

## SECURITIES CROWDFUNDING AND INVESTOR PROTECTION

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As most who have been or worked with entrepreneurs know well, there are many practical and legal constraints on financing small business entities and projects. One significant practical impediment to capital access for small ventures is the lack of a pre-existing set of established contacts from and through which funding may be sought. In other words, it can be hard for entrepreneurs and others involved in small business undertakings to find people who want to contribute their financial wherewithal to unknown (and often untested) venturers and ventures.

Yet business finance is a creative enterprise. Participants in business capital formation, large and small, are constant innovators. They are forever fashioning new financing instruments and means of offering them to address barriers to access.

In this innovative business finance environment, the internet was destined to play a more leading role. Given the success of e-commerce and social media, it was only logical that businesses and projects needing funding and those keen to fund them would find each other online. Crowdfunding, as we have come to call this web-enabled, crowdsourced financing proposition, has been hailed as the panacea for the ills of small business capital-raising. A form of business finance almost unknown ten years ago, crowdfunding has become a popular topic in entrepreneurial circles and an established term in the lexicon.

Panacea, passing fad, or otherwise categorized, crowdfunding most often enables fundraisers and funders to meet through electronic intermediation.<sup>2</sup> Participants not only do not know each other, but also cannot see

each other in person or easily verify facts about the business or project seeking funding using methods customary in other, more traditional financing transactions. Crowdfunding's use of the faceless internet to generate and consummate financing transactions between and among fundraisers and funders who may not have pre-existing relationships gives rise to concern that crowdfunding will be the source of rampant fraudulent activity – or at least frequent misunderstandings – giving rise to inherent agency costs and information asymmetries (Hazen 2012; Ibrahim 2015). Heminway and Hoffman (2011, 933) observed generally that:

Comprised of a rapidly changing set of internet business models, crowdfunding may be less transparent and more intangible to investors and regulators. Promoters of crowdfunding interests are often anonymous individuals and unknown entities. Moreover, in its prevalent current form as a small business start-up financing method, crowdfunding shares many of the overall negative attributes of small business and start-up capital formation.

Media reports have begun to catalogue public instances of fraud and suspected fraud in crowdfunding (Fredman 2015).

The application of protective regulation in this environment is to be expected. And the transaction participant most likely to need protection is the individual or entity providing the funding. The key fears are those common to funding in any context: that the fundraiser will misappropriate received funds for personal benefit or employ them unwisely.

This article addresses the responses to these concerns in the context of crowdfunding involving investment interests recognized as securities under applicable law. It begins by defining and explaining securities crowdfunding (also known as investment crowdfunding, crowdfund investing, or equity crowdfunding) conceptually and legally – firstly by further describing crowdfunding and subsequently by outlining the specific attributes and regulatory consequences of crowdfunding involving securities. The article then elucidates investor protection in the securities crowdfunding setting, focus-



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<sup>2</sup> The intermediary most commonly involved in crowdfunding is referred to as a *platform* (or sometimes, a *portal*).

ing on the diverse attributes of securities crowdfunding investors and the emerging elements of investor protection regimes tailored to securities crowdfunding. The descriptions, analysis, and observations in the article are founded in and rely primarily on US legal doctrine. International or multinational references are included, however, where possible.

### The nature of securities crowdfunding

In order to intelligibly define securities crowdfunding, one must first define crowdfunding. Despite the omnipresence of crowdfunding in academic and industry conversations about small business finance, a universal definition of crowdfunding has proven rather elusive. In some circles, the definition of crowdfunding is contended. In general, however, it is fair to note that there are a number of helpful contextual definitions and taxonomies of crowdfunding. “As in any emergent field, the popular and academic conceptions of crowdfunding are in a state of evolutionary flux that makes complete definitions arbitrarily limiting” (Mollick 2014, 2).

This article takes an expansive view and defines crowdfunding as a method for financing businesses or projects that involves soliciting and securing funding from a broad, disaggregated mass of potential funders, typically through the internet.<sup>3</sup> Belleflamme, Lambert and Schwienbacher (2013, 586) summarize the nature of crowdfunding in a manner consistent with the definition proffered here.

[T]he objective is to collect money for investment, generally by using online social networks. In other words, instead of raising money from a small group of sophisticated investors, crowdfunding helps firms to obtain money from large audiences (the “crowd”), in which each individual provides a very small amount. Such investment can take the form of equity purchase, loan, donation, or pre-ordering of the product ...

Bradford (2012b, 5) takes a similar view when he defines crowdfunding as “funding from the crowd – raising small amounts of money from a large number of investors.”

<sup>3</sup> Although this definition is broad, it is not intended to include financing in which funding is solicited or received from a restricted group or groups of funders. For example, under these definitions, internet offerings made under Rule 506(c) of Regulation D adopted by the US Securities and Exchange Commission under the Securities Act of 1933, as amended, are not considered crowdfunding (since sales can only be made to “accredited investors” – well-compensated and high net-worth individuals and entities that can bear the risk of the loss of their investment).

Definitions of crowdfunding are often accompanied or enriched by categorizations. For instance, crowdfunding may be used to solicit donations – funding for which nothing is promised in return. This form of crowdfunding is typically referred to as *donative crowdfunding*. However, crowdfunded offerings may also involve promises to funders of some specific benefit as a reward for their largess. These promises may be of a commercial or financial nature. For example, a business or project seeking funding may offer a discount on, presale of, or other preference relating to the product or service being developed or may offer another type of incentive reward (usually a promotional item related to the fundraiser’s business). Offerings in which these types of commercial promises are made are variously identified. Among the more popular descriptive labels: *presale crowdfunding* and *reward crowdfunding*. When promises of a financial nature (e.g., profit-sharing, revenue-sharing, or the provision of any other pecuniary benefit) are made to funders in a crowdfunding campaign, the resulting financial interest is commonly known as a security, and the campaign is most commonly characterized as *securities crowdfunding* or *investment crowdfunding*. With these categories in mind, Belleflamme, Lambert and Schwienbacher (2014, 588) synthesize the following salient definition of crowdfunding: “Crowdfunding involves an open call, mostly through the Internet, for the provision of financial resources either in the form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes.”

The different types of crowdfunding engage a rich and varied body of law and regulation (Heminway 2014a). Donative crowdfunding, presale crowdfunding and reward crowdfunding may be regulated through generally applicable laws governing commercial activity (e.g., those relating to contracts, torts, agency, property and trusts). In particular situations, specialized regulatory regimes also may provide prescriptions and proscriptions. For example, donative crowdfunding campaigns involving nonprofit organizations may require compliance with charitable solicitation regulations. Presale and reward crowdfunding can trigger the application of consumer protection regulations, including those governing fair trade practices.

By its very nature, securities crowdfunding engages the vast and complex body of securities regulation. Securities regulation is, like most financial regulation, territorially based (Brummer 2011). Globalization and technological advances, especially including the in-

ternet, present challenges for territorial regulatory regimes. Securities crowdfunding is no exception. In cross-border operational and enforcement settings, determining the applicable law is a nontrivial task.

There are certain general observations that can be made about securities regulation, however, that are important to the matters addressed in this article. Securities regulation typically uses three different regulatory tools: mandatory disclosure; fraud, misstatements, and omissions prohibitions; and substantive regulation of participants and processes. These tools are employed to serve a central underlying policy: the promotion of business venture capital formation. However, two important subsidiary policy considerations accompany and support that core regulatory objective, namely maintaining a fair market for securities transactions and protecting investors.

As among these policy underpinnings of securities regulation, investor protection takes a leading role. If investors do not feel secure, they will not participate in the market for capital formation. In short, without investors, there is no market. Accordingly, the generation of a sustainable securities crowdfunding market requires an understanding of the attributes of securities crowdfunding investors and an assessment of the types and levels of protection they may need to feel safe enough to contribute their funds.

### **Protecting those who invest in crowdfunded securities**

The demographics of crowdfunding are emergent. There is no comprehensive data on securities crowdfunding investors available to date. However, the sense among those most familiar with crowdfunding is that these investors are a varied lot. Investor objectives may be multifaceted (i.e., they may encompass more than financial wealth maximization) and situational. Mollick (2014, 3) observes that “the relationship between funders and founders varies by context and the nature of the funding effort,” and further notes that “[e]ven within these contexts, the actual goals of funders are extremely heterogeneous.” Investor attributes may also vary based on the nature of applicable regulation. Hornuf and Schwienbacher (2015) indicate that the availability of an exemption from prospectus requirements may impact investor participation in securities crowdfunding campaigns.

The risks to which these crowdfunding investors are subject also vary. The securities in which they invest may be equity, debt, or a form of investment contract – the term used in US securities regulation for other financial instruments with a profit-generating potential (Schwartz 2015, 615).<sup>4</sup> Each instrument carries different risks and rewards by its nature and through its individualized terms. Moreover, the type and level of information provided about the security, the manner in which the crowdfunded offering is being conducted, and the business or project seeking funding differs based on applicable regulation (if any) and industry or service provider terms or practices. Some legal rules or platform terms of use, for example, require specific disclosures, but there is no standardization.

Certain observers highlight the potential for this diverse investment environment to self-police, providing enough inherent protection through “the wisdom of crowds” (Surowiecki 2005) for investors and others to support a healthy, vibrant market (Heminway 2014b; Ibrahim 2015; Schwartz 2015). Yet a market-based solution has not been universally embraced as a means of protecting crowdfunding investors. To those who believe the market alone cannot adequately regulate crowdfunding, the varied crowdfunding landscape – comprising a range of investors, investment instruments, and offerings – suggests the need for a broad spectrum of regulation.

In a number of jurisdictions, securities regulation facilitated crowdfunding from the very start (Cumming and Johan 2013; Hornuf and Schwienbacher 2015). However, in many instances, existing regulation was not a perfect – or even comfortable – fit for crowdfunding. In some jurisdictions, the United States included, securities crowdfunding initially required compliance with an expensive, time-consuming registered offering system that – especially when taken together with other impediments under US federal securities law – discouraged all but a handful of crowdfunded securities offerings (Bradford 2012b; Heminway and Hoffman 2011).

In the past five years, a number of regulators have enacted or are in the process of enacting (or assessing the need for) specific securities crowdfunding rules (Cumming and Johan 2013; Hornuf and Schwienbacher 2015). The United States enacted securities crowdfunding legislation in 2012. That legislation, the Capital Raising Online While Deterring Fraud and Unethical

<sup>4</sup> In the United States, a number of ventures unlawfully offered short-term investment contracts through crowdfunding that this author has labeled *unequity* (Heminway 2012, 360), catalyzing federal regulation.

Non-Disclosure Act (known as the “CROWDFUND Act”), Title III of the Jumpstart Our Business Startups Act, became effective in May 2016 after being tied up for several years in the rulemaking process. Italy was the first mover in Europe, with effective crowdfunding regulation in 2012. The adoption of tailored crowdfunding schemes followed in Great Britain, France, and Belgium in 2014 and in Germany in 2015 (Hornuf and Schwienbacher 2015).

Perhaps unsurprisingly, crowdfunding regulation follows the pattern of securities regulation generally by using mandatory disclosure, liability for fraud, misstatements, or omissions, or substantive regulation as investor protection tools. Substantive regulation limiting the aggregate offering amount and individual investor contributions seem to be the most popular type of rule. Mandatory disclosure rules are also employed in some jurisdictions. Tailored fraud, misstatements, and omissions liability provisions are seemingly rare, but that may be explained by the applicability of adequate pre-existing liability provisions.

The United States is an outlier. It uses all three regulatory tools in the CROWDFUND Act and Regulation CF (adopted by the SEC under the CROWDFUND Act). Specifically, US crowdfunding regulation: provides for the issuer offering disclosures and periodic reporting (including specific requirements for reviewed and audited financial statements); creates a new cause of action for issuer misstatements or omissions to state material facts; and imposes a variety of substantive constraints on issuers, investors, platforms, and the crowdfunding process generally. These constraints include (among many other things) requiring the use of a qualified, regulated intermediary, capping investor and issuer participation to specific dollar amounts over a 12-month period, and requiring issuers and platforms to comply with various requirements in conducting their operations (Bradford 2012a; Cohn 2012; Heminway 2013-2014; Hornuf and Schwienbacher 2015; Schwartz 2013). The resulting regulatory environment is complex and costly (Bradford 2012a; Cohn 2012; Heminway 2013-2014).

Other jurisdictions use a lighter touch in regulating crowdfunding. French crowdfunding regulation includes an issuer disclosure requirement and also requires platform accreditation, investor risk assessments, and a limited aggregate offering size (Hornuf and Schwienbacher 2015). Under the Italian flagship crowdfunding regime, although prospectus requirements are inapplicable, only “innovative startups” (relatively nar-

rowly defined to include certain small new firms) and certain innovative small and medium enterprises are permitted to use the rule (Hornuf and Schwienbacher 2015). Britain’s regulations restrict investor participation in offerings based on their ability to appreciate and bear the attendant investment risk, and Belgium’s and Germany’s rules governing crowdfunding limit the aggregate offering size and the amount of funding an investor can supply in specified crowdfunded offerings (Hornuf and Schwienbacher 2015).

### Concluding remarks

Crowdfunding remains a bit of an unknown in business finance. Securities crowdfunding, as a subset of that financing market, is no more familiar. Diverse investors and risks make for a complex regulatory puzzle.

Investor protection regulation has begun to develop in a path-dependent manner. Although there are some core similarities in rule types (e.g., as to offering and investment limits), there is a lot of variation beyond those fundamental similarities. Whether the crowdfunding regulations adopted in various jurisdictions adequately protect investors while, at the same time, promote capital formation through crowdfunding remains to be seen. Hornuf and Schwienbacher (2015) generally find and hypothesize that the nature of regulation affects market participation in a number of ways. Bradford (2012a), Cohn (2012), and Heminway (2013-2014) express doubt that securities crowdfunding will be popular in the United States as a small business capital formation alternative, but it is too soon to tell. Experience should give regulators enough information about crowdfunding investors and their risk profiles to enable a more accurate calibration of investor protection mechanisms. If crowdfunding business practices and regulations become more consistent across jurisdictions, investor protection rules may then begin to converge.

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