (2016), https://www.universocrowdfunding.com/wp-content/uploads/UC_Informe-AnualCF_en-Espana%28%29.pdf (showing that completed equity crowdfunding transactions in Spain during 2015 raised €6,018,944 ($6,989,707.28); in 2016, completed equity crowdfunding transactions raised €16,078,958 ($18,352,201.87), an increase of 167.14%; in addition to equity crowdfunding transactions, completed crowdlending transactions in Spain totaled €32,792,040; the next year, completed crowdlending transactions totaled €61,989,491 and completed real estate crowdfunding transactions totaled €61,689,491).

382. Id.

383. Id.

384. Id.

385. Id.

First, Ley 5/2015 imposes a number of requirements on a platform and its operations that are not present in its U.S. counterpart. These include character experience and knowledge requirements for the operator and adequate systems of internal controls, electronic systems, security, and reliability, as well as conflict of interest and employee conduct. Furthermore, unlike the situation in the United States, platforms are subject to minimum capitalization and liability insurance requirements. Moreover, issuers in consumer crowdfunding projects in Spain are able to raise twice as much capital as their counterparts in the United States. In the Spanish system, intermediaries are responsible for the completeness and accuracy of the disclosure set forth in the platform. As a result, the Spanish investor is able to diversify her crowdfunded investment and, consequently, is better able to minimize her potential loss than her U.S. counterpart.

Similarly, Ley 5/2015 specifically requires issuers to ensure that investors in crowdfunded transactions have the right to participate in shareholder meetings through electronic means and grant them the right to vote by proxy. Spanish investors in crowdfunding issues have a much lower investment cap than their U.S. counterparts, but the cap expressly increases for investments in more than one crowdfunded issue. Notably, Ley 5/2015

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388. Id. art. 55.
389. Id. art. 56.
390. See id. arts. 56, 68 (allowing issuers to raise €2,000,000 ($2,264,000) per project, while the JOBS Act places the limit at $1,000,000 adjusted for inflation (currently $1,115,634.55). Compare 15 U.S.C. § 77d(a)(6)(A) (2018) (allowing issuers to raise a maximum of one million dollars adjusted for inflation during a twelve-month period), with Law of Promoting Business Financing art. 68 (allowing issuers to raise a maximum of two million euros during a twelve-month period).
391. Law of Promoting Business Financing art. 86.
392. Id. art. 80.
393. See id. art. 56 (discussing the financial requirements in the statute — U.S. investors under Regulation CF have a yearly cap for all issues of the greater of $2,200 or five percent of annual income for investors with either an annual income or net worth of less than $107,000, or ten percent of the lesser of the investor’s annual income or net worth if the investor’s annual income and net worth exceed $107,000 — and stating that the purpose of this cap is, presumably, to limit an unaccredited investor’s risk of loss in a crowdfunding investment; for the drafters of the JOBS Act, the higher the investor’s income, the more capacity she has to absorb risk; Ley 5/2015 works differently: it sets a €3,000 ($3,396) yearly cap for a single investment; but allows investors to invest up to €10,000 ($11,328) in multiple crowdfunded investments).
does not prohibit the resale of securities sold in crowdfunding transactions, allowing investors an exit opportunity not available to consumer crowdfunding investors in the United States.\textsuperscript{394} As a result, the Spanish investor potentially faces less liability than her U.S. counterpart. As in the United States, accredited investors have no investment cap in crowdfunded offerings.

The income and net worth requirements for accredited investors are similar.\textsuperscript{395} Ley 5/2015, unlike its U.S. counterpart, allows individuals who may not meet the minimum assets and income requirements to be considered an accredited investor if they are represented by an appropriate investment advisory firm.\textsuperscript{396} Finally, and most importantly, Ley 5/2015 does not prohibit the resale of securities sold in crowdfunded transactions.\textsuperscript{397}

Ley 5/2015, whose regulatory template resembles that of the JOBS Act, has nevertheless done a better job at balancing the interests in the crowdfunding conundrum than its U.S. counterpart. By doubling the amount that issuers may raise while maintaining disclosure requirements similar to those in the JOBS Act, Ley 5/2015 allows issuers more fundraising flexibility and lower costs, while protecting investors by requiring the disclosure of all material information related to the investment.

Intermediaries are much more regulated by Ley 5/2015 than by Regulation CF.\textsuperscript{398} Ley 5/2015 imposes a series of experience, knowledge, capitalization, insurance, infrastructure, and conduct requirements that ensure that intermediaries can perform their functions well. One issue is of particular note here: the provision that specifies that intermediaries are only responsible for a review of the issuers’ qualifications for listing and the accuracy and completeness of the information posted on the site provides regulatory clarity as to the nature of their vetting obligations.\textsuperscript{399}

Ley 5/2015 allows both accredited investors and consumers to make investments in crowdfunded issues.\textsuperscript{400} For consumers, the set investment caps and the ability to split that cap among more than one issuer limits their

\textsuperscript{394} See supra note 207 and accompanying text.
\textsuperscript{397} Id. art. 77.
\textsuperscript{398} See id. arts. 61(e)–(h) (outlining several types of requirements that serve to regulate source platforms and other intermediaries).
\textsuperscript{399} See supra Part IV.B.ii.–C.ii.
\textsuperscript{400} Law of Promoting Business Financing art. 81.
risk of loss and allows for diversification. For all investors, the ability to resell a crowdfunded investment allows them to realize their gains or minimize their losses within a reasonable time. Notably, the Ley 5/2015 investors’ bill of rights forces issuers to provide mechanisms that give the purchasers of crowdfunded shares the opportunity to be treated the same as other shareholders of the same class. The inclusion of similar provisions in Regulation CF is also worthy of consideration.

VI. ENTER THE EUROPEAN UNION: THE PROPOSED EU CROWDFUNDING REGULATION

In March of 2018, the European Commission proposed a Regulation on European crowdfunding service providers to the European Council and Parliament. Its purpose is to facilitate the expansion of crowdfunding services throughout the European market by supplementing the varying crowdfunding legislative frameworks currently in existence. The Commission views crowdfunding as an important source of non-bank financing, especially for small and medium enterprises, that can further a system of more sustainable financial integration and private investments and promote job creation and economic growth. The proposed Regulation seeks to create a stand-alone voluntary European crowdfunding regime, which would leave current systems unchanged and allow crowdfunding platforms to choose to provide their services under national law or engage in cross-border crowdfunding using European norms.

A. Provisions relating to Intermediaries (Platforms)

Intermediaries must have an establishment in an EU member state and be registered with and authorized to operate by the European Securities and

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404. See id. at 5–8 (detailing the crowdfunding benefits to investors and small businesses).
Markets Authority (“ESMA”).

Once authorized, an intermediary is listed in a register maintained by ESMA and is subject to its jurisdiction and regulation. ESMA has substantial powers to regulate platforms, including the power to request information, inspect, investigate, fine, and impose penalties.

Intermediaries are expected to act honestly, fairly, professionally, and in the best interest of their clients. Unlike the case of the United States and Spain, they are allowed to open discretionary accounts that allow employees of the platform to make investment decisions on behalf of their client, but they must disclose the exact method and parameters of that discretion. Intermediaries are also required to take all necessary steps to obtain the best possible results for their clients and are expected to establish and oversee adequate policies and procedures to ensure their effective and prudent management, as well as procedures for the prompt, fair, and consistent handling of customer complaints. They may outsource some of their activities to third parties but remain responsible for compliance with outsourced activities.

Intermediaries are subject to specific conflicts of interest provisions.

405. See id. art. 10 (providing that the application process requires a platform to provide substantial information regarding its structure, operations, governance arrangements, systems, outsourcing arrangements, and internal control mechanisms and that management staff must be identified and substantial information regarding their background, knowledge, skills, experience and absence of criminal record and financial improprieties must be submitted).

406. Id. arts. 11–12; see id. art. 13 (stating that ESMA also has the power to withdraw a panel’s authorization for a number of reasons).

407. Id. arts. 22–30, 32–34; see id. arts. 13(2), 20, 30, 35, 37 (summarizing that the proposed Regulation envisions substantial cooperation in the regulation of crowdfunding between ESMA and national regulatory agencies).

408. See id. art. 4(2)–(4) (providing that intermediaries are not allowed to pay or accept any remuneration or benefit for routing investors’ orders to a particular crowdfunding offer in their or a third party’s platform).

409. Id. art. 5.

410. Id. art. 6(2).

411. See id. art. 8(2) (requiring that outsourcing of any operational functions may not materially impair the platform’s internal controls or impair ESMA’s ability to monitor the platform’s compliance with its obligations).

412. Id. art. 9.

413. See id. art. 7 (stating that the provisions include, for example, that platforms must maintain and operate effective internal rules to prevent conflicts of interest, platforms may not have any financial participation in any crowdfunding offer on their platform and may not accept as clients any of its employees, shareholders, or controlling persons; that all conflicts of interest, as well as the steps taken to mitigate any risks arising therefrom,
They are also responsible for providing prospective investors with a key investment information sheet and keeping it updated. The platform is also required to insert a risk warning in all key investment information sheets. Further, the intermediaries must keep all agreements and records related to their services for five years and provide clients with immediate access to these records at all times.

B. Provisions relating to Sellers of Securities

Unlike the JOBS Act and Ley 5/2015, the proposed Regulation has virtually no provisions directly related to issuers seeking to list their securities for sale with an intermediary. The only such provision appears to be Article 16, which provides that the key investment information sheet about proposed crowdfunding transactions must be drawn up by the issuer and must contain the specific information set forth in the Annex to the proposed Regulation. Issuers are also required to complement or amend the key investment information sheet in order to correct any material omissions, mistakes, or inaccuracies identified by the platform. The lack of provisions that seek to hold issuers liable for fraud or misrepresentation is striking.
The proposed Regulation requires that all information that intermediaries provide to clients or potential clients about themselves and any proposed services or investments, including the nature of risks associated therewith, is clear, comprehensible, complete, and correct. This information must be provided before any potential client enters into a crowdfunding transaction.\textsuperscript{421}

Although the provisions of the proposed Regulation are similar to those of the U.S. and Spanish legislation, they include several noteworthy provisions. First, before giving prospective investors access to crowdfunded offers, the platform is required to assess whether and which crowdfunding services offered are appropriate for the investors.\textsuperscript{422} This assessment involves consideration of the prospective investor’s general knowledge of risk in investing and particular knowledge of risk in crowdfunding based on the investor’s knowledge and experience.\textsuperscript{423} How this assessment is to be undertaken is unclear from the proposed Regulation. If the platform determines that the prospective investor has insufficient knowledge and experience of the risks involved in crowdfunding transactions, it must inform her that their services may be inappropriate and give a warning of the risks involved. How such a warning is to be given to the prospective investor is unclear, and a potential investor may still invest in the site after receiving this warning. This requirement goes beyond those set forth in the U.S. and Spanish legislation.\textsuperscript{424} Another innovative provision requires platforms to offer the prospective investors and investors the ability to use a simulation in order to determine their ability to bear loss as a result of their proposed investments.\textsuperscript{425}

The proposed Regulation has three unique provisions of interest. The first, which allows platforms to exercise discretion in investing on behalf of its clients,\textsuperscript{426} does not exist in either the U.S. or Spanish systems and is highly problematic. Given the nature of crowdfunding, this authority may be subject to abuse and increase the investment risk to unsophisticated investors, especially given the lack of provisions establishing liability for

\textsuperscript{421} Id. art. 14.
\textsuperscript{422} Id. art. 15(1).
\textsuperscript{423} See id. (providing that crowdfunding platforms are required to make this assessment for each investor every two years).
\textsuperscript{424} Id. art. 15(4).
\textsuperscript{425} Id. art. 15(5).
\textsuperscript{426} See id. art 4(4) (providing that crowdfunding service providers may “exercise discretion on behalf of their clients with respect to the parameters of the clients’ orders”).
issues or intermediaries in the proposed Regulation. The requirement that
the platform investigate the suitability of potential investors, which goes
beyond the requirement of both the JOBS Act and Ley 5/2015, is also
likely to be controversial. It requires the platform to go beyond the investor’s
representation about investor knowledge and understanding of risk and
requires an assessment of the investor’s suitability for investing in
crowdfunded transactions. Although this proposition sounds desirable from
a consumer protection perspective, it is problematic. The proposed
regulation does not state how this assessment is to be done, and what criteria
— objective or subjective — it must be based on. This assessment is likely
to be expensive and time-consuming, and platforms will not, in all
likelihood, be able to recoup their expense in complying with this
requirement. Moreover, since the proposed Regulation does not forbid
unsuitable investors from investing in crowdfunded transactions, its value as
a consumer protection measure is limited. The simulation requirement, however, is not only innovative, but worthy of being considered by both the
United States and Spain. A computer-generated graph simulation would
probably more vividly illustrate the risk of investing in crowdfunded
securities than a series of general disclosures about the risk of investing in
crowdfunded transactions. Given current computer technology, this
simulation should be relatively simple and inexpensive to create and
implement.

The proposed Regulation is meant to supplement, not supplant, national
crowdfunding legislation. For those EU member states with no
crowdfunding legislation, the Regulation may serve as a way to introduce
crowdfunding to their legal systems. Many of its provisions are similar to
those of the JOBS Act, Regulation CF, and Ley 5/2015. Others, worsen,
rather than vet, the accuracy and completeness of the information posted
online. Intermediaries are allowed to open discretionary accounts and are
allowed to outsource most, if not all, of their operational functions. As noted
above, the potential for a platform to engage in acts of fraud, negligence, and

427. Compare supra notes 190–92, 216 and accompanying text (describing and
analyzing the JOBS Act’s consumer crowdfunding investor suitability requirements),
with supra notes 317–19 and accompanying text (describing and analyzing Ley 5/2015’s
crowdfunding investor suitability requirements).
428. See supra Part IV.B.ii.c. (discussing investor motivation).
429. See EU Proposed Reg, supra note 401, art. 15(5).
430. See EU Proposed Reg, supra note 401, at 2, 8.
431. See id. at 2–3. See generally Macchiavello, supra note 417 (describing the
current regulatory environment around crowdfunding, including the JOBS Act and Ley
5/2015).
abuse is very high under these circumstances.

Although intermediaries are required to assess the suitability of potential investors to a much greater degree than the United States or Spain (and it is unclear from the proposed Regulation what information this vetting encompasses), a finding that the potential investor is unsuitable for a crowdfunding investment does not prevent that individual from investing. In this case, what is the purpose of investor vetting if its results have no effect? However, the proposed Regulation’s requirement that investor education include computer-generated simulations is innovative and worthy of consideration.

Unlike its Spanish and U.S. counterparts, the proposed Regulation has very few provisions directly related to issuers.\(^{432}\) Notably, although issuers are responsible for the completeness and accuracy of the information about them posted on the intermediary’s site, there is no provision making issuers liable for fraud or misrepresentations.

Lastly, it is striking that the proposed Regulation does not contain any of the investor protection provisions set forth in its United States and Spanish counterparts.\(^{433}\) This defect must be remedied before the Regulation is finalized.

VII. CONCLUSION

As we have seen, raising capital through crowdfunding transactions is by its nature a risky endeavor and presents a series of issues that affect startup companies seeking financing, as well as potential investors and the state, acting regulator of the investment markets. These issues are difficult to resolve because government regulators are faced with two contradictory missions: facilitating the acquisition of capital by businesses and protecting investors and the market from fraud and manipulation. Given the nature of crowdfunding and its actors, fulfilling both missions is extremely challenging.

On one hand, in order to facilitate the acquisition of capital by startup businesses through crowdfunding, regulators must make the process simple, quick, and inexpensive. This would involve simple forms, limited disclosures, and low fees. Protecting investors and the market from fraud

\(^{432}\) See EU Proposed Reg, supra note 401, at 8–10 (discussing who the proposed regulation’s provisions apply to and how it addresses money laundering and fraud concerns).

and manipulation, on the other hand, may be achieved by educating investors, requiring full disclosure of all material facts regarding the company and the offering, establishing time constraints on sales to allow both potential investors and the market time to absorb and evaluate the disclosed information and appropriately price the offering, or limiting investments for small investors. Unfortunately, utilizing these investor protection mechanisms adds time, cost, and complexity to the capital acquisition process.

The easier a regulator makes it for a startup company to raise capital by deregulating the process, the less protection investors have against fraud and manipulation. Conversely, the more protection investors have against fraud and manipulation, the higher the cost and difficulty of raising capital. These two interests need to be balanced, so that companies face a capital acquisition process that provides them with reasonable access to capital, and investors have an appropriate level of protection against fraud and manipulation. This is the crowdfunding conundrum.

A. Solving the Crowdfunding Conundrum?

The crowdfunding conundrum has no solution. The major issue is whether and how well the JOBS Act and Regulation CF, Ley 5/2015, and the EU Proposed Regulation have balanced the risks and problems that occur in crowdfunding transactions.

The answer to this question with regard to the JOBS Act and Regulation CF is mixed. Issuers complain that the costs, regulatory burdens, and potential liability make crowdfunding an unattractive proposition. Other than the cost issue, these complaints are unfounded. The treatment of intermediaries is, however, problematic. They are not required to have minimum capital, insurance, experience, and expertise, which can result in the registration of less than adequate firms on platforms. The vetting of investors, issuers, and their principals imposes substantial compliance obligations, and it is essentially outsourced to intermediaries without indicating how this must be done and what amount of vetting by the intermediary will protect it from liability. The protection of investors is also inadequate, because of Regulation CF’s sliding investment caps and its prohibitions against diversification and resale of crowdfunded investments. Lastly, the limitations on the communications channel that I discussed above are also an issue.

As I have noted, Congress and the SEC should consider the following changes to the Act and Regulation CF:

- Increase the maximum amount that can be raised in consumer
crowdfunding transactions from one million to two million dollars;
☐ Add minimum capitalization and insurance requirements to crowdfunding intermediaries;
☐ Clarify how the required vetting of investors and transactions will be undertaken while balancing the interests to be protected with the costs and effectiveness of the requirements to be adopted;
☐ Replace the sliding investment cap with a set and relatively low investment cap for unsophisticated crowdfunding investors and allow for the diversification of investments within this cap;
☐ Reconfigure investor educational materials so that they require investor interaction and consider the use of computer graphics and simulations in these materials;
☐ Consider opening a portion of the communications channel administered by the intermediaries to non-registered potential investors who might have relevant information concerning the company or the issue;
☐ Consider adopting a shareholder’s bill of rights similar to that of Ley 5/2015.