Financing the New Innovation Economy:

Making Investment Crowdfunding Work Better for Startups and Investors

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Executive Summary

The Jumpstart Our Business Startups Act (JOBS Act) was signed into law by President Obama in 2012 to great fanfare. By facilitating new forms of startup fundraising, it offered the potential to boost entrepreneurial activity, drive capital to underserved entrepreneurs, and allow everyday investors to participate in the startup economy. While many of the JOBS Act's provisions have already been rolled out with considerable success, its most heralded achievement—investment crowdfunding for non-accredited investors under Title III—has yet to be implemented, stuck in a prolonged Securities and Exchange Commission (SEC) rulemaking proceeding.

While the increasing agitation with the SEC's inaction is understandable, new market developments in the three years since the JOBS Act passed provide evidence that several basic adjustments to the investment crowdfunding framework established under Title III of the JOBS Act and the SEC's proposed rules will help create a more vibrant non-accredited investor crowdfunding market. Since 2012, related crowdfunding markets in the U.S. and abroad have taken off while operating under regulatory regimes more flexible and open than Title III.

In an effort to protect novice investors from significant losses, policymakers inserted several costly disclosure obligations and limitations on issuers looking to raise funds through Title III. As developments in related crowdfunding markets have shown, such rules are likely unnecessary to protect investors and may end up limiting the potential scope of the investment crowdfunding market and actually increasing investor risk. In the U.S., rewards-based crowdfunding platforms have become an ever greater source of startup capital for entrepreneurs, and accredited investors have taken advantage of the investment crowdfunding marketplace that developed from Title II of the JOBS Act. Internationally, investment crowdfunding is legal for both retail and sophisticated investors alike in the U.K., and the market for crowdfunded securities there has grown exponentially. In each of these markets, fraud has been virtually non-existent, even though issuers are subject to few, if any, of the disclosure requirements that typically accompany public capital raises.

Considering investment crowdfunding's potential to make the startup economy more efficient and equitable, policymakers would be wise to learn from the experience of these ancillary markets and modify the proposed regulatory approach to non-accredited investor crowdfunding. To help improve Title III, this paper identifies important lessons from other forms of crowdfunding and proposes several key changes to the existing framework:

Policy Recommendations:

1. **Reduce disclosure requirements**
   Existing crowdfunding markets in the U.S. and U.K. have proven resistant to fraud and abuse, even under a lighter touch regulatory framework. Current statutory disclosure obligations are overly burdensome and their costs are not proportionate to the investor protections they may provide.

2. **Increase aggregate funding limits**
   The fundraising limits established by the JOBS Act do not appear to reflect startups' actual capital needs. New evidence from markets in the U.S. and U.K. suggests that the current statutory cap of $1 million is too low and will exclude a large swath of potential issuers.

3. **Explicitly authorize intermediaries to curate and provide information about issuers**
   The SEC has interpreted the JOBS Act to prohibit funding portals from curating offers by subjectively deciding which issuers can seek funds through their sites. Developments in similar U.S. and U.K. markets show that this approach is misguided and would bar portals from providing an additional level of screening that could better protect investors.

4. **Allow entities other than companies to raise funds**
   Innovative special purpose vehicles such as venture funds are not eligible for the crowdfunding exemption under Title III, though similar crowdfunded venture funds have already developed in the U.K. These sorts of investment vehicles could help non-accredited investors better diversify their portfolios and could consequently make investment crowdfunding safer and more profitable for investors.

5. **Allow portals to take equity stake in companies**
   Allowing portals to take equity stakes in issuer companies will help make it more economically viable for portals to list the seed-stage companies that would likely benefit most from expanded capital access. To discourage unscrupulous behavior, this allowance should be coupled with robust financial interest disclosure requirements.

6. **Include a "testing the waters" provision**

   Existing markets in the U.S. and U.K. have shown that about two-thirds of crowdfunding campaigns fail to reach their funding goals. Issuers should be permitted to communicate with potential investors to gauge interest before incurring burdensome filing and preparation costs.

7. **Modify investor limits**

   Evidence from the U.K. crowdfunding market suggests that caps on non-accredited investor participation are unnecessary and overly restrictive. Hard caps included in the JOBS Act will prevent sophisticated, experienced investors that nevertheless fall short of the SEC's accredited investor thresholds from participating in investment crowdfunding to the extent that they would like.

The Promise of the JOBS Act

When the JOBS Act passed in 2012 with overwhelming bipartisan support, the startup community held high expectations for the bill's potential to open up new sources of startup capital and usher in a new era of innovation and entrepreneurship. The JOBS Act has, for the most part, met its goal of boosting capital formation. Title I's IPO "on-ramp" has been credited for helping spur increased IPO activity in the past few years.[1] Title II has enabled a novel method of financing, allowing startups to use digital tools to communicate with and raise money from high-net worth investors. And the recently-enacted Title IV could open up new avenues to capital for growing companies and allow everyday investors to take part in the startup economy. However, the JOBS Act's most promising achievement—investment crowdfunding under Title III —has been stalled in the SEC rulemaking process for more than three years.

While this delay has been frustrating to many, it has also provided ample time to observe and learn from the experiences of similar online fundraising markets to determine whether the regulatory structures of Title III are likely to enable safe and profitable investment crowdfunding activity. Unfortunately, the available evidence from these related markets suggests that some significant changes to Title III and the related SEC rules are necessary if investment crowdfunding in the U.S. is to reach its full potential.

In this paper, we first revisit why investment crowdfunding is so promising for the growth of the innovation economy. We then delve into what systems and rules have worked well in similar crowdfunding markets and explain what these regimes can teach us about the optimal structure for investment crowdfunding in the U.S. Finally, we draw upon the rules governing these successful crowdfunding regimes to propose legislative changes to Title III that will enable the investment crowdfunding market to flourish.

Why Crowdfunding

Startups and our Nation's Economy

Small businesses are America's driving economic force. They account for 48.5 percent of the nation's private sector employment and are responsible for virtually all net job growth.[2]

[1] Steve Case, "Hey, Washington, the JOBS Act You Passed Is Working," *Wall Street Journal*, Apr. 2, 2014, http://www.wsj.com/articles/SB10001424052702304418404579469312174499556.
[2] Small Business Administration Office of Advocacy, "Frequently Asked Questions," (2014), https://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf.

However, new firm creation has slowed over the past three decades.[3] While this trend has been reversing in recent years, the economic importance of the startup sector warrants exploring all available policy options to encourage the formation of new businesses.

Starting a company requires a myriad of inputs, but access to capital remains an entrepreneur's greatest challenge in getting a new business off the ground. Fortunately, just as technological advances have opened up new avenues for communication and creativity, they have also opened up new sources of capital for entrepreneurs. Rewards-based crowdfunding platforms like Indiegogo and Kickstarter have launched Americans' artistic, charitable, and even small business ventures all across the country. Investment crowdfunding platforms enabled under Title II of the JOBS Act are also affording emerging companies access to a wide new pool of accredited angel investors. However, these new tools are limited in their impact insofar as companies can only raise capital from high-net worth investors (Title II) or donors that provide funds in exchange for material goods (rewards-based crowdfunding). Investment crowdfunding—soliciting capital from a wide pool of relatively anonymous backers in exchange for equity or debt interests in an enterprise—will maximize the fundraising potential of the Internet by connecting an enormous pool of startups and potential funders.

Financing a New Generation of Entrepreneurs

The lack of diversity in American tech entrepreneurship demonstrates that existing startup financing options are not meeting the capital needs of potential new business leaders.[4] Because investment crowdfunding will allow millions of new people to easily provide capital to startups, it has the unique potential to drive much-needed capital to underrepresented groups of entrepreneurs.

Perhaps the most obviously underserved group of entrepreneurs consists of those who lack adequate personal and family finances. A recent study from the Kauffman Foundation that surveyed some of the nation's fastest growing companies reported that over 67 percent of these firms tapped into personal savings to finance their ventures and over 20 percent

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[3] JIm Clifton, "American Entrepreneurship: Dead or Alive?" *Gallup Business Journal*, Jan. 13, 2015, http://www.gallup.com/businessjournal/180431/american-entrepreneurship-dead-alive.aspx.

[4] A 2013 paper from University of California, Berkeley economists Ross Levine and Rona Rubenstein found most entrepreneurs are white, male, and highly educated. *See* Ross Levine and Yona Rubinstein, National Bureau of Economic Research, "Smart and Illicit: Who Becomes an Entrepreneur and Do They Earn More?" NBER Working Paper No. 19276 (2013), http://www.nber.org/papers/w19276.pdf.

depended on support from family.[5] For many people, financial sources like these are not realistic options.

Traditional sources of growth capital are also highly concentrated to just a few geographic areas. In 2014, 30 percent of venture capital deals and 46 percent of total dollars invested nationwide took place in Silicon Valley.[6] Moreover, almost 75 percent of 2014 venture capital investments were limited to businesses in California, Massachusetts, and New York, leaving only 25 percent of venture capital dollars in the other 47 states. Unsurprisingly, the regions and states where funding is most concentrated have the greatest number of venture capital firms.[7]

Online crowdfunding platforms make proximity between investors and issuers far less relevant. A 2011 study of crowdfunding deals found that the majority of investments were from individuals 3,000 miles away from the issuer, whereas most investors in traditional VC deals reside within 70 miles of the issuer.[8] Unsurprisingly, entrepreneurs that live outside traditional tech hubs are currently far less likely to secure funding than California- or New York-based peers.

Finally, it's been well-documented that women and minorities are vastly underrepresented among CEOs and founders.[9] This disparity is similarly pronounced when it comes to funding. On the investor side, women make up only 18 percent of angel investors and 11 percent of venture capitalists; non-whites comprise only 4.5 percent of angel investors and less than 13 percent of venture capitalists.[10] The lack of diversity amongst startup investors is reflected in the pool of entrepreneurs. Minority- and female-owned companies are 22.2 percent and 18.7

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[5] Jason Weins and Jordan Bell-Masterson, Ewing Marion Kauffman Foundation, "How Entrepreneurs Access Capital and Get Funded," (2015), http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/how-entrepreneurs-access-capital-and-get-funded.

[6] Ben Veghte, National Venture Capital Association "U.S. Venture Capital Investment Spanned 160 Cities in 2014 - NVCA," (2015), http://nvca.org/pressreleases/u-s-venture-capital-investment-spanned-160-cities-2014.

[7] National Venture Capital Association and PricewaterhouseCoopers, "Venture Capital Dollars and Deals by State, 2009-2014," http://ssti.org/blog/useful-stats-venture-capital-activity-capitagdp-state-2009-2014.

[8] Ajay K. Agarwal, Christian Catalini, and Avi Goldfarb, National Bureau of Economic Research, "The Geography of Crowdfunding," (2011), http://www.nber.org/papers/w16820.

[9] Gene Teare and Ned Desmond, "Female Founders on an Upward Trend, According to Crunchbase," *TechCrunch*, May 26, 2015, http://techcrunch.com/2015/05/26/female-founders-on-an-upward-trend-according-to-crunchbase/#.kvmo8r:qaxW.

[10] Jeffrey Sohl, Univ. of N.H. Center for Venture Research, "The Angel Investor Market In Q1Q2 2013: A Sustainable Growth Continues," (2013), http://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/Q1Q2%202013%20Analysis%20Report.pdf; National Venture Capital Association, "Gender Wage Gap Remains Unchanged," (2011), http://www.diversityinc.com/medialib/uploads/2011/11/VentureCensus2011PRFINAL.pdf.

percent less likely to successfully raise a venture round, respectively, than companies owned by white males.[11] And, these minority- and female-run firms are significantly less capitalized than companies owned by white male counterparts. From 2011-2013, companies with a female CEO received only 3 percent of the total venture capital dollars distributed.[12] Similarly, in 2010, less than 1 percent of VC backed company founders were African-American.[13]

The inequitable disbursement of venture funds is not attributable to a lack of minority- or female- run businesses. In fact, from 2002-2007, the number of minority-owned firms grew four times faster than non-minority-owned firms, increasing by 46 percent while the number of non-minority businesses only grew by 10 percent.[14] During the period from 1997-2014, female firms saw similar growth, with the number of female-owned businesses increasing by 68 percent.[15] And while those female- and minority-owned businesses who do receive funding tend to do more with less,[16] they are often unable to access the capital necessary to scale their businesses. Having access to additional capital from a more diverse range of sources will likely drive needed funds to these businesses.

Rewards-based crowdfunding has already proven effective in providing capital to traditionally underfunded entrepreneurs. While women still tend to seek smaller raises than their male

[11] John Paglia, "The Effects of Private Equity and Venture Capital on Sales and Employment Growth in Small and Medium Sized Businesses," *Journal of Banking and Finance*, (2014), at 31, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2479574.

[12] Candida Brush, Arthur M. Blank Center for Entrepreneurship Babson College, "Women Entrepreneurs 2014: Bridging the Gender Gap in Venture Capital," (2014), http://www.babson.edu/Academics/centers/blank-center/global-research/diana/Documents/diana-project-executive-summary-2014.pdf.

[13] CB Insights, "Venture Capital Human Capital Report Card," (2010), https://www.cbinsights.com/blog/venture-capital-human-capital-report.

[14] Minority-owned firms grew by 46 percent over this time period, compared to only 10 percent growth in non-minority-owned businesses. *See* Sumiye Obuko, U.S. Dept. of Commerce Minority Business Development Agency, "The State of Minority Business Enterprises: An Overview of the 2007 Survey of Business Owners," (2015), http://www.mbda.gov/sites/default/files/State_Minority_Business_Enterprises_2007Data.pdf.

[15] American Express, "Women Flexing Their Economic Muscle, Starting More Than 1200 New Businesses Per Day, According to New Research," (2014), http://about.americanexpress.com/news/pr/2014/women-flex-economic-muscle-new-research.aspx.

[16] On average, men start their businesses with nearly twice as much capital as women ($135,000 vs. $75,000). This disparity is slightly larger among firms with high-growth potential ($320,000 vs. $150,000), and much larger in the Top 25 firms ($1.3 million vs. $210,000). *See* Susan Coleman and Alicia Robb, National Women's Business Council, "Access to Capital by High-Growth Women-Owned Businesses," (2014), https://www.nwbc.gov/research/high-growth-women-owned-businesses-access-capital.

counterparts on Kickstarter, they've also achieved their funding goals at higher rates.[17] The greater success that female entrepreneurs find in rewards-based crowdfunding as compared to traditional VC is perhaps not surprising considering women investors are more likely to fund women-led ventures than their male investor counterparts: according to one study, 40 percent of the funds of female investors were invested in projects by female entrepreneurs, while only 22.5 percent of the male investor funds went to female-led projects.[18] Though there is currently insufficient data to evaluate how underrepresented minorities fare on rewards-based crowdfunding platforms, the lack of racial diversity in the venture capital community suggests that underrepresented groups are also likely to find more success raising funds through rewards-based platforms than from traditional VC sources.

Simply put, a more diverse pool of funders leads to a more diverse pool of entrepreneurs. And, because online investment crowdfunding will allow for more diverse investor participation than any currently available funding options, a robust investment crowdfunding market could go a long way towards correcting the lack of diversity in America's startup economy.

Related Crowdfunding Markets: Lessons Learned

Investment crowdfunding as envisioned under Title III of the JOBS Act is a variation on current online fundraising protocols, many of which predate the JOBS Act of 2012. The most well-known of these—rewards-based crowdfunding—allows companies, organizations, and individuals to solicit monetary donations from the broader public in support of their projects, typically in exchange for early-release prototypes of products or similar perks. Kickstarter, the top U.S. rewards crowdfunding portal by volume, has by itself facilitated more than $1.5 billion in fundraising since its launch in 2009.[19]

Similarly, Title II of the JOBS Act authorized for the first time securities-based crowdfunding for accredited investors, which allows companies to use the Internet to solicit investments from high-net worth individuals. Since the SEC rules implementing Title II were finalized, a

[17] Dan Marom, Alicia Robb, and Orly Sade, "Gender Dynamics in Crowdfunding (Kickstarter): Evidence on Entrepreneurs, Investors, Deals and Taste Based Discrimination," (2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442954.
[18] Dan Marom, Alicia Robb, and Orly Sade, "Gender Dynamics in Crowdfunding: Evidence on Entrepreneurs, Investors, and Deals from Kickstarter," (2013), at 4, http://funginstitute.berkeley.edu/wp-content/uploads/2013/11/Gender-Dynamics-in-Crowdfunding.pdf.
[19] Kickstarter, "Stats," last accessed Aug. 8, 2015, https://www.kickstarter.com/help/stats.

more exclusive—though rapidly growing—investment crowdfunding market for accredited investors has taken off in the United States.

While investment crowdfunding in the U.S. for non-accredited investors has not yet been legally authorized, other countries have already established crowdfunding markets for retail investors. In 2011, the U.K. legalized crowdfunding for all investors, spurring the development of a multi-billion dollar financial market.

Each of these models (see Table 1)—rewards-based crowdfunding, Title II investment crowdfunding, and U.K. investment crowdfunding—offers practical and empirical lessons applicable to formulating an effective regulatory framework for Title III investment crowdfunding. Below, we describe and analyze results from each of these corollary markets to consider how policymakers should restructure the proposed Title III crowdfunding framework to ensure the viability of a functioning market for widely crowdfunded securities.

Crowdfunding Type	Year Established	Fundraisers / Issuers	Type of Returns	Backers/Funders	Regulatory Context / Requirements
Rewards and Donation Crowdfunding	2008 - 2009	Individuals, organizations and companies	None or rewards	Anyone	Subject to consumer protection laws
Title II Investment Crowdfunding	2013	Companies	Equity	Accredited Investors	Subject to Securities laws, SEC rulemaking
Title III Investment Crowdfunding	TBD	Companies	Equity	Anyone	Subject to Securities laws, SEC rulemaking
U.K. Investment Crowdfunding	2011	Companies	Equity	Anyone	Subject to Financial Conduct Authority rules
Intrastate Crowdfunding	2011 (Kansas)	Companies	Equity	Anyone residing in state of listing company	State Securities Regulators

Table 1: Crowdfunding Models

Rewards and Donation-Based Crowdfunding

Background

Rewards and donation-based crowdfunding platforms such as Kickstarter, Indiegogo, and Fundable have become part of a new digital landscape for entrepreneurs, artists, and inventors to promote and fund their ideas.[20] Unlike the investors in securities-based crowdfunding, contributors to these crowdfunding campaigns receive no financial returns in exchange for their funds; instead backers donate to campaigns for altruistic reasons or, commonly, in exchange for "rewards" or gifts. Accordingly, these platforms and their participants are not subject to federal securities regulations.

This market has grown substantially in the past few years and is only expected to experience further growth in both the numbers of projects funded as well as the number of donors offering contributions. Some analysts estimate that in 2014 alone the rewards-based crowdfunding market was worth more than $4 billion.[21]

Most sites operate on an all-or-nothing model in which fundraisers only receive pledged funds if the amount of money donated meets or surpasses a predetermined goal. The rate at which fundraisers meet their stated funding goals varies greatly among sites. Of the most popular platforms, Kickstarter reports a 37.2 percent funding success rate,[22] while Indiegogo reports a 34 percent rate.[23] Many fundraisers have used successful campaigns to launch growing businesses. A recent study of the 50 highest funded projects through 2012 on Kickstarter found that 45 of the successful campaigns launched ongoing entrepreneurial firms.[24] For example, Oculus Rift, a virtual reality headset device, raised $2.4 million on Kickstarter and was acquired by Facebook only a year and a half later.[25] Pebble, a smartwatch manufacturer, raised over $20 million, and has since significantly expanded the company.[26]

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[20] Indiegogo was founded in 2008, Kickstarter in 2010, and Fundable in 2012.

[21] Crowdfunding.com, "The History of Crowdfunding," (2015) https://www.crowdfunder.com/blog/wp-content/uploaded-files/History-of-Equity-Crowdfunding.pdf.

[22] Kickstarter, "Stats," *supra* note 19.

[23] Darrell Etherington, "Kickstarter Reportedly Owns Indiegogo With Around 6X More Total Dollars Raised, Average Success Rate Much Higher," *TechCrunch*, Aug. 30, 2013, http://techcrunch.com/2013/08/30/kickstarter-owns-indiegogo-with-around-6x-more-total-dollars-raised-average-success-rate-much-higher.

[24] Ethan Mollick, "The Dynamics of Crowdfunding: An Exploratory Study," *Journal of Business Venturing, 29*(1), 1-16, June 23, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2088298.

[25] Josh Constantine, "Facebook's $2 Billion Acquisition of Oculus Closes, Now Official," *TechCrunch,* July 21, 2014, http://techcrunch.com/2014/07/21/facebooks-acquisition-of-oculus-closes-now-official.

[26] Darrell Etherington, "Pebble Time's $20M Kickstarter Campaign By The Numbers," *TechCrunch*, Mar. 29, 2015, http://techcrunch.com/2015/03/29/pebble-times-20m-kickstarter-campaign-by-the-numbers.

Rewards-based crowdfunding has empowered individuals and organizations from around the globe to pursue an incredible variety of projects and ventures. And what's especially remarkable about this relatively new financial market is that in light of its rapid growth, fraud remains extremely rare—the first lesson we observe and discuss further below. Nonetheless, those multi-million dollar success stories make up only a small proportion of the overall crowdfunding activity. While they showcase the potential for crowdfunding to fill substantial capital needs for some growing companies, reliance on a rewards-based model is ultimately insufficient for the range of potentially high-growth companies seeking capital. Below, we also explore the promise as well as the limitations of rewards-based crowdfunding.

Lessons Learned

Fraud and the Wisdom of the Crowd

To those unfamiliar with rewards-based crowdfunding—a system in which donors give relative strangers money in exchange for non-binding promises of pre-release merchandise without any detailed information about the fundraiser beyond the contents of short video presentations—it may seem hopelessly naive. Yet though rewards-based crowdfunding platforms require almost none of the financial disclosures associated with other forms of fundraising, fraud is exceedingly rare. Indeed, a 2013 World Bank report on crowdfunding found fraud to be virtually non-existent in rewards-based crowdfunding:

> Data from the major existing platforms show no successful fraud has been perpetrated through pledge-based crowdfunding platforms. Attempts at fraud have been made but were thwarted by the transparency inherent in crowdfunding: would-be investors asked questions and challenged the fraudulent postings, revealing the frauds and resulting in their removal from funding platforms within 24 hours.[27]

Other studies of fraud on rewards-based crowdfunding platforms showed similar findings. A 2014 paper analyzing projects on Kickstarter found that only 11 of the 381 projects in the study stopped responding to backers.[28] Assuming that all of these non-responding projects were fraudulent (as opposed to simply having failed to achieve their objectives), it equates to

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[27] Information for Development Program/The World Bank, "Crowdfunding's Potential for the Developing World," (2013), at 44, http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf.
[28] Mollick, "The Dynamics of Crowdfunding," *supra* note 24, at 11.

a fraud rate of under 3 percent. When considered on a per dollar basis, the rate of fraud was under 0.5 percent.[29]

Given the size of the rewards-based crowdfunding market, it is inevitable that some fraudulent or dishonest projects will get funded.[30] But, the rewards crowdfunding market has developed several mechanisms that have proven effective in mitigating fraud. The most valuable anti-fraud mechanism in rewards crowdfunding is the wisdom of the crowd itself. As the World Bank report noted, having potential backers publicly question and debate the merits of a campaign adequately ferrets out most dishonest campaigners and bad ideas. Without any formalized financial disclosures or business plans, the community of backers on rewards-crowdfunding platforms can effectively determine which campaigns are legitimate and which are fraudulent, relying largely on a series of simple proxies: campaigns with spelling errors are 13 percent less likely to succeed than those without such errors, and campaigns without accompanying videos are 26 percent less likely to succeed.[31]

While portals themselves have historically avoided injecting their opinions or oversight into the activities taking place on their sites, many rewards crowdfunding portals have instituted policies designed to mitigate fraud, from pre-listing algorithms designed to detect fraudulent activity[32] to a ban on using renderings of products that give a false impression of a product's feasibility and development progress.[33] But, perhaps because of the crowd's proven ability to accurately evaluate the quality of campaigns, some platforms have in recent years minimized their screening protocols in order to give more agency to the crowd. For example, Kickstarter modified its policies last year to remove a requirement that potential campaigns receive approval from "community managers" before listing.[34]

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[29] *Id*. at 12-13 ("[T]he projects that were not responding totaled just $21,324 in pledges, compared to nearly $4.5 million for the remaining projects").

[30] When fraudulent campaigns have been funded, traditional consumer protection organizations like the Federal Trade Commission and state Attorneys General have stepped in to address the malfeasance. *See, e.g.* Amy Schatz, "FTC Takes First Action Against a Fraudulent Kickstarter Campaign," *Re/code*, June 11, 2015, http://recode.net/2015/06/11/ftc-takes-first-action-against-a-fraudulent-kickstarter-campaign/; Taylor Soper, "Kickstarter Fraud: Washington Files First Consumer Protection Lawsuit Involving Crowdfunding," *GeekWire*, May 1, 2014, http://www.geekwire.com/2014/attorney-general-asylum-playing-cards-crowdfunded-project.

[31] Mollick, "The Dynamics of Crowdfunding," *supra* note 24, at 8.

[32] Rubin Slavia, "Trust and the Future of Open Funding," *Indiegogo Blog*, April 11, 2014, https://go.indiegogo.com/blog/2014/04/trust-and-the-future-of-open-funding.html.

[33] Charles Adler, Perry Chen, and Yancey Strickler, "Kickstarter Is Not a Store," *Kickstarter Blog*, September 20, 2012, https://www.kickstarter.com/blog/kickstarter-is-not-a-store.

[34] Joe Silver, "Kickstarter projects no longer need human vetting prior to launch," *Ars Technica*, June 4, 2014, http://arstechnica.com/tech-policy/2014/06/kickstarter-projects-no-longer-need-human-vetting-prior-to-launch/; https://www.kickstarter.com/blog/introducing-launch-now-and-simplified-rules-0.

Between portal-driven anti-fraud policies and community engagement, rewards crowdfunding has managed to grow exponentially in recent years without significant fraudulent activity, despite portals typically taking a hands-off role to campaign curation.[35] Without access to virtually any of the financial information contained in typical SEC filings, participants in rewards-based crowdfunding have been able to screen out most fraudulent activity. It is therefore unlikely that the stringent disclosure regime proposed in the Title III rules would materially decrease the risk of fraud in crowdfunding.

Inadequate Capital for Growing Companies

While fundraisers may treat rewards-based crowdfunding as an alternative to bank loans or venture funding, contributors to rewards-based crowdfunding campaigns do not typically view the money they pledge as investment activity. Indeed, in one study, fewer than ten percent of backers surveyed viewed their support as an investment,[36] instead thinking of rewards-based crowdfunding as charitable support for creative or interesting projects.[37] This laid-back attitude towards rewards crowdfunding as a financial tool is no surprise, considering the stakes for the typical rewards-based crowdfunding campaign are relatively low, and donors have almost no recourse for fundraisers that fail to deliver on their pledges. The typical rewards crowdfunding backer provides only $75, and the average successful raise brings in only $7,825.[38] More than 70 percent of the successfully funded Kickstarter campaigns raise less than $10,000.[39]

The structure of rewards-based crowdfunding makes it relatively difficult for startups to use rewards-based crowdfunding as a source of capital. Starting a technology company often requires more capital than the average crowdfunding campaign can provide.[40] The more donors a company must convince to contribute to a project, the more likely it is to fail.

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[35] While portal curation has proven to be relatively uncommon in rewards-based crowdfunding (likely because raises tend to relatively small, making high deal-flow critical to portal profitability), investment crowdfunding will likely be more capital intensive, making fraud more profitable to dishonest actors and increasing the need for portal curation.

[36] As demonstrated by the negative reaction many backers of Oculus Rift's Kickstarter campaign had to Oculus's $2b sale to Facebook, backers may even be angered when rewards-based crowdfunding is used to launch high-growth companies. See, e.g., Jillian Berman, "I Backed Oculus Rift On Kickstarter And All I Got Was This Lousy T-Shirt," *The Huffington Post*, Mar. 26, 2014, http://www.huffingtonpost.com/2014/03/26/oculus-rift-kickstarter_n_5034511.html.

[37] Peter Baeck, et al., Nesta and the University of Cambridge, "Understanding Alternative Finance," (2014), https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf.

[38] *Id*. at 24 (hereafter "Nesta Report"). By contrast, the average rewards-based crowdfunding campaign in the U.K. raises around $5,880. *Id.* at 10.

[39] Kickstarter, "Stats" *supra* note 19.

[40] According to Kickstarter, almost 10 percent of all successful technology-based campaigns bring in more than $100,000. *Id.*

Kickstarter “technology” campaigns—which tend to be more capital intensive—fail at a higher than average rate: only 20.6 percent of technology campaigns successfully fund, compared to around 38.4 percent of non-technology campaigns.[41] As a likely consequence, technology campaigns account for only around 3 percent of all successful campaigns on Kickstarter.[42]

Not only do increased capital requirements make startups less likely to use rewards-based crowdfunding, but the necessity to provide rewards to potential donors also drastically limits the scope of the companies for which rewards-based crowdfunding is a viable source of capital. Really, only those startups that produce some kind of tangible product of modest price are likely to find success in the rewards-based crowdfunding space. The many startups that provide software, services, or high-cost products will find it difficult to properly incentivize donors.

In spite of these limitations, a growing number of startups now use rewards-based crowdfunding platforms for high-volume capital raises. On Kickstarter, between its launch in 2009 and June 2012, only 111 “technology” campaigns successfully raised more than $20,000 (accounting for 4.22 percent of all such raises), and none raised more than $1,000,000.[43] Since then, 1,627 technology campaigns have raised more than $20,000 (12 percent of all such raises), and 38 have raised more than $1,000,000.[44]

Clearly, since the JOBS Act passed in 2012, startups have become increasingly interested in and dependent upon rewards-based crowdfunding as a source of capital, and investors/donors have become more interested in funding technology companies through crowdfunding campaigns. The recent history of rewards-based crowdfunding for startups reveals that raising capital from a number of distant investors via the Internet is a promising and increasingly powerful fundraising tool for entrepreneurs. But because of structural limitations in the rewards-based crowdfunding market (low-volume average contributions and the need to provide material rewards), harnessing the power of the crowd to raise capital will remain unavailable to many entrepreneurs unless other forms of crowdfunding become available to non-accredited investors.

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[41] *Id.*
[42] *Id.* In comparison, “music” campaigns account for nearly a quarter of all successful campaigns.
[43] Kickstarter, “Kickstarter Stats,” June 21, 2012, https://web.archive.org/web/20120621212851/http://www.kickstarter.com/help/stats.
[44] Kickstarter, “Stats,” *supra* note 19.

Title II Crowdfunding for Accredited Investors

Background

When Title II of the JOBS Act went into effect in September 2013 with the promulgation of final SEC rules, a new form of crowdfunding became possible. With the easing of a long-standing ban on general solicitation, companies can now advertise private investment opportunities to the the crowd, though this exemption—known as 506(c)—is only valid if the company's ultimate backers are all accredited investors.[45] This new exemption has spurred the proliferation of online investment platforms that in many ways resemble their rewards and donation-based counterparts. These new platforms seamlessly connect accredited investors around the country with companies raising capital.

Since late 2013, hundreds of platforms have entered this market to serve as intermediaries between private companies and interested investors, and a subset of those have gained significant traction among investors and issuers.[46] By some estimates, there has been approximately $765.15 million in recorded capital commitments since the passage of the JOBS Act.[47] Data from the top ten equity crowdfunding platforms through 2014 showed over $203 million had been invested in over 460 startups.[48] These figures are projected to grow at pace with the wider crowdfunding industry.

The types of entities raising funds on Title II platforms differ substantially from those on Kickstarter or Indiegogo, where a larger proportion of projects are artistic endeavors or for one-off consumer products. Title II issuers are more highly concentrated in the financial and technology sectors.[49] Companies soliciting investment through Title II platforms also generally aim to raise far more than the typical rewards-based crowdfunding campaign. The average capital commitment per offering, based on data available from the top Title II crowdfunding platforms, is currently around $130,000.[50]

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[45] Under SEC rules, an accredited investor earns an individual income of more than $200,000 per year, a joint income of $300,000 with his or her spouse, or has a net worth exceeding $1 million. *See* U.S. Securities and Exchange Commission, "Investor Bulletin: Accredited Investors," (2013), http://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors.

[46] Charles Luzar, "OurCrowd Infographic: Equity Crowdfunding In 2014 & Beyond," *Crowdfund Insider*, April 1, 2014, http://www.crowdfundinsider.com/2014/04/34982-ourcrowd-infographic-equity-crowdfunding-2014-beyond.

[47] Crowdnetic, "Crowdnetic's Q2 Report: the Industry Continues to Grow," (2015), http://www.crowdnetic.com/reports/jun-2015-report.

[48] Luzar, "OurCrowd Infographic," *supra* note 46.

[49] *Id*.

[50] Crowdnetic, "Crowdnetic's Q2 Report," at 2, *supra* note 47.

In its short lifespan, Title II crowdfunding has already attracted sizeable capital commitments for growing companies and accredited investor participation continues to increase. Though the specific regulatory framework for Title II as set out by the JOBS Act and proposed SEC rules differs drastically from that of Title III, the only significant functional difference between Title II and Title III investment crowdfunding is Title II's restriction to accredited investors. Thus, understanding what's allowed this market to flourish so far can offer insight into how a robust Title III market should be formulated.

Lessons Learned

The Value of Curation

Because Title II of the JOBS Act is limited in its scope to providing new investment opportunities for accredited investors, the law requires issuers disclose only very basic company information in order to qualify for the exemption, unlike the pending proposed Title III requirements.[51] The mandatory disclosures in Title III are meant to help provide more comprehensive information to unsophisticated investors and prevent issuer fraud—a concern that is less salient for sophisticated, accredited investors, even if the definition is solely based on income rather than demonstrated financial knowledge. Yet despite these lightweight statutory requirements, Title II portals have created robust pre-listing due diligence mechanisms to ensure the deals they make available are viable, high-quality investment opportunities.

Title II platforms have a pecuniary interest in ensuring only the best potential investment opportunities are available on their sites. Their long-term sustainability depends on attracting issuers that will provide strong returns, and which will in turn attract more capital and draw more quality companies to the portal. Typically, high-quality, well-regarded platforms employ experienced teams of industry analysts and investment experts to thoroughly vet every prospective company that inquires about being listed.

Even for the accredited investors utilizing Title II-enabled portals, this additional portal-based filter for offerings is valuable. CircleUp, an online platform for consumer product companies, reports that they only accept "a low-single-digit percentage of companies" that apply to be

[51] 15 U.S.C § 77d.

listed on the platform after ample due diligence.[52] Another crowdfunding platform based in Austin, MicroVentures, wrote in a recent op-ed touting their platform, "At MicroVentures, we proactively perform two levels of due diligence before our investors review an opportunity to ensure that we are offering what we believe are high quality, curated opportunities."[53] And Syndicate Room, a U.K.-based investment platform that enables retail investors to fund ventures alongside well-known angel investors boast on the homepage of their site, "All opportunities have passed a thorough check at the hands of our investment team before they are listed on our platform,"[54] as one of the top three reasons to invest in their companies.

Allowing Title II portals to curate offerings not only helps to increase investor safety through pre-listing vetting, it also helps facilitate a diverse array of business models that will better serve investor needs and interests. The current range of Title II portals include syndicate-led models whereby investors fund businesses alongside well-known, credible angel investors; industry-specific models that allow portals to capitalize on their expertise in financing a given sector; portals that offer only convertible debt securities; and portals that focus exclusively on equity. Giving portals the flexibility to determine which issuers can list on their sites and on what terms contributes to the diversity, quality, and safety of the Title II ecosystem.

While Title II investors appear to prefer carefully curated portals, it is even more crucial that Title III portals—those serving less experienced non-accredited investors—should also be permitted to curate offerings. Not only will non-accredited investors likely benefit from the extra layer of vetting, but permitting only Title II portals to curate and diversify their platforms may drive quality issuers to accredited investor platforms (as they will be more efficient and versatile), leaving non-accredited investors to choose amongst lower-quality, higher-risk options. Failing to provide Title III portals with the same flexibility afforded to Title II peers will potentially relegate Title III crowdfunding to second-tier status and prevent the non-accredited investor market from finding the success that accredited portals have seen in the past few years.

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[52] Ryan Caldbeck, "All Crowdfunding Capitalists Should Ask This Question," *MarketWatch*, Nov. 19, 2013, http://www.marketwatch.com/story/all-crowdfunding-capitalists-should-ask-this-question-2013-11-19.

[53] MicroVentures, "Why due diligence matters in equity crowdfunding," *VentureBeat,* May 25, 2013, http://venturebeat.com/2013/05/25/why-due-diligence-matters-in-equity-crowdfunding/.

[54] *See* https://www.syndicateroom.com/.

Investment Crowdfunding in the U.K.

Background

The investment crowdfunding industry in the U.K. was established around the same time as the passage of the JOBS Act in the U.S. But whereas non-accredited investors remain unable to participate in the U.S. crowdfunding market, investment crowdfunding in the U.K. has been open to both high-net worth and retail investors since its inception. As one of the more mature securities crowdfunding markets that allows participation from all investors, investment crowdfunding in the U.K. provides valuable lessons for the development of the U.S. market, especially with respect to rules designed to impact retail investors.

Since the U.K.'s regulatory commission, the Financial Conduct Authority ("FCA"), first proposed a legal framework for investment crowdfunding in 2013, the U.K. has seen exponential growth in the crowdfunding sector. In 2014, the U.K. market for crowdfunded equity grew by 201 percent, raising an estimated £84 million.[55] Business debt crowdfunding grew even more rapidly, increasing by 288 percent and raising an estimated £749 million.[56] By the end of 2015, crowdfunding in the U.K. is expected to be worth £4.4 billion.[57]

As with Title II crowdfunding in the U.S., companies utilizing equity crowdfunding in the U.K. raise an average of £199,095—far greater than in a rewards or donation-based crowdfunding campaign where the average amount ranges from £3,000 - £6,000.[58] Investment crowdfunding in the U.K. has been a success both in terms of market capitalization and, more importantly, the business growth this new source of capital has facilitated. The U.K. research organization, Nesta, reports that investment crowdfunding has enabled 47 percent of fundraisers to increase their profits and 60 percent to hire new employees.[59] Investors have also fared well: One popular U.K. debt-based platform, Funding Circle, reports an average annual return on capital of 6.8 percent,[60] while Syndicate Room recently saw its first crowdfunded company successfully complete an IPO.[61] Investment crowdfunding in the U.K.

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[55] Nesta Report, *supra* note 37, at 52.
[56] *Id*. at 28.
[57] Nesta, "Alternative Finance Market Set to Double in 2015," (2014), http://www.nesta.org.uk/news/alternative-finance-market-set-double-2015.
[58] Nesta Report, *supra* note 37, at 11.
[59] *Id*. at 53.
[60] Funding Circle, "Marketplace Performance," https://www.fundingcircle.com/statistics, last accessed Aug. 24, 2015.
[61] Daniel Hunter, "First Combined IPO Takes Place in London," *FreshBusinessThinking.com*, Dec. 23, 2014.

has also helped expand the pool of investors participating in startup finance. Nesta's report found that nearly two-thirds of equity crowdfunding investors in the U.K. are retail investors with no previous experience in early stage or venture capital investments.[62]

Because the U.K. crowdfunding market allows all investors to participate, regardless of income or net worth, it serves as perhaps the best indicator of what Title III crowdfunding could look like in the U.S.—assuming U.S. policymakers adopt a similar regulatory model. Here, we describe how the U.K.'s light touch regulatory approach has facilitated a thriving, fraud-resistant financial market and identify some of the rules that have made investment crowdfunding in the U.K. so successful.

Portal Freedom and Self Regulation

Compared to Title III and the SEC's proposed rules, the U.K.'s crowdfunding regime is quite spartan, particularly with respect to issuers' disclosure obligations. In short, the FCA does not require startups to release any specific financial information as a precondition to raising funds through crowdfunding portals. In contrast, Title III of the JOBS Act specifies a host of mandatory disclosures an issuer must provide in order to qualify for the crowdfunding registration exemption, including certified or audited financial statements.[63]

The available evidence to date suggests that the lack of government-mandated disclosures for crowdfunding issuers in the U.K. has not led to any increased fraud or other investor harm. Portals have a strong financial interest in ensuring that users have access to information sufficient to make them comfortable investing in the companies listed on the portal while keeping pre-listing disclosure/due diligence costs low enough for issuers to attract high-quality companies to their sites. Thus, rather than forcing issuers to spend money creating financial statements that are of limited utility to retail investors trying to determine whether a startup company's future growth potential is sufficient to merit investment, portals can limit issuer disclosures to the information that investors actually find helpful, like the company's projected growth strategy and the quality of its management team.[64]

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http://www.freshbusinessthinking.com/news.php?NID=24615&Title=First+%27Combined+IPO%27+Takes+Place+in+London#.VJIG0V4gPA.

[62] Nesta Report, *supra* note 37 at p.53.

[63] 15 U.S.C §77a.

[64] U.K. equity crowdfunding investors reported that the quality of a company's management team and its pitch were the two biggest factors in determining whether or not to back an issuer. Management and pitch materials were deemed "important" or "very important" by 96 and 97 percent of surveyed investors, respectively. *See* Nesta Report, *supra* note 37, at 53.

Without strict guidelines mandating particular disclosures, U.K. investment crowdfunding portals have crafted a variety of disclosure obligations for issuers on their platforms, allowing issuers and investors to determine what level of information is appropriate for their needs. Robust competition amongst portals for greater deal flow and investor activity gives these portals a strong incentive to experiment with different disclosure protocols to determine the optimal balance between cost to issuers and value to investors.

Not surprisingly, without mandated disclosure protocols, U.K. investment crowdfunding portals have nevertheless created proprietary, platform-specific processes around pre-issuance vetting, disclosure, and operating obligations. Crowdcube, for example, requires issuers to submit detailed financial histories including profit and loss statements and cashflow reports, in addition to a full business plan.[65] Seedrs requires very basic information from issuers, such as general information on the market, the company's business model, and its leadership—including description and details on the company and directors such as salary—all of which is self reported on the Seedrs online platform prior to campaign listing.[66] As its name suggests, Syndicate Room operates a syndicate model in which issuers must have an existing commitment from an angel investor of 25 percent of the fundraising target before listing on the site.[67] This requirement serves an additional investor protection function, as angel investors will likely require ample due diligence before investing in a startup.

To the extent that Congress added the mandatory disclosure obligations to Title III out of concern that portals would not establish adequate disclosure protocols on their own, the U.K. market has shown that such fears are ungrounded. Without any government-mandated disclosures, U.K. investment crowdfunding portals have already developed a variety of disclosure models that attempt to successfully strike a balance between attracting issuers and protecting investors.

Early Success, Without Disclosure

The FCA's decision to leave disclosure protocols up to portals does not appear to have compromised investor safety in any way. Though the rapid growth in the U.K. investment

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[65] Crowdcube, "Financial Forecasting Standards," (2015), https://files-crowdcube-com.s3.amazonaws.com/portal_id_1/Crowdcube_Financial%20Forecasting%20Standards%20May%202015.pdf.
Crowdcube, "Business Plan Content," (2015), https://files-crowdcube-com.s3.amazonaws.com/portal_id_1/Business%20Plan%20Content%20-%20A%20Quick%20Guide_May%202015.pdf.
[66] General details and web-based submission forms are accessible via a user account. Seeders. *See* https://www.seedrs.com/raise.
[67] Syndicate Room, "Frequently Asked Questions," (2015), https://www.syndicateroom.com/faqs.aspx.

crowdfunding market suggests that the system operates effectively and without significant fraud, it is difficult to assess at this time how profitable and safe equity crowdfunding will be for investors over the long term, as both the U.K. market and the companies funded through that market are relatively young. Whether funded through the crowd or VCs, startups fail at a high rate—though often not for several years. Data from the U.S. Small Business Administration (SBA) suggests that around half of all startups will survive for at least five years.[68] As such, while it is possible in the short term to determine the "safety" of equity crowdfunding investments in terms of the prevalence of fraud, it will take longer to determine whether such investments are "safe" in the sense of being a adequately profitable investment class for retail investors. Anecdotal evidence suggests that the U.K. equity crowdfunding market has experienced little to no fraud, despite the lack of government mandated disclosures, but it remains to be seen whether the crowd can adequately source quality investments without such disclosures.

The U.K. debt crowdfunding market is more mature than the equity crowdfunding market, and the structure of debt investments makes it easier to determine their performance in a shorter time frame. Zopa, the first U.K. peer-to-peer lending platform, reports a historical default rate of less than 1 percent for its loans.[69] Funding Circle, a peer-to-peer lending platform that focuses on small business loans estimates a bad debt rate of less than 2 percent, with an all-time average return to investors of 6.6 percent after fees and bad debts.[70] The historical performance of U.K. debt crowdfunding platforms suggests that portals are capable—independent of regulatory mandates—of crafting disclosure regimes that provide adequate information for investors without imposing ruinous costs on issuers.

Investors Setting Their Own Limits

In both the U.K. and U.S., regulatory authorities have sought to protect unsophisticated investors from excessive losses by limiting the amount of money they can invest via investment crowdfunding portals. The Great Recession—still fresh in the minds of U.S. legislators when the JOBS Act was passed—served as a powerful reminder that reckless investment activity can cause harms far beyond the imprudent investor's bank account. Still, because rules that cap investor participation in investment crowdfunding will limit the pool of

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[68] There is much debate over what constitutes startup "failure," rendering statistics about business failure of limited value. According to a study by Shikhar Ghosh of Harvard Business School, 30-40 percent of startups will ultimately fail to return any investor money.
Deborah Gage, "The Venture Capital Secret: 3 Out of 4 StartUps Fail," *The Wall Street Journal*, Sept. 20, 2012, http://www.wsj.com/articles/SB10000872396390443720204578004980476429190.
[69] Zopa, "Expected and Actual Defaults," (2015), http://www.zopa.com/lending/risk-data.
[70] Funding Circle, "Marketplace Performance," (2015), https://www.fundingcircle.com/statistics.

available capital for issuers, policymakers must work to ensure that any such limits do not restrict activity more than necessary. For example, as critics of the SEC's accredited investor definition have noted, it seems wholly unreasonable that a Ph.D student in economics should be subject to the same investment restrictions as the colloquial "widows and orphans" that such regulations are typically meant to protect.

Contrary to the U.S.'s strict means-testing protocol for determining who should be subject to investment restrictions, the U.K.'s crowdfunding-specific rules employ a more holistic test for determining whether an investor should be exempt from limitations on retail investor participation. Under the FCA's guidelines, a retail investor can only invest 10 percent of his or her net investable assets unless the investor has prior financial experience (a "sophisticated investor"[71]), is receiving investment advice from a financial professional, or has a sufficiently high net worth.[72]

Both "sophisticated" and non-exempt retail investors in the U.K. have approached investment crowdfunding quite responsibly. According to data from the Nesta, the average retail investor's equity crowdfunding portfolio is less than £4,000, while high net worth or "sophisticated" investors average slightly more than £8,000.[73] Around one-third of all investors participating in equity crowdfunding have invested less than £1,000.[74] In short, all investors in the U.K. average well below the theoretical maximum investment of £10,000.

While retail investors in the U.K. do not appear to be taking unreasonable risks in investment crowdfunding, they still tend to invest more in crowdfunding than they would be allowed to under the proposed Title III rules, which would cap non-accredited investor participation at between $2,000 and $10,000.[75] Considering equity crowdfunding in the U.K. has been most popular amongst unsophisticated and low-net worth investors—a full 62 percent of equity crowdfunding investors identified in one survey claimed to have no prior investment experience, and 79 percent had annual salaries of less than £100,000, below the threshold to qualify as high net worth investors[76]—failing to allow non-accredited investors to participate

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[71] Investors can either obtain "sophisticated" investor status by passing a financial knowledge test or can self-certify if they can attest to having other investment experience that would make them aware of the risks inherent in investing in illiquid securities. *See* Financial Conduct Authority Conduct of Business Sourcebook §§ 4.12.7-8.
[72] U.K. Finacial Conduct Authority,"Policy Statement 14/4," Mar. 2014, http://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf, at § 1.14.
[73] Nesta Report, *supra* note 37, at 53.
[74] *Id*. at 11.
[75] 15 U.S.C §77(d)(6)(B)
[76] Nesta Report, *supra* note 37, at 19-20.

fully in equity crowdfunding may unnecessarily limit the value of the U.S. market with little to no investor protection benefit.

State Crowdfunding

Finally, though non-accredited investor crowdfunding has stalled at the federal level, more than 20 states have recently passed laws authorizing intrastate investment crowdfunding. While the impact of these intrastate crowdfunding regimes is marginal to date, they speak to the widespread enthusiasm for the potential of nationwide non-accredited investor crowdfunding, particularly in states that lack sizeable venture capital markets.

Among the various legislative packages that states have passed, several important trends have emerged. First, nearly every state has set the funding limits to $1 million and some allow issuers to raise up to $2 million.[77] Given that intrastate crowdfunding raises are limited to in-state investors, these numbers are significant and suggest that a nationwide crowdfunding regime should set limits much higher than $1 million if it is to maximally serve all the companies and investors that wish to participate.

State legislatures have also intentionally limited the disclosure requirements necessary for companies to seek investments from the crowd in their states.[78] Most states require issuers to provide basic information about the issuing company and a handful do require some kind of ongoing reporting. However, recognizing that the expense of burdensome disclosure obligations could deter companies from participating in intrastate crowdfunding, the majority of states do not require issuers to submit annual reports, audited financial statements, or lengthy filings with state securities commissions.[79]

Hoping to spur business growth at home, state lawmakers have deliberately crafted crowdfunding exemptions to encourage participation by both issuers and investors. However, despite their best efforts, intrastate crowdfunding is inherently limited as these exemptions only apply to raising funds from investors within a given state. These in-state limits most likely account for the minimal intrastate crowdfunding activity that's taken place in the past few

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[77] Anthony J. Zeoli and Georgia P. Quinn, "Summary of Enacted Intrastate Crowdfunding Exemptions as of June 2015," https://crowdfundinglegalnews.files.wordpress.com/2015/01/int-summary-enacted-6-15.pdf.

[78] Carolyn P. Meade, "States Pilot Crowdfunding Initiatives to Increase Funding for Small Business," *Bloomberg Law*, June 18, 2013, http://www.bna.com/states-pilot-crowdfunding-initiatives-to-increase-funding-for-small-business/.

[79] Zeoli and Quinn, *supra* note 77.

years. While intrastate crowdfunding may be a viable option for a business with roots and customers in its own neighborhood, any high-growth company will need to solicit funds far beyond the investors in its state, especially if that company is based in a less-populated state. State crowdfunding will look different in Texas than it does in Idaho or Maine, for instance.

Action on the part of state legislatures has been heartening for crowdfunding advocates nationwide and the legal structures of these intrastate exemptions serve as useful proxies for improving federal rulemaking and legislation. However, only nationwide investment crowdfunding can make the kind of substantial economic impact that state lawmakers have hoped to see at home.

The Limits of Title III and Proposed Legislative Changes

While the provisions of the JOBS Act that have already been implemented have, on the whole, been fairly successful, evidence from the corollary markets that have developed since the passage of the JOBS Act suggests that the proposed Title III framework may not function as well as intended. In light of the above lessons learned, we suggest that more modified legislation will help to better structure the market for investment crowdfunding and ensure its long-term success for both everyday investors and the companies they support. These suggestions have been formulated based on our analyses of corollary marketplace activity described above and further, with the input of industry experts and practitioners who are closest to the day-to-day operations of both crowdfunding portals as well as growing startups.

At a high level, these proposals reflect three overarching lessons: first, that the market has proven resistant to fraud and abuse; second, that overly burdensome disclosure and auditing requirements could do more harm than good for investor protection; and finally, that any major statutory investor protection obligations should fall on the intermediaries, rather than the issuers. We hope these proposals will help guide legislative decisions in crafting an improved version of the JOBS Act's Title III crowdfunding provisions.

Proposed Legislative Changes

(1) <u>Minimize disclosure requirements</u>

Companies seeking to raise capital through equity crowdfunding under Title III of the JOBS Act are subject to a number of statutorily defined disclosure obligations meant to protect investors from fraud and financial loss. These obligations, including pre-issuance financial statement disclosures that must be certified or independently audited, depending on the size of the offer, impose significant costs on issuers. These costs make investment crowdfunding a foolish proposition for many companies, particularly those seeking to raise small amounts of money. Because limited access to seed capital is one of the most common barriers to entrepreneurship in the U.S.,[80] a crowdfunding regime that imposes prohibitive costs on low-value raises is particularly inefficient.

The first bill attempting to establish a registration exemption for crowdfunded securities in the U.S.—H.R. 2390 (the Entrepreneur Access to Capital Act)—did not require issuers to provide many financial documents to investors as a predicate to obtaining an exemption from registration,[81] and instead merely asked intermediaries to "take[] reasonable measures to reduce the risk of fraud."[82] But, as the bill morphed into what became the JOBS Act, legislators added a host of specific disclosure obligations. Under Title III, issuers seeking under $100,000 must provide certified financial statements to investors, issuers seeking between $100,000 and $500,000 must submit financial statements reviewed by independent accountants, and issuers seeking more than $500,000 must submit fully audited financial statements.[83] In addition to this initial disclosure requirement, successful issuers must submit annual reports in perpetuity, so long as the crowdfunded shares are outstanding.[84]

As many commenters have noted, such disclosure obligations are likely to make investment crowdfunding unattractive to quality issuers. According to the SEC's own analysis, estimated costs of compliance for crowdfunding will likely be significant. The SEC predicts that a company raising $50,000 through a Title III portal will incur costs of between $12,960 and $17,960 for the first year of the raise, depending on the fees the portal charges.[85] For each additional year, the issuer will incur an additional $4,000 for preparing mandatory annual

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[80] A recent Kauffman Foundation survey found that over 67 percent of startup founders tapped into personal savings to finance their ventures and over 20 percent received financial support from family members. Kauffman Foundation, "How Entrepreneurs Access Capital and Get Funded," *Entrepreneurship Policy Digest*, June 2, 2015, http://www.kauffman.org/~/media/kauffman_org/resources/2015/entrepreneurship%20policy%20digest/june%202015/how_entrepreneurs_access_capital_and_get_funded.pdf.

[81] The bill did require issuers seeking to raise between $1m and $2m to provide audited financial statements to investor. *See* Entrepreneur Access to Capital Act of 2012, H.R. 2390, 112 Cong. § 2(a)(6)(A)(ii).

[82] *Id* at § 4(a)(3).

[83] Crowdfunding, 78 Fed. Reg. 66428, 66521-66523 (proposed November 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232 et al. *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf.

[84] *Id.*

[85] *Id.*

reports. Assuming the portal's fees fall in the middle of the SEC's predicted range, an issuer seeking $50,000 would spend 31 percent of the raise on associated fees.

Commenters have also taken issue with many of the SEC's estimated costs, predicting that the actual cost of compliance will be much greater. For one, the SEC assumes without any justification that issuers themselves will bear 75 percent of the burden of preparing disclosure documents, with outside vendors handling the remaining work.[86] Considering most investment crowdfunding issuers are likely to be relatively inexperienced with SEC reporting requirements (and considering the liability regime for misstatements), it seems likely that the SEC is underestimating the amount of time issuers will spend on disclosures or outsource to vendors. Regardless of the time issuers actually spend preparing disclosure statements, the SEC's estimate does not account for the opportunity cost of diverting an entrepreneur's time from building a business to preparing disclosure forms.

According to comments from Seedinvest, a leading Title II investment crowdfunding platform, the costs of complying with the SEC's exemption qualifications would make investment crowdfunding financially irrational for even medium-sized raises.[87] Seedinvest estimates that companies seeking to raise less than $115,000 would have negative cash flow, and the cost of capital for issuers seeking to raise $300,000 would approach 40 percent, making investment crowdfunding all but impossible for companies seeking less than $350,000.[88] And, for companies seeking more than $350,000, the cost structure will make other forms of funding more profitable, leaving only those companies with no other options (i.e., the highest risk companies) seeking capital through investment crowdfunding. Even assuming the SEC's more optimistic analysis is correct, the high financial and opportunity costs associated with investment crowdfunding disclosures will make crowdfunding an unattractive source of funding for companies seeking seed capital.

Not only does Title III's financial statement disclosure obligation dramatically increase the cost of capital under investment crowdfunding, it does so without any real investor protection benefit. The small startup issuers most likely to seek relatively low amounts of capital through investment crowdfunding are the least likely to have significant financial histories to report. Thus, requiring companies to submit financial statements as a prerequisite to (and ongoing obligation for) investment crowdfunding will likely make investors less safe.

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[86] *Id.*
[87] Letter from Kiran Lingham, General Counsel, SeedInvest, LLC, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, Jan. 21, 2014, http://blog.seedinvest.com/wp-content/uploads/2014/01/s70913-134.pdf.
[88] *Id*. at 6-7.

Quality companies will seek cheaper alternatives for capital, and investors will not be privy to more useful financial information regarding the remaining lower-quality issuers using investment crowdfunding.

As the recent successes of rewards-based crowdfunding in the U.S. and investment crowdfunding in the U.K. show, the JOBS Act's mandatory disclosures provisions are not necessary for fraud prevention. The wisdom of the crowd and portals' vested interest in providing quality investment opportunities to users deter fraud far better than access to relatively uninformative issuer financial statements. As such, eliminating the JOBS Act's mandatory disclosure obligations (both pre-listing and ongoing requirements) and allowing portals to formulate their own protocols for vetting companies and educating investors will likely increase the efficacy and safety of investment crowdfunding in the U.S. While the mandatory disclosure of audited financial statements is unduly expensive for issuers of any size, it is particularly unnecessary for small raises and will likely only serve to make equity crowdfunding impossible for seed-stage companies.

However, if transferring responsibility to portals to determine what disclosures are appropriate for the customers that invest on their sites is impossible, new legislation should, at the very least, lower the disclosure burden on new companies and small issuers. Because a startup will, by definition, have almost no financial history to speak of, financial statements will be difficult to produce and virtually useless to investors. Any mandatory disclosures should reflect this reality.

A more sensible approach could entail requiring companies less than three years old seeking crowdfunded capital to fill out a form disclosure with more relevant and less onerous information, such as the company's projected future revenues, addressable market, capital structure, and burn rate. Or, for small volume raises, companies could disclose recent tax returns to the extent that any such returns exist. Ultimately, while new legislation removing mandatory issuer disclosures would be ideal in maximizing the potential of investment crowdfunding, any disclosure regime that does not require issuers to produce expensive and possibly irrelevant reports for investors will be an improvement on the current Title III framework.

(2) Increase aggregate funding limits

The fundraising limits established in Title III of the JOBS Act are necessarily somewhat arbitrary. Without any mature investment crowdfunding markets to draw from, Congress capped the crowdfunding exemption at $1 million per year, apparently believing that higher value raises are more likely to be fraudulent, as the value of defrauding investors increases. As a preliminary matter, there is no evidence from ancillary markets in the U.S. or U.K. suggesting that higher volume raises are in fact more likely to be fraudulent. Considering higher volume raises are more likely to garner more attention and scrutiny, it seems just as likely that bigger raises would be less prone to fraud. Nevertheless, new evidence from the Title II market and investment crowdfunding in the U.K. suggests that Title III's $1 million dollar limit will exclude a large swath of companies that would otherwise use Title III to raise funds, drastically curbing Title III's potential impact.

Title II crowdfunding platform EquityNet reported that the average fundraising goal for companies listing on its platform was just over $1.2 million in 2015 to date, up slightly from 2014's average of $1.16 million.[89] The history of investment crowdfunding in the U.K. tells a similar story. According to a report from U.K. research firm Beahurst, from 2011 to Q1 2014, the average U.K. equity crowdfunding deal raised approximately $336,000.[90] The difference between the average deal size in U.S. and U.K. equity crowdfunding is likely explained by the fact that U.S. crowdfunding is currently limited to accredited investors who are more likely to invest larger sums of money than the retail investors that make up a majority of U.K. crowdfunding participants. This makes small volume raises more viable in the U.K. than the U.S.[91] While a large majority of equity crowdfunding campaigns in the U.K. raise smaller amounts than the average U.S. Title II raise (91 percent of all U.K. equity crowdfunding deals raised less than £500,000 or around $780,000),[92] the 9 percent of U.K. campaigns that raised more than £500,000 represent around 35 percent or more of the total amount of capital brought in by equity crowdfunding raises from 2011 to 2014.[93] Thus, while Title III investment

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[89] Equity Net, "Crowdfunding Statistics," https://www.equitynet.com/crowdfunding-statistics.aspx.

[90] British Business Bank, "Equity Crowdfunding in the UK: Evidence from the Equity Tracker," (2015), http://british-business-bank.co.uk/wp-content/uploads/2015/03/230315-Equity-crowdfunding-report-final.pdf. Nesta reported similar results, pegging the average equity crowdfunding deal at approximately $310,000. *See* Nesta Report, *supra* note 37 at 11.

[91] *See supra* note 73 (U.K. retail investors average £4,000 portfolio, as compared to £8,000 for sophisticated investors; 62 percent of U.K. crowdfunding investors identify as retail investors).

[92] In comparison, data from one Title II platform shows that approximately 50 percent of U.S. equity crowdfunding issuers seek less than $500,000 in capital, and approximately 67 percent seek less than $1 million. Judd Hollas, Equitynet, "U.S. Equity Crowdfunding Activity Infographic," (2013), https://www.equitynet.com/blog/us-equity-crowdfunding-activity-infographic/. That investment crowdfunding in the U.K. enabled more small volume raises than U.S. Title II crowdfunding suggests that some combination of lower disclosure costs and greater retail investor participation (probably the two most salient differences between the U.S. Title II crowdfunding market and the U.K. investment crowdfunding market) makes investment crowdfunding more attractive for seed-stage capital.

[93] This figure is likely conservative, as it assumes that the 6 percent of deals that raised between £500,000 and £999,999 brought in an average of £750,000 and that the 3 percent of deals that raised £1 million or greater were limited to £1 million.

crowdfunding could likely have a greater impact on seed stage companies than more mature firms, evidence from Title II and U.K. platforms suggests that Title III's current $1 million raise limit could curb the potential of Title III crowdfunding by a third. To ensure that Title III investment crowdfunding achieves its full potential as a vehicle for startup financing, policymakers should increase the fundraising cap well above the current $1 million limit.

(3) <u>Explicitly authorize intermediaries to curate and provide information about companies</u>

Title III of the JOBS Act prohibits "funding portals" (crowdfunding intermediaries that are not registered broker-dealers) from offering investment advice.[94] The SEC rules interpreting this statutory restriction prohibit a funding portal from using "criteria based on an assessment of the merits or the shortcomings of a particular issuer or offering" to reject potential issuers that the portal deems likely to fail.[95] Essentially, the SEC's rules prohibit a portal from pre-screening companies that seek to raise funds from its site in order to weed out obviously bad investments. These rules proceed from the notion that, if a funding portal rejects a company because it subjectively believes the company is not likely to succeed, it is implicitly advising investors that the companies it has not rejected are likely to succeed, and thereby is impermissibly offering investment advice.

Preventing funding portals from helping winnow out unduly risky companies does not appear to serve any reasonable investor protection purpose. The risk that an unsophisticated investor would fund a dubious business seems far greater than the risk that such an investor would interpret a portal's inclusion of a particular issuer as a promise that the issuer will succeed. So long as a funding portal makes clear that the companies it chooses to list on its site are still highly risky, there is little reason to believe that portal curation would do anything other than protect investors by filtering out likely failures.

Even at the time the SEC announced its proposed Title III rules, many commenters questioned the wisdom of preventing funding portals from curating offers, and subsequent developments in other crowdfunding markets demonstrate even more clearly why rules barring portal curation are misguided. Most, if not all, of the top Title II crowdfunding portals curate their offerings, rejecting companies that they subjectively determine are likely to fail.[96] If the high-net worth investors that participate in Title II crowdfunding believe that pre-listing

[94] 15 U.S.C. § 78c (a)(80)(A). Intermediaries that are registered as broker-dealers can offer investment advice.
[95] 78 Fed. Reg. 66428 at 66486-66487.
[96] CircleUp, "Frequently Asked Questions," 2015, https://circleup.com/faq/#investors-q-how-does-a-company-get-listed-on-the-circleup-site.

curation is important, it's even more important for non-accredited investors under Title III who may lack the same financial sophistication. And, in the U.K., virtually all of the top crowdfunding sites—catering to both sophisticated and retail investors—pre-screen potential issuers for quality.[97]

Even though the wisdom of the crowd has proven effective in determining issuer quality in rewards-based crowdfunding, participants in the higher-stakes investment crowdfunding space value the additional security and quality that portal curation allows. In light of this new evidence, portals should be expressly permitted to subjectively analyze the merits of potential issuers and reject those deemed inadequate.

(4) Allow entities other than companies to raise funds

Portfolio diversification is one of the core principles of sensible financial management, particularly when investing in a risky and high-variance asset class like startups. Yet, because of a statutory limitation in Title III of the JOBS Act on which entities can raise funds through investment crowdfunding, non-accredited investors are unlikely to be able to properly diversify their investment crowdfunding portfolios. Under the JOBS Act, special purpose vehicles ("SPVs") are not eligible for the crowdfunding exemption.[98] Essentially, this means that non-accredited investors are limited to investing directly in startups and cannot pool money into a venture fund or other such vehicle for portfolio diversification. Considering the JOBS Act caps participation by non-accredited investors to between \$2,000 and \$5,000, it is unlikely that such investors will be able to adequately diversify their investments without using SPVs.[99] Allowing non-accredited investors to pool money into managed venture funds will help investors diversify their portfolios and also potentially limit investor risk by transferring the task of selecting profitable companies to fund managers who presumably have more experience than retail investors in valuing startups.

It's no surprise, then, that crowdfunded venture funds have taken off in the U.K. in the past few years, with several platforms offering customers the opportunity to invest in managed

[97] See, e.g., p. 17 *supra*.
[98] 15 U.S.C. § 77a.
[99] While some U.K. platforms allow minimum investments of £10, because companies prefer to have a smaller number of investors, the minimum investment on many platforms is high enough that non-accredited investors in the U.S. would only be able to put money into one company. Indeed, the average individual investment in U.K. equity crowdfunding campaigns is nearly £1,599. *See* Nesta Report, *supra* note 37 at 52.

funds rather than directly in individual startups.[100] While it remains to be seen whether venture funds will provide better returns to investors than direct investments, allowing venture funds and investors to test this model could help make investment crowdfunding in the U.S. safer and more profitable for non-accredited investors, which will in turn drive more capital into the sector, opening up more funds for startups. As such, Congress would be wise to modify Title III of the JOBS Act to allow SPVs to raise funds through the crowd by exempting them from regulation under the Investment Company Act of 1940.

(5) Allow entities to take equity stake in companies

Because funding portals play such an important role in the functioning of the proposed Title III investment crowdfunding system, the success of crowdfunding will depend in large part on whether portals have the proper incentives to provide quality investment opportunities for companies and investors alike. Since the startups that will most likely benefit from investment crowdfunding are by definition short on capital, they likely will not be able to afford to pay large fees for the privilege of listing through portals. This is a particular problem for companies seeking small amounts of capital through investment crowdfunding. Presumably, the effort required for a portal to list a company that is seeking $1 million is approximately the same as for a company seeking $10,000. As such, unless portals charge proportionally higher fees to companies seeking small amounts, portals will have a strong incentive to list only companies seeking large amounts of capital. But, charging issuers a high percentage of the fundraising goal for small campaigns will likely make the cost of capital too high for seed-stage companies—the very companies most likely to benefit from crowdfunding.[101]

Startups face this cash-compensation problem in a variety of other circumstances, and the most common way they compensate third parties without spending valuable monetary resources is through options grants. For example, in lieu of the higher salaries that large tech companies can provide, startups will often give employees shares in the company to make up for the lower salaries. Giving stock options to employees and vendors is also beneficial for the company insofar as it helps align employee incentives.

Allowing portals to take equity stakes in issuers will help make it more economically viable for portals to list seed-stage companies and will give portals an incentive to make sure the company succeeds. But, under Title III, portals are barred from having any kind of financial

[100] *See, e.g.*, Seedrs, "Types of Equity," (2015) http://learn.seedrs.com/guides/types-of-equity/ (fund campaigns).
[101] The SEC estimates that portals will charge issuers between 5 and 15 percent of the campaign goal. *See* 78 Fed. Reg. 66428 at 66581, FN. 918.

stake in issuing companies.[102] Though this provision was likely motivated by concern about the possibility of unscrupulous portals engaging in "pump and dump" schemes, such concerns could be obviated by obligating portals to fully disclose any ownership interest in issuing companies.

Ultimately, allowing portals to take equity in the companies they list will likely help make investment crowdfunding more accessible to seed-stage companies seeking low-volume raises from the crowd and will help align portal, company, and investor incentives. Whatever residual risk remains that portals will try to profit fraudulently can be mitigated through robust financial interest disclosures and the reputational effects of the crowd.

(6) Include a "testing the waters" provision

Because the JOBS Act requires issuers to spend money on disclosures prior to initiating an investment crowdfunding campaign—money that will go to waste if the issuer does not meet its campaign goal—Title III investment crowdfunding is a risky proposition for companies already short on funds. While both Title I (for companies pursuing IPOs) and Title IV (for companies raising funds under Regulation A) of the JOBS Act include "testing the waters" provisions that allow companies to gauge investor interest in their offerings before dedicating valuable time and money to filing with the SEC, Title III does not permit issuers to communicate with investors about their interest in offerings before incurring filing and preparation costs.[103]

The risk that Title III crowdfunding issuers will fall short of their funding goals and see no benefit from the money spent on pre-campaign compliance is quite high. In similar markets, crowdfunding campaigns fail at high rates. Around two-thirds of the campaigns on both rewards-based platforms in the U.S. and investment crowdfunding platforms in U.K. fail to reach their funding goals.[104] Assuming similar failure rates, Title III crowdfunding will likely be too risky to be sensible for most startups. Thus, according to the SEC's analysis, a company will have to spend between approximately $13,000 and $18,000 upfront for a one-in-three chance to raise $100,000.[105] Only companies that can afford to incur these upfront costs will

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[102] An intermediary must "prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services." 15 U.S.C. § 77a.

[103] 15 U.S.C. § 77c(b)(2)(E) and 15 U.S.C. § 77e (d).

[104] Kickstarter's campaign success rate is around 37 percent while the research organization, Nesta found the average success rate among several leading U.K. platforms is around 35 percent.

[105] Crowdfunding, 78 Fed. Reg. 66428 at 66521.

participate in crowdfunding, and even then, the low expected value of such raises will drive most quality issuers to less risky sources of capital.[106]

Given these relatively low success rates, allowing issuers to determine ahead of time whether their campaigns will succeed will help make investment crowdfunding a more sensible option for entrepreneurs. Including a "testing the waters" provision in Title III would help improve overall campaign success rates by deterring issuers who recognize their businesses aren't investor-ready and, therefore, also keep would-be investors from committing equity to potentially failure-prone campaigns. Such a provision will ultimately make crowdfunding far more valuable to issuers while likely enhancing investor safety.[107]

(7) Modify investor limits

To ensure that non-accredited investors don't put more money into equity crowdfunding than they can reasonably afford to lose, the JOBS Act limits how much money individuals can invest in crowdfunded securities each year. Investors with less than $100,000 annual income or net worth are limited to the greater of $2,000 or five percent of annual income or net worth, while investors with an annual income or net worth between $100,000 and $200,000 can invest up to ten percent of annual income or net worth.[108] Although capping non-accredited investor participation is a more sensible investor protection mechanism than burdensome disclosure requirements for issuers,[109] evidence from the U.K. market suggests that such caps are too restrictive or altogether unnecessary.

As discussed above, the U.K.'s rules give retail investors (equivalent to non-accredited investors in the U.S.) significant discretion to participate in investment crowdfunding, allowing unlimited participation if they agree to receive financial advice from a regulated professional or if they self-certify as a sophisticated investor.[110] Retail investors who do receive advice or

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[106] Under SeedInvest's analysis, an issuer that seeks $500,000 in funding will net approximately $342,000 in cash flow if the campaign succeeds, but given the likely failure rate, the expected value of such a campaign is really only around $120,000. *See* Lingham, *supra* note 87 at 6.

[107] Furthermore, any permissive "testing the waters" language should also preempt relevant state-by-state blue sky laws. Because state securities laws vary in their approach to allowing testing the waters communications, without broad-based preemption, companies could still be required to file individual with state securities regulators. *See also* Andrew Stephenson, "Regulation A+ and Testing the Waters," *Crowdcheck*, April 1, 2015, http://www.crowdcheck.com/blog/regulation-and-testing-waters.

[108] 15 U.S.C. §77d.

[109] Jumpstart Our Business Startups Act, Pub. L. No. 112-106 (codified as amended in scattered sections of 15 U.S.C.).

[110] Financial Conduct Authority, "The FCA's regulatory approach to crowdfunding (and similar activities)," (2013, http://www.fca.org.uk/static/documents/consultation-papers/cp13-13.pdf.

qualify as sophisticated investors can invest up to ten percent of their net investible portfolio in crowdfunded securities.[111] Even though in practice these rules allow virtually unlimited participation by novice investors, both retail and high-net worth investors approach crowdfunding cautiously, averaging £4,000 and £8,000 portfolios, respectively.[112]

That the average retail investor in the U.K. stays close to or underneath the investment limits established in the JOBS Act may suggest that altering the limits would be unnecessary or unwise, since these limits wouldn't impact most investors, and instead would only constrain the few outliers that would invest excessively. While hard caps may prevent some irresponsible, unsophisticated investors from jeopardizing their financial safety, they are just as likely to prevent sophisticated, experienced investors that nevertheless fall short of the SEC's accredited investor thresholds from participating in equity crowdfunding as much as they would like. Most studies estimate that around 5 to 7 million U.S. citizens[113] (or around 7 percent of U.S. households)[114] qualify as accredited investors. In comparison, a U.S. Census Bureau report estimates that more than 11 million U.S. citizens hold bachelor's degrees in business.[115] Though rules limiting certain classes of investments to accredited investors are meant to screen out investors who do not understand the risks associated with investing,[116] they are not precisely tailored to this end. Millions of individuals with years of financial training are excluded, unnecessarily capping the amount of capital available to fund startup activity.

To maximize the capital available for startup investment without undermining the statute's investor protection goals, any investment crowdfunding rules should permit those who do

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[111] *Id*.

[112] Nesta Report, *supra* note 37 at 53.

[113] Scott Shane, "How Dodd's Reform Plan Hurts Startup Finance," *Bloomberg Businessweek*, Mar. 19, 2010, http://www.businessweek.com/smallbiz/content/mar2010/sb20100318_367600.htm.

[114] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 17 C.F.R. pts. 230, 239 and 242 (2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16883.pdf; Securities and Exchange Commission, "Recommendation of the Investor Advisory Committee: Accredited Investor Definition," (2014), https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.

[115] Julie Siebens and Camille L. Ryan, U.S. Census Bureau, "Field of Bachelor's Degree in the United States: 2009," (2012), https://www.census.gov/prod/2012pubs/acs-18.pdf.

[116] While some claim that using financial resources as the defining characteristic of an accredited investor is meant to permit investment by those who can afford to lose investment money, this logic fails insofar as there are no limits on accredited investor participation. That is, an accredited investor with $1 million net worth can no more afford to lose $900,000 than can an non-accredited investor with $200,000 can afford to lose $100,000. But, nothing restricts an accredited investor from investing 90 percent of his or her net worth.

not qualify as accredited investors under the SEC's rules to invest in crowdfunded securities on the same terms as accredited investors so long as they demonstrate adequate financial sophistication. The U.K.'s crowdfunding market has demonstrated that this "sophisticated investor" qualification adequately balances the need for capital with the need to protect investors, and U.S. legislators should consider adopting a similar regime.

Conclusion

It is a testament to the incredible promise of investment crowdfunding that after three years since the passage of the JOBS Act, startups, investors, and policymakers remain eager and enthusiastic for the SEC to enact its long overdue rules. When the SEC finally puts Title III crowdfunding into effect, policymakers should approach the task of perfecting the rules governing the investment crowdfunding regime with the same enthusiasm. The successes of related crowdfunding markets that have developed In the years since Congress passed the JOBS Act should serve as a guide for lawmakers to ensure that the investment crowdfunding system in the U.S. is as dynamic and effective as the startup economy that it will help support.

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About Engine Advocacy

Engine is a technology policy, research, and advocacy organization that bridges the gap between policymakers and startups, working with government and a community of high-technology, growth-oriented startups across the nation to support the development of entrepreneurship. Engine creates an environment where technological innovation and entrepreneurship thrive by providing knowledge about the startup economy and constructing smarter public policy. To that end, Engine conducts research, organizes events, and spearheads campaigns to educate elected officials, the entrepreneur community, and the general public on issues vital to fostering technological innovation. To learn more, visit http://engine.is.