The Siren Call of Equity Crowdfunding

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Abstract: The JOBS Act opened a new frontier in start-up financing, for the first time allowing small companies to sell stock the way Kickstarter and RocketHub have raised donations: on the web, without registration. President Obama promised this novel form of crowdfunding would generate jobs from small businesses while simultaneously opening up exciting new investment opportunities to the middle class. While the new exemption has its critics, their concern has largely been confined to the limited amount of disclosure issuers must provide. They worry that investors will lack the information they need to separate out the Facebooks from the frauds. This is the wrong concern. The problem with equity crowdfunding is not the extent of disclosure. The problem is that the companies that participate will be terrible prospects. As a result, crowdfunding investors are virtually certain to lose their money. This essay examines the data on angel investing – the closest analogue to equity crowdfunding – and concludes that the majority of the issuers that sell stock to the middle class over the internet will lose money for investors, with many failing entirely. The strategies that help the best angels profit will not be available to crowdfunders. Plus, the losses most issuers inflict will not be offset by a few huge winners. Investors will not find tomorrow’s Googles on crowdfunding portals because they will not be there; instead, start-ups with real potential will continue to use other programs, such as the newly expanded Rule 506 exemption. This outcome is the inevitable result of the nature of start-up investing and crowdfunding. No amendments to the Act or rule-making by the SEC can prevent it. The only solution that will protect investors is to abolish equity crowdfunding for the unaccredited.

I. Introduction

Imagine a young, geeky entrepreneur has just invited you to invest in his new venture, a website that will allow users to share information, photos, and even videos with one another. Users can also form groups focused on particular interests and invite friends to join. Should you risk your hard-won capital and make the investment? Who wouldn’t jump at the chance to be an early investor in the next Facebook? Peter Thiel bought ten percent of Facebook in 2004 for $500,000. While he sold the bulk of his stake well in advance of the stock’s recent recovery,¹ he still garnered at least hundreds of millions of

dollars and perhaps more. That’s an astonishing return, something like one thousand times his initial investment. At that rate, risking a few thousand dollars could provide riches to last a lifetime.

One problem with the fantasy of investing in the next Facebook at the start-up stage is that Facebook’s founder Mark Zuckerberg wasn’t looking for a thousand dollar investment. Zuckerberg needed a substantial infusion of cash, not just a few thousand dollars. Few people have half a million available to invest. Thiel, an early investor in PayPal, was already wealthy when he made the historic choice to back Facebook. Early stage companies looking for investors generally lack the time to raise money in small chunks, and federal securities laws have historically made that sort of fund-raising impractical.

But it seems undemocratic to limit these amazing investment opportunities to the rich, as one more way in which the gap between the rich and poor widens in the United States. Apparently President Obama and both parties in Congress felt this way. In the spring of 2012, Congress passed and President Obama signed the Jumpstart Our Business Startups Act (the “JOBS Act”). Title III of the JOBS Act opened the door to middle class investing in early stage companies by authorizing a new form of crowdfunding.

In recent years, crowdfunding has become an increasingly popular and successful fundraising method for the arts, video games, and even some technology products. But this form of fundraising is either reward-driven, where donors receive a prize such as a copy of the film being made or an early version of the video game, or purely donative. For example, Eric Migicovsky raised over $10 million to fund his Pebble watch project by promising donors a Pebble watch at a discounted price.

Before the JOBS Act, the federal securities laws prevented enterprises from selling off equity stakes (such as stock in the company)
through crowdfunding (what I will call “equity crowdfunding”).

Cloaked in “wisdom of crowds” mystique and combining private investment, the promise of jobs, aid to small businesses, and middle class access to exciting investment opportunities, the crowdfunding aspect of the JOBS Act was an easy sell to both parties. Not surprisingly, then, this portion of the JOBS Act rushed through Congress with little opposition.

Many experts have been less sanguine than the politicians about equity crowdfunding. Academics and newspaper columnists have expressed serious concerns about the amount of disclosure required. One of the central purposes of the federal securities laws is to provide investors with sufficient information to make a rational judgment about a company’s prospects. In order to reduce the substantial costs associated with such disclosure, the JOBS Act cut back sharply on the breadth and depth of the information start-ups are required to provide when taking advantage of the crowdfunding exemption. Many commentators fear that the combination of crowdfunders’ relative lack of sophistication with this reduced disclosure obligation will produce fertile ground for con artists.

Interestingly, concerns about disclosure come both from those who think the JOBS Act requires too little disclosure to protect investors and from those who believe it demands too much disclosure to maintain the provision’s usefulness to entrepreneurs. Some experts have argued that the costs of fulfilling the JOBS Act’s disclosure obligations are out of proportion with the amount of money that the law permits entrepreneurs to raise through crowdfunding. They contend that unless the SEC ameliorates these obligations through its (still unissued) regulations, few businesses will find it worth their while to raise money this way.

Both sides seem to agree, however, that if the rules were set up correctly, equity crowdfunding would be a bonanza for middle class investors, entrepreneurs, job seekers, and the economy. Their dispute is purely about fine-tuning, how to find just the right balance between

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11 See infra, Part II.
12 See Wroldsen, supra note 10, at 594 (quoting one Senator as stating, “We want to support our entrepreneurs. We want to make this process more democratic. We want to get out of the secret boardrooms and the private conversations on Wall Street. So many more people could take advantage, appropriately, of exciting investments in the entrepreneurial spirit of America.”)
13 See infra, note 104.
14 Id.
15 Id.
16 See infra notes 104-120 and associated text.
The Siren Call of Equity Crowdfunding

protecting investors from fraud and lowering investors’ costs of fundraising. Both groups concur that equity crowdfunding has enormous potential if the government can set up the rules correctly.

Unfortunately, they could not be more wrong.

The real problem with equity crowdfunding cannot be remedied by fine-tuning the disclosure obligations. The core issue has nothing to do with disclosure: it’s that these investments are going to be terrible. While the enterprise described in the opening paragraph could be Facebook, it’s far more likely to be Eons or Diaspora or Xanga or any of a host of other failed or failing social networks.18

The vast majority of these enterprises are going to flop. Even the few companies that succeed will be unlikely to produce much of a return for the crowdfunders who believed in them at the beginning. Almost no one is going to make money through crowdfunding as an investor, yet people who can’t afford to are going to plunk down their money anyway. And no amount of disclosure – no matter how clearly or boldly written or engagingly presented or tested in online quizzes – is going to stop them.

How do I know?

We do not yet have any data on equity crowdfunding investments, for the simple reason that they do not yet exist in this country. There is an equity crowdfunding portal in the United Kingdom – Crowdcube.com – but it is too new to have generated any measurable results.19 Our closest analogues are either “friends and family” rounds or angel investors. Although equity crowdfunding may end up resembling the friends and family stage more than the later angel stage, I am unaware of any systematic data available on the return rate at the friends and family phase.

It is also challenging to gather data about angels’ investment outcomes, but there are some studies that are quite good. These studies demonstrate that even the companies chosen by sophisticated, wealthy angels squander their investors’ money more often than not.20 While angels as a class may receive positive returns across all investments21 (and there is some reason to doubt even this22), the bulk of the positive

19 See http://www.crowdcube.com/. Crowdcube boasts on its website about the amount of money it has raised so far (over £10 million as of August 14, 2013), but says nothing on its site about the returns investors have gained. Instead, it shares a link to one of the angel surveys discussed infra, Part IV. Crowdcube was founded in 2010. As I will explain in Part IV, angel-type investments typically take several years to produce a return, so it may simply be too soon for any meaningful investment results.
20 See infra notes 133-153 and associated text.
21 Id.
22 As I will discuss infra at note 132 and associated text, the angel data comes from surveys and is therefore subject to survivorship bias and self-selection bias.
returns are generated by about ten percent of the investments. Without these small minority of winners, angel investing would be a losing proposition on average.

But these winners are precisely those companies that are least likely to seek crowdfunding. Angel investing offers numerous advantages over equity crowdfunding under the JOBS Act, so it seems unlikely that any business that could obtain angel investments would seek out crowdfunding instead. Crowdfunding is therefore likely to attract those businesses that are least likely to succeed. Perhaps even more importantly, angel investments are most likely to prosper when the angels (a) possess a great deal of experience in the same industry as the investment target; (b) spend a fair amount of time investigating prospects before investing; (c) spread their risk across several start-ups; and (d) actively advise the entrepreneurs. Crowdfunders will generally not be able to pursue these strategies. With worse investments to choose from and without the experience or ability to help the businesses succeed, crowdfunders are highly unlikely to see the companies they choose thrive.

Even if crowdfunders overcome the odds and luck into a winning business, their returns are unlikely to justify the risk. The JOBS Act limits the amount of money an enterprise can raise through crowdfunding to $1 million per year. That may suffice to get companies over their first cash crunch, but most businesses will need considerably more capital as they grow, and few will be able to self-finance through earnings or traditional bank loans. The angels and venture capitalists who are the most likely sources of further funding typically dilute prior investors’ interests, often to extreme. Without some protection against dilution, crowdfunders are unlikely to reap the rewards of their risk-taking, even in those rare instances when the company itself thrives.

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23 See infra notes 140, 143 and associated text.
24 See infra, note 181.
25 See infra notes 182-207 and associated text.
26 Id.
27 See infra notes 154-160 and associated text.
28 See infra notes 161-170 and associated text.
Despite the very high likelihood that crowdfunding will offer poor investment opportunities, we can expect unsophisticated middle class hopefuls to line up in droves to hand over their money, at least for a while. The allure of easy riches will be too hard to resist at the beginning, especially when endorsed by such high-profile leaders as President Obama.\footnote{See Barack Obama, \textit{Remarks by the President at JOBS Act Bill Signing} (April 5, 2012), available at \url{www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing}.}

Unfortunately, nothing commentators have suggested to tinker with the crowdfunding provisions will fix these problems. Investors will not be sufficiently swayed by additional disclosure, even if they read the warnings they are given.\footnote{See infra notes 212-215 and associated text.} And adding mandatory protections will only serve to drive more of the best prospects away from crowdfunding towards alternative funding mechanisms, such as the newly improved Regulation D.\footnote{See \textit{Pub. L. No. 112-106}, 126 Stat. 306 (2012), codified at 15 U.S.C. §77e(d).}

The best solution would be to scrap the crowdfunding portion of the JOBS Act entirely. But since Congress is highly unlikely to reverse itself so quickly, the SEC should use the power granted it by the JOBS Act to achieve effectively the same end by piling on so many additional investor protections and disclosure requirements that portals find it undesirable to list crowdfunding opportunities, and businesses are driven to look elsewhere for capital.\footnote{See, \textit{e.g.}, 15 U.S.C. §77d-1(a)(3) (requiring funding portals to provide disclosure as the SEC deems appropriate); 15 U.S.C. § 77d-1(a)(4) (requiring funding portals to ensure that each investor reviews investor-education information in accordance with standards established by the SEC and answers questions demonstrating his or her understanding of the riskiness of start-up investments); 15 U.S.C. §77d-1(a)(5) (requiring funding portals to take whatever steps the SEC requires to reduce the risk of fraud); 15 U.S.C. §77d-1(a)(9) (requiring funding portals to take whatever steps the SEC requires to protect the privacy of investors); 15 U.S.C. §77d-1(b)(1)(I) (requiring crowdfunding issuers to provide any additional information the SEC requires for the protection of investors and the public interest); 15 U.S.C. §77d-1(b)(4)(requiring crowdfunding issuers to file with the SEC and provide to investors the financial reports the SEC determines are appropriate); 15 U.S.C. §77d-1(b)(5) (requiring crowdfunding issuers to comply with any other requirements the SEC prescribes for the protection of investors and the public interest).}

In Part II of this essay, I will briefly describe how the federal securities law prevented equity crowdfunding prior to the JOBS Act and the rules that will govern it now that it’s permitted. In Part III, I will explain why Congress and President Obama wanted to legalize equity crowdfunding before sketching out the concerns critics have. Then, in Part IV, I will argue that equity crowdfunding will be a trap for investors. The problem is not the risk of fraud (though that is certainly a serious concern). The real issue is that most crowdfunding investors will lose money, and that the investors equity crowdfunding hopes to attract
can ill afford to do so. Finally, in Part V, I will conclude by arguing that equity crowdfunding is not salvageable and should be scrapped.

II. How Did the JOBS Act Change the Legal Landscape for Equity Crowdfunding?

At this point, almost no one needs to be told what crowdfunding is. Kickstarter\textsuperscript{35} and to a lesser extent its competitors such as Indiegogo\textsuperscript{36} and RocketHub\textsuperscript{37} have made the concept a household word. These sites and others have transformed the web into an incredibly powerful fundraising tool. Crowdfunding has fueled projects as diverse as the Little Bee Pop popsicle,\textsuperscript{38} the film \textit{Incident in New Baghdad} (which was nominated for an Oscar),\textsuperscript{39} the video game \textit{Broken Age} (originally titled \textit{Double Fine Adventure}),\textsuperscript{40} a new font for the City of Chattanooga,\textsuperscript{41} an artist-decorated bus stop,\textsuperscript{42} the card game \textit{Cards Against Humanity},\textsuperscript{43} the opera \textit{Oceanic Verses},\textsuperscript{44} a civilian space suit,\textsuperscript{45} the world’s first pizza museum,\textsuperscript{46} Atlanta’s first squirrel census,\textsuperscript{47} and a marriage proposal.\textsuperscript{48} On Kickstarter alone, users raised nearly a quarter of a billion dollars in 2012 and over two million people pledged money.\textsuperscript{49}

Projects encourage donations in a variety of ways. Some are purely donative; funders participate because they believe in the cause.\textsuperscript{50} Others offer different rewards for different levels of funding, such as a t-shirt, movie poster, or a copy of the movie.\textsuperscript{51} Still others are essentially

\begin{footnotes}
\footnotetext{35}{See http://www.kickstarter.com.}
\footnotetext{36}{See http://www.indiegogo.com.}
\footnotetext{37}{See http://www.rockethub.com.}
\footnotetext{38}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#popsicle.}
\footnotetext{39}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#oscars.}
\footnotetext{40}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#double_fine; http://www.doublefine.com/dfa.}
\footnotetext{41}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#chattanooga.}
\footnotetext{42}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#love_shack.}
\footnotetext{43}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#cards_against_humannity.}
\footnotetext{44}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#oceanic_verses.}
\footnotetext{45}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#space_suit.}
\footnotetext{46}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#pizza_museum.}
\footnotetext{47}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#squirrel_census.}
\footnotetext{48}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#proposal.}
\footnotetext{49}{http://www.kickstarter.com/year/2012?ref=what_is_kickstarter#overall_stats.}
\footnotetext{50}{See Joan MacLeod Heminway, \textit{What is a Security in the Crowdfunding Era?}, 7 OHIO ST. ENTREPRENEURIAL BUS. L. J. 335, 358 (2012). For example, one project on Kickstarter currently seeks donations to open a Little Free Library in Winston Salem, North Carolina. Donors above a certain level can receive a bookmark or have a book dedicated to them, but there are no substantial prizes. See http://www.kickstarter.com/projects/1106918453/little-free-library-project-winston-salem-nc?ref=popular.}
\footnotetext{51}{See Heminway, supra note 50, at 358. For example, one entrepreneur seeking to raise money to publish a book of his grandfather’s photographs from World War I has}
\end{footnotes}
pre-sales of the product the entrepreneurs wish to develop, generally offered at a discount over the post-development price.\textsuperscript{52} Finally, some entrepreneurs seek loans they promise to repay, either interest-free, as on Kiva,\textsuperscript{53} or for a rate they set themselves, as coordinated by Prosper Loans Marketplace, Inc. or Lending Club Corp.\textsuperscript{54}

What was not legally possible until the JOBS Act was for a new business to sell equity or a share of its future profits over the internet without registering the sale under the Securities Act of 1933.\textsuperscript{55} Section 5 of the ’33 Act bars the use of “means or instruments of transportation or communication in interstate commerce or of the mails” to sell an unregistered security.\textsuperscript{56} An equity interest in a company would certainly count as a “security,” as would a right to a share of the company’s profits.\textsuperscript{57} (Websites such as Lending Club that match borrowers with lenders who charge interest are also selling securities; these loans are made pursuant to a prospectus filed with the SEC that covers all the loans as a group.\textsuperscript{58} Nevertheless, twenty-six states have banned investors from making loans this way.\textsuperscript{59})

Securities cannot be sold unless the sale is registered with the SEC or falls within one of the exemptions. Registration is an extremely time-consuming and expensive process; it has been estimated to require

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\textsuperscript{52} See Heminway, supra note 50, at 358. For example, a group looking to develop a mouse that can be held like a pen – which they plan to sell for $69 each – is offering to supply a sample of the product to anyone who pledges at least $25. See http://www.kickstarter.com/projects/529738175/gstick-the-mouse-you-hold-like-a-pen-for-pcs-and-m?ref=discover_pop.

\textsuperscript{53} See http://www.kiva.org/start.


\textsuperscript{55} See 15 U.S.C. §77e.

\textsuperscript{56} Id.

\textsuperscript{57} See 15 U.S.C. §77b(a)(1) (defining “security” in part as an “investment contract” or “any interest or instrument commonly known as a ’security’”); Heminway, supra note 50, at 353-60. See also Sec. & Exch. Comm’n v. W. J. Howey Co., 328 U.S. 293 (1946) (defining the “investment contract” portion of the statutory definition of a “security” as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .”).

\textsuperscript{58} See, e.g., Lending Club Prospectus (April 30, 2013), available at https://www.lendingclub.com/fileDownload.action?file=Clean_As_Filed_20130430.pdf&type=docs.

\textsuperscript{59} See Dugan, supra note 54.
some twelve hundred hours of work and can easily cost hundreds of thousands of dollars. In addition, registration subjects the company to regulation under the ’34 Act, which requires periodic disclosure reports. Periodic reporting is also expensive, and many companies are understandably reluctant to reveal the type of information the ’34 Act mandates they disclose. For all of these reasons, then, registration is seldom a viable option for small, early-stage companies looking to raise initial seed money.

Even before the JOBS Act, there were a number of exemptions from the registration requirement that were designed to enable small companies to raise capital without bearing the costs of registration. But none of these would permit equity crowdfunding.

Regulation A provides an exemption from registration requirements to companies that are not subject to the periodic disclosure obligations of the ’34 Act (“non-reporting companies”). Regulation A offerings may be made for up to $5 million, which should be ample for early round financing of small start-ups. But Regulation A still requires issuers to file a document with the SEC, Form 1-A, that involves considerable disclosure. Even this substitute for full registration can be quite expensive, which is likely why few companies have used Regulation A in recent years.

Regulation D provides three different exemptions under Rules 504, 505, and 506. These allow for different levels of funding, from an annual cap of $1 million (Rule 504) to $5 million (Rule 505) to an

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63 See Bradford, supra note 30, at 70 (explaining that economies of scale make registration inefficient for small offerings).
64 See Bradford, supra note 30 (so concluding); Thaya Brook Knight, et. al, A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act, 2 MICH. J. OF PRIVATE EQUITY & VENTURE CAPITAL LAW 135 (2012) (same); Thomas Lee Hazen, Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure, 90 N.C. L. REV. 1735, 1746-1749 (2012) (same).
67 See Bradford, supra note 30, at 31-32 (in 1997, average Regulation A offering cost $40,000-$60,000).
exemption unlimited in amount (Rule 506\textsuperscript{72}). But until the JOBS Act, none of these exemptions permitted what is called a “general solicitation,” when the issuer or its agents makes a broad pitch to the public in order to market the securities. Since the whole point of equity crowdfunding is to make such a pitch in order to reach as many people as possible, Regulation D was not available to crowdfunders.\textsuperscript{73} Also, prior to the JOBS Act, the exemptions under Rule 506 could be made to at most thirty-five unaccredited investors, and even these thirty-five had to be sophisticated.\textsuperscript{74} (An unlimited number of accredited investors could participate.) This requirement would be hard to square with Kickstarter-type equity crowdfunding, which seeks investment from as broad a swath of the population as possible, often in small amounts.

There are additional exemptions, but they are similarly unhelpful to equity crowdfunders. The intrastate exemption under Section 3(a)(11) of the ’34 Act cannot not be used by an issuer selling securities to buyers from more than one state\textsuperscript{75} and so is not useful to issuers making a broad solicitation over the web.\textsuperscript{76} Section 4(2) exempts sales of securities that avoid making a public offering,\textsuperscript{77} but again, the whole point of equity crowdfunding is to make a public offering. Also, these are limited to sophisticated investors.\textsuperscript{78} Finally, section 4(5) of the ’34 Act permits issuers to sell up to $5 million of securities, but forbids the kind of general solicitations that are critical to crowdfunding.\textsuperscript{79}

The JOBS Act changed the laws surrounding crowdfunding by providing a new exemption allowing issuers not already subject to the ’34 Act reporting requirements to sell securities worth up to $1 million per year through crowdfunding portals.\textsuperscript{80} The Act also made other changes that may affect crowdfunding.\textsuperscript{81} One of these changes –

\textsuperscript{71} See 17 C.F.R. § 230.505(b)(2) (2013).
\textsuperscript{72} See 17 C.F.R. § 230.506 (2013).
\textsuperscript{73} See Bradford, \textit{supra} note 30, at 29-31 (so arguing); Hazen, \textit{supra} note 64, at 1746-1749 (same).
\textsuperscript{74} See 17 C.F.R. § 230.506(a)(2) (2013). An investor is “accredited” most relevantly for our purposes if she has a net worth over $1 million (alone or with a spouse, minus certain exclusions) or has an income over $200,000 per year (or $300,000 with a spouse). See 17 C.F.R. § 230.501(a) (2013). An investor is “sophisticated” if she, “either alone or with [her] purchaser representative(s) has such knowledge and experience in financial and business matters that [s]he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.” \textit{Id.}
\textsuperscript{75} See 15 U.S.C. § 77c(a)(11).
\textsuperscript{76} See Hazen, \textit{supra} note 64, at 1745.
\textsuperscript{78} See Hazen, \textit{supra} note 64, at 1745.
\textsuperscript{81} The JOBS Act also provided for a Regulation A type of exemption for up to $50 million and made it easier for companies to avoid falling under the periodic disclosure
exempting Rule 506 offerings from the ban on general solicitations—will become relevant to our discussion a bit later, when I explain why these investments will mostly be poor ones. But for now, we should focus on the unaccredited crowdfunding provision, section 302 of the JOBS Act.

Section 302 created the exemption that best emulates Kickstarter’s model. Section 302 allows anyone to invest, regardless of income or level of sophistication. To protect this vulnerable population from fraud and poor judgment while enabling companies to raise small amounts of money without spending a fortune on lawyers and accountants, the JOBS Act replaces the usual (expensive) registration requirement with a number of safeguards. First, each issuer can only raise $1 million per year under this provision, which restricts the scope of any fraud (assuming this limit is well-enforced). Second, the Act limits how big a bet investors can make on equity crowdfunding based on the investor’s income and net worth, though anyone – no matter how impoverished – can make at least a $2,000 annual investment, as long as the check clears. Third, all securities purchased using this exemption must be made through either a broker or a funding portal that complies with certain rules (more on those in just a moment). Finally, the issuers selling securities through this exemption must provide certain disclosure to the SEC, the funding portal or broker, and to investors, and must obey rules to be set by the SEC to prevent the broker or funding portal from suffering from an undisclosed conflict of interest.

The brokers and funding portals play a critical role in protecting investors under the Act. The Act requires them to provide whatever disclosures the SEC decides are appropriate, including investor education materials. They must also somehow ensure that each investor (1) reads these materials, at least the investor-education component; (2) asserts that a total loss of the invested funds is possible.

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83 See infra, Part IV.
85 Those whose annual income or net worth is less than $100,000 may invest at most $2,000 or five percent of their annual income or net worth per year (whichever is greater) across all equity crowdfunding issuers. See JOBS Act § 302(a), 126 Stat. at 315, 15 U.S.C. §77d(a)(6)(B)(i). This means that those who earn the maximum in this category of $100,000 per year may invest as much as $5,000 per year in various start-up enterprises through crowdfunding, but even someone who earns nothing could invest $2,000. Those whose annual income or net worth exceeds $100,000 per year may invest up to ten percent of their annual income or net worth, subject to an absolute cap of $100,000 per year. See JOBS Act § 302(a), 126 Stat. at 315, 15 U.S.C. §77d(a)(6)(B)(ii).
and bearable; and (3) answers questions demonstrating an understanding of the risks of investing in small companies, the problems with illiquid investments, and whatever else the SEC determines appropriate.\textsuperscript{89} The broker or portal must also:

- take whatever steps the SEC determines to prevent fraud;
- facilitate the issuer’s provision of information to the SEC and to investors;
- prevent the issuer from receiving any proceeds from the securities sale unless and until the target funding goal is met;
- enforce the investment amount limits (which remember are based on each investor’s income and net worth);
- protect the privacy of investors’ information;
- take certain steps to prevent conflicts of interest; and
- do whatever else the SEC determines is advisable to meet the goals of protecting investors and the public interest.\textsuperscript{90}

We do not yet know the details of how brokers and funding portals are supposed to comply with all these requirements. The SEC, overwhelmed by the volume and complexity of the regulatory tasks assigned it by both Dodd-Frank and now the JOBS Act, has not yet issued its regulations for this exemption as of this writing. The intent of the Act, though, is quite clear: to change the federal securities laws to permit equity crowdfunding so that anyone, regardless of wealth or sophistication, can invest in start-up enterprises. The next section will discuss why this seemed like a good idea to Congress and President Obama, and why many experts have serious reservations.

### III. Equity Crowdfunding’s Advocates and Detractors

Although the JOBS Act changed the federal securities laws in many controversial ways – making it easier for companies to avoid falling prey to the reporting requirements of the ’34 Act,\textsuperscript{91} effectively raising the limit on Regulation A exemptions to $50 million,\textsuperscript{92} authorizing issuers using the Rule 506 exemption to make a public appeal for buyers,\textsuperscript{93} among others – equity crowdfunding took center stage when politicians were promoting the bill.\textsuperscript{94} At the Rose Garden signing ceremony, for example, President Obama spent much of his

\textsuperscript{89} Id.
\textsuperscript{90} Id.
\textsuperscript{91} See JOBS Act § 501, 126 Stat. at 325. See also Michael D. Guttentag, Patching a Hole from the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosure, 88 Indiana L.J. 151 (2013) (discussing when companies should be subject to the ’34 Act’s disclosure requirements); Donald C. Langevoort and Robert B. Thompson, “Publicness” in Contemporary Securities Regulation After the JOBS Act, 101 GEORGETOWN L. J. 337 (2013) (same).
\textsuperscript{92} See JOBS Act § 401, 126 Stat. at 323.
\textsuperscript{93} See JOBS Act § 201, 126 Stat. at 313-14.
\textsuperscript{94} See, e.g., See Obama, supra note 31.
speech talking about equity crowdfunding, while the new provision making it easier for companies to avoid going public by accident received not a whisper of recognition.95

Equity crowdfunding holds the appeal of being quintessentially American. It is the classic rags to riches story, where an enterprising young person turns a smart idea into a globe-straddling company and along the way makes fortunes for those investors perspicacious enough to see the idea’s value early on. But it is also thoroughly democratic and rather oddly antiestablishment, because it opens up these investment opportunities – which were previously limited to the already wealthy – to ordinary folks.96 It even makes oblique reference to the wisdom of crowds notion recently popularized by James Surowiecki but really as old as the Republic, that the common people as a whole possess a deeper wisdom than the educated elites.97

These themes appear in Obama’s bill-signing speech and also in the remarks of some members of Congress during the debates on the Act. Obama opened by talking about America as a “nation of doers” whose legacy of entrepreneurship included Edison and Ford, Google and Twitter.98 He then tied entrepreneurship to job growth and the economy, claiming “new businesses account for almost every new job that’s created in America.”99 Obama trumpeted the benefits of equity crowdfunding both for entrepreneurs and for small investors. He stated:

Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors -- namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.100 Similarly, senators pushing for the bill during the debate boasted that it would both support entrepreneurs and open up investment opportunities to more people.101 For example, Senator Mary Landrieu said:


95 Id.
96 See Douglas S. Ellenoff, Making Crowdfunding Credible, 66 VAND. L. REV. EN BANC 19 (2013) (pointing out that crowdfunding’s most important impact may come from the fact that seventy percent of venture capital funding goes to businesses headquartered in New York, California, and Massachusetts and that over ninety-five percent of venture capital funding is provided to enterprises managed by men).
97 See JAMES SUROWIECKI, THE WISDOM OF CROWDS (2005). This notion also animates the famous (and probably apocryphal) story of Abraham Lincoln’s response to a heckler’s jibe, “Is that the President? He looks like such a common man.” Lincoln allegedly responded, “God must have loved the common people; He made so many of them.” See PAUL F. BOLLER, JR. AND JOHN GEORGE, THEY NEVER SAID IT: A BOOK OF FAKE QUOTES, MISQUOTES, AND MISLEADING ATTBUTITIONS 84 (Oxford 1990).
98 See Obama, supra note 31.
99 Id.
100 Id.
101 See Wroldsen, supra note 10, at 594 (quoting Senate speeches).
We want to support our entrepreneurs. We want to make this process more democratic. We want to get out of the secret boardrooms and the private conversations on Wall Street. So many more people could take advantage, appropriately, of exciting investments in the entrepreneurial spirit of America.¹⁰²

Equity crowdfunding combines the instant gratification of a get-rich-quick scheme with the respectability of entrepreneurship, the rebelliously democratic spirit of the Occupy movement, and the gee-whiz marvel of technology. With all that going for it, who could be against it?

The short answer is no one. Even the JOBS Act’s harshest detractors seem to like the idea of equity crowdfunding. It’s the execution that concerns them. In fact, Senator Landrieu herself argued that without adequate protections for investors, the Act could prove destructive. She stated:

This isn’t about a conservative-liberal fight. This is about the right regulations that are necessary before we take a good idea and mess it up. Crowdfunding is a good idea. It is an exciting idea. There are great entrepreneurs out there. The internet could be a very powerful tool. But everyone knows if you enter into new territory without caution and care, you can fall off a cliff that you didn’t even know was there. That is exactly what the House bill is going to do.¹⁰³

Most critics of equity crowdfunding fall into one of two groups: those who worry that the JOBS Act requires too little disclosure and therefore opens the floodgates to securities fraud and those who complain that the JOBS Act imposes so much disclosure that it’s made equity crowdfunding too expensive for small issuers to use.¹⁰⁴ Those

concerned about deception point to the substantial incidence of fraud in both small businesses and on the internet generally.\textsuperscript{105} Investors risking relatively small sums are unlikely to investigate opportunities very closely, and the type of middle class or blue collar worker targeted by crowdfunding issuers will generally lack the necessary background and experience to understand complicated financial disclosures (to the extent they are provided).\textsuperscript{106} This group has some historical precedent to point to as well. When the Rule 504 exemption was first enacted, it did not ban general solicitations.\textsuperscript{107} Issuers therefore used this exemption to sell securities over the internet.\textsuperscript{108} Once the web became sufficiently well-developed, the incidence of fake or fraudulent securities issued under this exemption mushroomed, until the SEC stepped in and banned general solicitations under Rule 504.\textsuperscript{109} Equity crowdfunding seems to provide a similar opportunity for criminals to take advantage of investors’ gullibility, which argues for significant protections against fraud.

But others are concerned that the JOBS Act already went too far in reacting to this concern.\textsuperscript{110} The JOBS Act subjects equity crowdfunding to the general antifraud provision of Rule 10b-5 and the other liability provisions of the federal securities laws.\textsuperscript{111} To these, the Act added a new liability rule, section 4A(c) of the Securities Act, that makes any issuer liable for making “an untrue statement of a material fact” or omitting “to state a material fact required to be stated or necessary in order to make the statements, in the light of the

\textit{Safeguards}, 64 ADMIN. L. REV. 473 (2012) (raising the fraud concern but concluding the Act contains sufficient protections to prevent fraud); Peter C. Sumners, \textit{Crowdfunding America’s Small Businesses After the JOBS Act of 2012}, 32 REV. BANKING & FIN. L. 38 (2012) (JOBS Act puts investors at high risk of fraud); with C. Steven Bradford, \textit{The New Federal Crowdfunding Exemption: Promise Unfulfilled}, 40 SECURITIES REGULATION L. J. 195 (2012); Stuart R. Cohen, \textit{The New Crowdfunding Registration Exemption: Good Idea, Bad Execution}, 64 FLA. L. REV. 1433 (2012) (arguing the JOBS Act has made crowdfunding too expensive for small issuers to use); Parsont, \textit{supra} note 61 (most issuers will ignore retail crowdfunding because of the new availability of accredited crowdfunding under Rule 506 given the relative cost and benefits of each); Nikki D. Pope, \textit{Crowdfunding Microstartups: It’s Time for the Securities and Exchange Commission to Approve a Small Offering Exemption}, 13 U. PA. J. BUS. L. 973 (2011) (arguing that preventing fraud in this context is too expensive and that it is more important to facilitate capital formation); and Andrew A. Schwartz, \textit{Keep It Light Chairman White: SEC Rulemaking Under the Crowdfund Act}, 66 VAND. L. REV. EN Banc 43 (2013) (advocating for sparse regulations for equity crowdfunding in order to maintain affordability and because the statutory protections such as the income-based investment limits will suffice to prevent fraud).

\textsuperscript{105} See Burkett, \textit{supra} note 104; Hazen, \textit{supra} note 64; Heminway & Hoffman, \textit{supra} note 104; Sigar, \textit{supra} note 104; Sumners, \textit{supra} note 104.

\textsuperscript{106} See Hazen, \textit{supra} note 64, at 1766.

\textsuperscript{107} Id.

\textsuperscript{108} Id.

\textsuperscript{109} Id.

\textsuperscript{110} See Bradford, \textit{supra} note 104; Cohen, \textit{supra} note 104; Parsont, \textit{supra} note 61.

\textsuperscript{111} See Bradford, \textit{supra} note 104, at 210.
circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission.” An issuer that can prove it did not know the statement was untrue can avoid liability. Directors, officers and certain senior officers of the issuer may also be liable, as may anyone who offers or sells the securities. This new liability provision may significantly expand the liability of issuers and those affiliated with them would be subject if they were instead registering the offering or using one of the other exemptions such as Rule 506.

The Act also requires issuers to provide fairly extensive disclosure to the SEC and to investors, including a description of the issuer’s financial condition. The SEC has not yet issued rules with the details of what this disclosure will entail, but the statute mandates that it include the issuer’s financial statements – certified by the issuer’s CEO to be accurate – as well as tax returns. For larger offerings, the financial statements must be either reviewed by an independent accountant (for offerings between $100,000 and $500,000) or be formally audited (for offerings above $500,000).

Although these disclosure requirements will almost certainly be less extensive than those required for full registration (that is, after all, the entire point of an exemption), they may add sufficient expense that – when combined with expanded liability – issuers are deterred from using equity crowdfunding. As Jason Parsont has argued, the newly strengthened Rule 506 exemption should offer decisive advantages over equity crowdfunding to most small issuers.

But this kerfuffle over disclosure masks the more important problem, one that commenters on both sides have gotten entirely wrong: these investments are likely to be quite bad. The next section will explain why this is the case.

IV. Why Equity Crowdfunding Will Mostly Produce PoorReturns

The most important question surrounding equity crowdfunding is also the most neglected: how good will the investments be? If they provide generous returns on average, few will complain that the initial disclosure was sparse. But if most of them perform poorly, no amount of advance disclosure is likely to prevent the first wave of eager investors from plunging in.
Since equity crowdfunding is new – as of this writing, the SEC has not yet issued the relevant rules, so it remains illegal in the U.S.\(^\text{121}\) – we do not have an established track record to gauge the kind of returns investors can expect. Although there has been at least one portal operating in the United Kingdom since 2010 (Crowdcube.com), it has not posted information about the returns its investors have received.\(^\text{122}\) Instead, the site boasts prominently about how much money has been raised, an issue that matters a great deal to issuers but that should not provide any comfort to investors.\(^\text{123}\) It also provides information about how many investors have participated.\(^\text{124}\) Perhaps investors might care about this, either because they want to know how much competition they have (which would make a lower number more advantageous) or because they take some comfort from the investments’ popularity (so many people can’t possibly be wrong). Based on the way the site highlights this figure, Crowdcube seems to think its audience will think a large number of investors is a good thing. That may be because its primary audience is really issuers or because its marketing force believes investors will reason that if thousands of other investors are on board, the investments must be worthwhile.\(^\text{125}\)

When it comes to what investors should care about most – investment returns – Crowdcube says very little, other than to warn investors that there are substantial risks.\(^\text{126}\) One conclusion to draw from Crowdcube’s silence is that their issuers have done poorly. If there were good news to tell, Crowdcube would be trumpeting it from the rooftops. Since it is not, the news must not be very good. But a more charitable explanation is that there simply has not been sufficient time to evaluate the returns. Early stage investments generally take several years to produce a result, and the start-ups actually tend to take longer than those that go belly-up, on the order of four to six years or so and sometimes over ten.\(^\text{127}\) (Those businesses that fail reach the end rather faster, typically taking about three years to reach the end of their ropes.\(^\text{128}\))


\(^{122}\) See http://www.crowdcube.com/.

\(^{123}\) Id. (posting that over £10 million has been raised as of August 14, 2013).

\(^{124}\) Id. (stating that nearly 42,000 investors have registered as of August 14, 2013).

\(^{125}\) I will discuss this sort of herding impulse and what may underlie it in the next section. See infra, Part V.

\(^{126}\) See http://www.crowdcube.com/ (“Investing in start-ups and early stage businesses involves risks, including illiquidity, lack of dividends, loss of investment and dilution, and it should be done only as part of a diversified portfolio.”) (emphasis in original).


\(^{128}\) Id.
Once a sufficient number of issuers have reached some termination event (such as a sale, an initial public offering, or a bankruptcy), perhaps Crowdcube will release returns data.

In the meantime, the best we can do is to examine the closest analogues to equity crowdfunding, the friends and family and angel rounds of investment in small enterprises. Crowdcube itself encourages this comparison by posting a study of angel investor returns on its site.\textsuperscript{129}

Unfortunately, data is sparse here as well. I am not aware of any study of returns that friends and family receive, though the conventional wisdom is that they generally lose their money.\textsuperscript{130} Angel returns are also difficult to investigate. Angels are, by definition, wealthy individuals (sometimes acting in a group) who invest in private companies.\textsuperscript{131} Neither the angels nor the companies are required to report their financial results publicly, making data difficult to acquire.\textsuperscript{132}


Similarly, venture capitalist Charles Moldow cautions:

True friends and family money is what I call “love money.” It’s money that they invest because they support and love you, with any possible future return seen merely as a nice bonus. It’s important for everyone involved to understand that there is a reasonably high likelihood that their money is gone for good. If this is the construct, the dynamic is healthy. But, when a friend or family member’s primary reason for investing is to see a return, things can become problematic.


\textsuperscript{131} See Colin M. Mason & Richard T. Harrison, Annual Report on the Business Angel Market in the United Kingdom: 2008/09, United Kingdom Department for Business, Innovation and Skills, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32214/10-994-annual-report-business-angel-market-2008-2009.pdf, at 1 (“A business angel is an individual, acting alone or in a formal or informal syndicate, who invests their own money directly in unquoted businesses in which there is no family connection in the hope of financial gain and who, after making the investment, takes an active involvement in the business, for example, as mentor, adviser or member of the board.”)
\textsuperscript{132} Id. at viii (“Most business angels (and most of their investment activity) are invisible and so virtually impossible to identify and track over time.”); Wiltbank & Boeker,
I am aware of only two significant recent surveys of angel investors, one in the United States and one in the United Kingdom. Both were conducted by Robert Wiltbank and found similar results. At first glance, the surveys seem very promising for equity crowdfunding. The U.S. study found that the angel investments on average produced a return of 2.6 times the investment after 3.5 years (profits of 1.6 times the investment), representing a roughly 27% internal rate of return. The U.K. study found similarly encouraging results, an average return of 2.2 times the investment after about four years (profits of 1.2 times the investment) or about a 22% internal rate of return. These both compare favorably to the average return for public equities, which has historically been around 10% for the past eighty years when dividends are included. At today’s rates, the average internal rate of return for angel investments is about double that of public equities.

The averages, though, tell only part of the story. The angels’ investment results were highly skewed, so that a small percentage of investments accounted for the bulk of the returns. In the U.S. study, the top 10% of investments garnered a whopping 75% of the total returns. Fifty-two percent of the investments lost money. Fortunately, many of the angels were sufficiently sophisticated to adopt a portfolio strategy, spreading their capital across a number of investments. As a result, while only 48% of the businesses generated a positive return, 61% of investors made at least some money. Even with this kind of risk-spreading, the angel investment world remains a feast-or-famine supranote127 at 2 (conducting a survey of angels and discussing the methodological problems with doing so, including survivor bias and self-selection bias).

See Wiltbank & Boeker, supra note 127; Robert E. Wiltbank, Siding with the Angels: Business Angel Investing – Promising Outcomes and Effective Strategies, National Endowment for Science, Technology and the Arts and British Business Angels Association (May 2009), available at http://www.crowdcube.com/ed_files/file/NESTA-BBA-Siding%20With%20The%20Angels.pdf. There is an older U.K. study, from 2002, but it was quite a bit smaller. See Colin M. Mason & Richard T. Harrison, Is It Worth It? The Rates of Return From Informal Venture Capital Investments, 17 J. OF BUSINESS INVESTING 211 (2002). Wiltbank and Boeker’s U.S. study was by far the largest, with 1,137 exits, as compared to Wiltbank’s U.K. study with 406 exits and Mason and Harrison’s study with 128. There was also one in Finland that was smaller (and older) yet. See Annareeta Lumme, et. al, The Returns From Informal Venture Capital Investments: An Exploratory Study, 5 J. ENTREPRENEURIAL SMALL BUS. FIN. 139 (1996) (49 exits). These smaller studies tell a similar story to the larger and more recent ones, namely that the investment outcomes are highly skewed with roughly the majority of investments turning into partial or total losses but a few generating very good returns. See Mason & Harrison at 215 (describing Lumme’s study) and at 222-23 (describing own results).

See Wiltbank & Boeker, supra note 127, at 1.
See Wiltbank, supra note 133, at 5.
See Wiltbank & Boeker, supra note 127, at 4.
Id. at 3.
Id.
The Siren Call of Equity Crowdfunding

universe; the top 10% of angel investors took home 50% of the total gains.\textsuperscript{140}

The results in the U.K. study were similar.\textsuperscript{141} There, 56% of the investments lost money. These losses were generally total, with investors receiving none of their capital back.\textsuperscript{142} The best 9% of the ventures generated 80% of the returns.\textsuperscript{143} About 60% of those angels using a portfolio strategy received positive returns of some degree.\textsuperscript{144}

These studies demonstrate that even sophisticated angels investing substantial sums\textsuperscript{145} have not succeeded very consistently in identifying promising start-up businesses. Instead, while a small percentage of their investments have earned out-sized returns, the majority have resulted in (often total) losses.\textsuperscript{146} Only by spreading their capital across a number of investments have the majority of angels garnered positive returns, and even with this strategy, nearly half still lost money.\textsuperscript{147}

And there are reasons to believe these studies actually exaggerate the angels’ returns. Both these studies were performed through surveys. The researchers sent out large number of forms, but only a small percentage of the angels responded.\textsuperscript{148} Because the data only includes those who voluntarily replied, because only those sent the form could possibly have responded, and because the information is all self-reported, a number of biases may skew the data to make the returns seem better than they really were.

As the researchers themselves acknowledge, the results may suffer from self-selection bias and survivor bias.\textsuperscript{149} Self-selection bias stems from people’s increased tendency to reply to a survey such as this

\textsuperscript{140}Id. at 4.
\textsuperscript{141}See Wiltbank, supra note 133, at 14.
\textsuperscript{142}Id. (85\% of losses were total).
\textsuperscript{143}Id. at 15.
\textsuperscript{144}Id.
\textsuperscript{145}In the U.S. study, the median investment was $50,000 and the mean was $191,000. See Wiltbank & Boeker, supra note 127, at 12.
\textsuperscript{146}See Wiltbank & Boeker, supra note 127, at 3-4; Wiltbank, supra note 133, at 14-15.
\textsuperscript{147}See Wiltbank, supra note 133, at 15; Wiltbank & Boeker, supra note 127, at 3. It is worth noting that venture capitalists, who tend to invest at a later stage than friends and family or angels, and who are assumed to be more sophisticated investors (See Mason &Harrison, supra note 133, at 219) have had difficulty earning returns that surpass those available in the public equity markets. See Diane Mulcahy, et. al, “We Have Met the Enemy . . . And He Is Us” Lessons From Twenty Years of the Kauffman Foundation’s Investments in Venture Capital Funds and the Triumph of Hope Over Experience, Ewing Marion Kauffman Foundation (May 2012), available at http://www.kauffman.org/uploadedFiles/We%20have%20met%20the%20enemy%20and%20he%20is%20us(1).pdf.
\textsuperscript{148}See Wiltbank & Boeker, supra note 127, at 2 (surveyors contacted 276 angel groups but only 86 participated and only 13\% of the angels in these participating groups responded); Wiltbank, supra note 133, at 11 (response rate of 18\%).
\textsuperscript{149}See Wiltbank & Boeker, supra note 127, at 2.
when they had a positive experience with the subject matter.\textsuperscript{150} If angels who lost money were less likely to respond, then the data would show a better set of results than the angels as a whole really experienced.

Survivor bias would have a similar effect. People who lost a lot of money by investing in start-up companies may have dropped out of the angel world entirely. The researchers would not have contacted these disaffected angels, so their (presumably quite poor) investment results would have been excluded from the data, making the averages look better than they really were.\textsuperscript{151}

Finally, the numbers may have been shifted by problems with the reliability of respondents’ recollections. Angels may have misremembered their investment results. In particular, their successes may have loomed larger in their memories than their failures.\textsuperscript{152} The reverse is also possible. To the extent participants’ memories systematically inflated (or deflated) their results, the data would be skewed in one direction or the other. Two of these biases (self-selection and survivor) likely inflated the return data; the third’s impact is unclear.

Looking at these results – and especially considering that they might actually have been worse than the studies reported – one is left to wonder why angels throw their money at start-ups at all. Part of the answer may be that they are not driven solely by the promise of investment returns; Mason and Harrison have argued that angels derive nonfinancial rewards by investing in the latest hot trend.\textsuperscript{153} Or they may be unaware that the odds of success are so slim, since this data is difficult to acquire. Their own results can be explained away as atypical or unlucky.

At any rate, angels are wealthy and sophisticated enough to understand what they can afford to risk. The losses they may suffer from these speculative investments are unlikely to force them to miss a mortgage payment or pull their children out of college. And to them, the chance of earning the enormous returns that the top 10\% of these investments generate may seem to make the risks worthwhile.

Plus, there are steps angels can take to improve their odds. In the studies, angels did much better when they had deep experience in the industries in which they invested, earning higher returns and suffering fewer total failures.\textsuperscript{154}

They also saw better outcomes when they spent more time evaluating a company before deciding to invest. In the U.S. study, angels who spent more than the median of twenty hours in due diligence earned an average of 5.9 times their investment, while those who spent fewer than twenty hours on due diligence earned an average of only 1.1

\textsuperscript{150} Id.
\textsuperscript{151} Id.
\textsuperscript{152} \textit{See} Mason & Harrison, \textit{supra} note 133, at 217.
\textsuperscript{153} Id. at 220.
\textsuperscript{154} \textit{See} Wiltbank & Boeker, \textit{supra} note 127, at 6; Wiltbank, \textit{supra} note 133, at 16.
times their investment.\(^{155}\) (Many angels clearly spent much more time than the median on research, driving the average due diligence time up to sixty hours.\(^{156}\))

As I mentioned above, angels also saw better returns when they spread their investment among a number of different enterprises.\(^ {157}\) Diversifying this way gave angels a better chance of having their money find one of the small number of outliers that produced exceptional returns, making up for the majority of companies that suffered losses.\(^ {158}\)

Finally, angels who actively participated in the venture – by coaching the entrepreneurs, helping them make business connections, and closely monitoring the enterprise – enjoyed better returns than those who took a more hands-off approach. In the U.S. study, angels who interacted with the enterprise at least a couple of times per month saw nearly triple the returns of those who did not (3.7 times their investment in four years instead of 1.3 times their investment in 3.6 years).\(^ {159}\) The U.K. study also revealed that having significant (though not overly intrusive) involvement improved investment outcomes for angels.\(^ {160}\)

These strategies, though, are mostly unavailable for equity crowdfunders. Some crowdfunders may have relevant experience, but few are likely to restrict themselves to industries they know deeply. Even the sophisticated angels only stayed within their comfort zone about half the time.\(^ {161}\) The U.K. study also showed that entrepreneurial experience generally was very helpful to the angels, something few crowdfunders can be expected to possess.\(^ {162}\)

Crowdfunders also seem unlikely to spend sufficient time investigating the issuers before investing. The median income in the United States for a family of four was $67,019 in 2008 (the most recent year for which the U.S. Census provides data as of this writing).\(^ {163}\) Under the JOBS Act, such a family could invest a maximum of $2,000 in equity crowdfunding ventures per year, though I suspect a family at that income level would invest considerably less.\(^ {164}\) Suppose such a family decides to invest $500 in a crowdfunding enterprise. Presumably they would investigate a number of prospects before deciding which one was

\(^{155}\) See Wiltbank & Boeker, supra note 127, at 5. The U.K. study also demonstrated the value of doing at least twenty hours of due diligence, with the more careful investors suffering fewer failures than those who invested on the fly. See Wiltbank, supra note 133, at 18.

\(^{156}\) Id.

\(^{157}\) See Wiltbank, supra note 133, at 15; Wiltbank & Boeker, supra note 127, at 3.

\(^{158}\) See Wiltbank, supra note 133, at 14; Wiltbank & Boeker, supra note 127, at 3.

\(^{159}\) See Wiltbank & Boeker, supra note 127, at 7.

\(^{160}\) See Wiltbank, supra note 133, at 19.

\(^{161}\) See Wiltbank & Boeker, supra note 127, at 6; Wiltbank, supra note 133, at 16 (55% of the time, angels had no relevant industry experience).

\(^{162}\) See Wiltbank, supra note 133, at 15-16.


most likely to succeed. It is unclear from the data whether the due diligence time reported was per investment possibility or overall, but intuitively it seems most likely to refer to the amount of time spent investigating the business in which the investor ultimately bought stock. Angels likely also spent time (for finalists, considerable time) researching businesses that did not ultimately win their investment dollars. Suppose a family looked at twenty start-ups, eliminating three-quarters after only spending an hour reading about each but spending ten hours each on the final four that lost out and a full twenty hours on the company that won out. Time spent on research could quickly add up to seventy-five hours this way. Even at the federal minimum wage of $7.25/hour,\(^{165}\) the family could have earned more than the investment amount by working instead of performing due diligence.

It’s simply irrational to spend the time necessary to make reasonable investment decisions when investing the small amounts permissible under equity crowdfunding.\(^{166}\) Many angels also chose to invest without investigating very much, but their returns suffered greatly in consequence.\(^{167}\)

On the other hand, crowdfunders might choose to diversify their investments, as many angels do. The nature of crowdfunding makes this easy to do; the funding portals will vastly simplify the search for start-ups in need of funds. But to the extent small crowdfunders divide their money among a number of different enterprises, it will become even less rational for them to spend significant time investigating each possibility.\(^{168}\) Crowdfunders who diversify may therefore make

\(^{165}\) See United States Department of Labor, Wage and Hour Division (WHD), available at [http://www.dol.gov/whd/minimumwage.htm](http://www.dol.gov/whd/minimumwage.htm).

\(^{166}\) Wealthier families can invest larger sums. But families with sufficient wealth or income to qualify to make large enough investments to render the necessary due diligence practical could also qualify as sophisticated investors and go after Rule 506 investments. These have significant advantages over equity crowdfunding, as I will discuss shortly. See infra, notes 181-207 and associated text.

\(^{167}\) Wiltbank & Boeker, supra note 127, at 5.

\(^{168}\) For example, suppose that spending twenty hours on due diligence boosted an investor’s chances of finding an investment that would produce a five-fold return from 20% to 40% (with the alternative being a total loss). If the planned investment is $1,000, that would mean that the due diligence would boost the expected return from a loss of $800 (leaving the investor with $200 of the original $1,000 investment without due diligence) to a gain of $400 (leaving the investor with $1,400 including the original investment with due diligence). 
\[
(0.2)(5)(1,000)+(0.8)(-1)(1,000)=200; \\
(0.4)(5)(1,000)+(0.6)(-1)(1000)=1,400. 
\]

This improved expected return of $1,200 translates to $60 per hour of due diligence, which some investors should find worthwhile. But if the investor divided her investment among four different companies ($250 each), and would have to spend the same twenty hours on each company to enjoy the boost in expected returns, that would mean she could expect to earn only $15 per hour of due diligence ($300 expected return divided by twenty hours of due diligence). Few investors are likely to spend time in due diligence when the expected return is so small. And note that this example assumes that the investor spent no time at all eliminating other investment prospects, a highly unrealistic assumption.
correspondingly worse investment decisions, offsetting at least to some extent the benefits of diversification. And equity crowdfunders may prove less likely than angels to diversify. If crowdfunders are aware of the risks they face, they may become risk accepting. Studies show that people who face small odds of winning a bet (with a correspondingly high return if they do win) are more risk accepting than those confronting a more certain bet (with a comparatively low return for winning). For example, in horse racing, bettors overvalue long-shot bets and undervalue bets on the horses that are favored to win. Crowdfunders who are aware of the risky nature of the enterprise may prove eager to place their entire bet on one roll of the dice. They may prefer having a chance of lucking into a life-changing investment to the less exciting possibility of returns that are somewhat better than they would earn in a mutual fund.

Active participation is the investment strategy least available to equity crowdfunders. The point of equity crowdfunding is to raise money in small amounts from many sources. If each of these sources wants to advise the company’s founders, the founders would have time to do nothing else than listen to their investors all day. Even if the investors had relevant expertise and could be helpful, it’s unlikely they would be willing to invest the time in mentoring the entrepreneurs, for the same reason they are unlikely to spend sufficient time conducting due diligence – the amounts involved are just too small to justify large time expenditures.

In sum, then, sophisticated angels mostly choose poorly when investing in start-up companies (and probably worse than the studies reveal), and the strategies angels use to improve their results are not available to equity crowdfunders (whose lack of sophistication already puts them at a serious disadvantage). These factors should suffice to dull investors’ enthusiasm for equity crowdfunding. But there are two additional considerations that make the picture even bleaker.

The first of these is dilution. Early investors buy a fixed number of shares that represent a particular percentage of the company’s equity. For example, an angel might buy 100 out of 1,000 outstanding shares of a start-up company for $50,000. Those 100 shares then represent 10% of the company’s equity. But that initial influx of $50,000 is unlikely to sustain the company for very long. Soon, it will need another, larger round of financing. This second round might also be financed by angels or perhaps by venture capitalists. Either way, the new buyers will typically demand a large chunk of the company in exchange for their cash.

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Suppose this second round financier negotiates for 20% of the company’s equity. The company’s founders could provide that entirely from their own stake (after all, they retained 90% of the equity in the first round). They seldom do, though. Instead, they will cause the company to issue new shares to the second round investor and perhaps to themselves as well. To the extent they create new shares, each share (including those previously issued) represents a smaller percentage of the company. Imagine they decided to issue an additional 1,000 shares in the second round, 400 to the new investor and 600 to themselves. Now there are 2,000 shares outstanding. The founders have 1,500 (900 from the first round and 600 from the second), representing a 75% stake in the company. The second round investors have their bargained for 20% stake with 400 shares. What has happened to our initial angel? Her 100 shares now represents only a 5% stake in the company; her equity stake has shrunk by half.\footnote{See Wroldsen, supra note 10, at 32-34 (explaining dilution).}

This dilution is not always a bad thing for the initial investor. She owns a smaller percentage, but the value of the company may have risen with the new cash infusion. If the second round investor paid more per share than the company was worth, part of that surplus will end up in the initial angel’s pockets. But if the new investor pays less than those shares are worth, the discount comes in part at the angel’s expense.\footnote{Id.}

It is not hard to see how this process can be manipulated to benefit the founders and the new investors at the expense of the early stage investors. Depending on the provisions in the company’s founding documents (its articles of incorporation or certificate of incorporation, if a corporation, or its operating agreement if organized as a limited liability company), the founders may be able to issue 1 million new shares instead of just 1,000, even though the new investment is not remotely 1,000 times the value in the first round (let us say it is $250,000).\footnote{In corporate law, the limit on the company’s ability to issue new shares is primarily the number of shares authorized in the certificate of incorporation. Early investors might therefore bargain to limit these. This protection is limited, though, because the certificate can be amended to expand the number of authorized shares (to any number) with the approval of the board of directors and an absolute majority of the shareholders. See 8 Del. C. §242(a)(3) (corporation may amend its certificate to expand the number of shares outstanding), 8 Del. C. § 242(b) (corporation may amend its certificate with the approval of the board of directors and an absolute majority of the shares entitled to vote, though sometimes an absolute majority of each class of share is also required).}

If the founders divide those new shares among themselves and the new investor, the early investor will be left with almost nothing, 100 shares out of 1,001,000 or .0099% of the company. Her stake has lost nearly all its value.\footnote{This action constitutes a breach of the founder’s fiduciary duties of loyalty to the minority if it violates the entire fairness test. See Gatz v. Ponsoldt, 925 A.2d 1265 (Del. 2007) (minority shareholders stated a direct claim for breach of fiduciary duty against a controlling shareholder based on a dilution claim); Gentile v. Rossetto, 906 A.2d 92, 99-
Angels and venture capitalists protect themselves from this sort of opportunistic dilution by writing in protections to the company’s founding documents. There are a variety of ways to do this, such as requiring a supermajority vote to authorize new shares, issuing different classes of stock with particular characteristics (such as permanently representing a certain equity percentage), or granting the initial investor a veto right over major decisions. None of these measures are likely to be available to equity crowd funders, though, unless the portals or the SEC require them. As John Wroldsen has argued, equity crowd funders will not be able to negotiate for these terms because they are likely unaware of their need for them and because they suffer from collective action problems. For this reason, Wroldsen contends that the government should provide protections to equity crowd funders both through “nudging” solutions (such as standard form contracts for equity crowdfunding that contain investor protections) and mandates (either by SEC rule or by statute). I will discuss Wroldsen’s approach in Part V. The important point for now is that dilution presents another reason why equity crowd funders are unlikely to profit from their investments.

The second additional problem is that the entrepreneurs who can secure funding from other sources such as business angels or Rule 506 offerings will prefer those sources to equity crowdfunding. As a result, equity crowdfunders will have available to them only those opportunities already rejected by more sophisticated investors. Their returns can be expected to be much worse, especially when we consider that most of the angel investments – after a considerable winnowing process – lost money. If not for the top 10% of the angel investments, the entire enterprise would look like a losing gamble. We can only imagine (for

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100 (Del. 2006) (same). But a lawsuit – even with a strong claim – is worthwhile only to the extent the damages are large enough to make the expenses of litigation worthwhile. You cannot squeeze blood from a stone. Start-up companies may often flunk this practical test, especially when most of the early investors are equity crowdfunders who have each invested relatively small amounts.

175 See Bradford, supra note 30, at 63 (Venture capital funds protect themselves against the founders’ opportunistic behaviors such as dilution by negotiating control rights and contractual provisions requiring shareholder approval for certain actions); Wroldsen, supra note 10, at 32.

176 See Bradford, supra note 30, at 63.

177 See Wroldsen, supra note 10, at 39-40.

178 Id.

179 Id. at 37-48.

180 See infra, Part V.

181 We can see why this is true using a slightly simplified example. Imagine there are ten companies and investors have sunk $100 into each one. Three companies suffer total losses, and two manage to return only $50 to their investors (a 50% loss). The remaining five return more than the investment such that on average, the companies have returned $220 each to their investors (a profit of $120 each). Of the five companies that returned a profit, 80% of the total returns came from one company. Under these facts, if X represents the average return of the top five companies, then
now) how desolate the landscape will look for equity crowdfunders who have to make do with the business angels’ leavings.

Entrepreneurs will prefer to avoid equity crowdfunding if they can in part because of another provision of the JOBS Act. As Jason Parsont has ably explained, what he terms “accredited crowdfunding” – the Rule 506 exemption, which the JOBS Act expanded by permitting general solicitations over the internet – imposes fewer investor protections and permits issuers to raise unlimited funds. As a result, Rule 506 will be far more desirable to issuers than “retail crowdfunding,” the Kickstarter-type crowdfunding that is open to everyone but limited to $1 million per year.

Accredited crowdfunding has many important advantages for issuers over retail crowdfunding. First, accredited crowdfunding allows issuers to raise unlimited funds and does not restrict how much each investor can put at risk. Retail crowdfunding issuers may not raise more than $1 million per year, and each investor has an annual limit on the amount she or he may invest through the crowdfunding exemption.

Second, retail crowdfunding entails a greater risk that the issuer or its officers will be liable, since the JOBS Act added a special liability provision for retail crowdfunding. This provision allows plaintiffs to establish liability without the usual securities laws requirements such as scienter or reliance. Accredited crowdfunding is subject only to the

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\frac{5X-3(100)-2(50)}{10} = \$220. \text{ Solving for } X \text{ shows us that the average return of the top five companies is } \$520, \text{ and these companies returned a total of } \$2,600. \text{ Then, if we let } R= \text{ the average return of the bottom four companies in this profitable group, we know the top company’s return was } 16R \text{ (because then the top company’s return would make up } 80\% \text{ of the top group’s total return, or } 16R+4R=20R\). \text{ Expressing the average return for this top group we have } 20R/5=\$520, \text{ and } R= \$130. \text{ The top company then returned } 16(130)=\$2,080, \text{ which is again } 80\% \text{ of the total return of the top group of } \$2,600. \text{ The remaining four profitable companies returned a total of } 4(130)=\$520. \text{ If we eliminate the top-performing company, then, we are left with only the } \$100 \text{ produced by the bottom five companies and the } \$520 \text{ produced by the top four, or } \$620. \text{ Since investors put } \$900 \text{ into these nine companies, they would have suffered an average loss of } (\$900-\$620)/9= \$31. \text{ This somewhat stylized example shows the enormous impact removing the top } 10\% \text{ of start-ups can have when the returns are highly skewed (as the survey data shows that they are).}
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182 See Parsont, supra note 61, at 19.

183 Id.

184 See 17 C.F.R. § 230.506.


188 The provision states that an issuer shall be liable if the issuer “makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements . . . not misleading, provided that the purchaser did not know of such untruth or omission . . . . “ 15 U.S.C. §77d-1(c)(2)(A). To avoid liability, the issuer must prove it “did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.” 15 U.S.C. §77d-1(c)(2)(B). Reasonable care is a negligence defense, not one premised on scienter.
rules banning fraud, which do have these requirements. In addition, the retail liability provision includes a long list of possible defendants, such as the issuer’s directors, its CEO, CFO, chief accounting officer, and any person who offered or sold the security in the offering. Under accredited crowdfunding, only the person who made the false or misleading statement is liable.

Third, as long as the issuer sells only to accredited investors, accredited crowdfunding does not require the issuer to engage in disclosure. Retail crowdfunding requires the issuer to describe the business, list the risks the business faces, and to provide some financial information (with the extent varying based on the size of the issuance), among other things. Retail crowdfunding also requires periodic disclosure after the sale is complete, while accredited crowdfunding does not.

Fourth, issuers using accredited crowdfunding enjoy the protection of a good faith, substantial compliance rule. Under the JOBs Act, on the other hand, there is no such express provision. It is possible the SEC will add one using its rule-making power, as some have advocated, but if not, this will be a significant advantage for accredited crowdfunding. Without a substantial compliance rule, even a trivial and accidental failure to comply with one of the rules may destroy the exemption for the entire issuance and allow buyers to sue for the return of their investment.

Given all the advantages accredited crowdfunding has over retail, issuers would be foolish to use the retail exemption if they were also able to attract the interest of accredited investors or angels. (Note that

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191 See Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011) (“For purposes of U.S.C.f Rule 10b–5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”).
192 See 17 C.F.R. §230.502(b)(1).
195 See 17 C.F.R. § 230.508 (failure to comply with the terms of Rule 506 will not eliminate the exemption if the issuer shows good faith, substantial compliance).
196 See 15 USC §77d(a)(6).
197 See Bradford, supra note 104, at 218-219; Parsont, supra note 61, at 57-58.
198 See Bradford, supra note 104, at 218-219.
199 Parsont points out two additional advantages accredited crowdfunding will have over the retail variety: a greater range of eligible issuers and an ability to sell securities directly rather than working through an intermediary such as a portal. See Parsont, supra note 61, at 21, 24-26. But the ones I discussed at length are more likely to be determinative. Interestingly, two new websites are already raising money from accredited investors in exchange for a small percentage of the borrower’s earnings for a set period of time. See Iris Dorbian, New Twist on Crowdfunding for Startups, WALL ST. J., Aug. 19, 2013, available at
accredited crowdfunding is likely to differ from ordinary angel investing primarily in the way investors and issuers find one another; both will likely use the Regulation D exemption. The major advance associated with accredited crowdfunding is its potential to make financing available to those without initial connections or geographic proximity to angel investors or venture capitalists.\(^{200}\)

Retail crowdfunding may have one or two advantages over accredited crowdfunding and business angels. Most important of these is that under retail crowdfunding, issuers may sell to absolutely anyone. Angels and purchases of an accredited crowdfunding issue must be, as the name suggests, accredited. To count as accredited, an investor must have either $1 million in assets (excluding the primary residence) or income exceeding $200,000 for individuals ($300,000 for couples).\(^{201}\) These requirements do significantly pare down the field of available investors, to about eight million.\(^{202}\) But eight million is still a considerable number, especially since each of them is permitted to invest an unlimited amount of money.\(^{203}\) Retail crowdfunders, in contrast, will often be limited to a maximum annual investment across all issuers using this exemption of $2,000 (and many of these middle class investors will not be able to afford to spend nearly this much).\(^{204}\)

Issuers using accredited crowdfunding must also verify their investors’ eligibility, which could add substantial costs.\(^{205}\) But retail crowdfunding similarly requires verification to ensure investors have not exceeded their permitted annual investment limits and would generally involve doing so for a much larger number of investors.\(^{206}\)

On balance then, the verification requirement should end up more or less a wash, and the limited number of investors available in accredited crowdfunding should be balanced out by the elimination of investment limits. Overall, accredited crowdfunding’s numerous


\(^{201}\) See Rule 501 of Regulation D, 17 C.F.R. §230.501(a)(5). In addition to individuals who meet these wealth or income requirements, institutions may also qualify, including banks, savings and loans, private business development companies, and certain non-profit organizations. Directors and executive officers of the issuer also qualify. *See* 17 C.F.R. §230.501(a).

\(^{202}\) See Parsont, *supra* note 61, at 36.

\(^{203}\) See Rule 506 of Regulation D, 17 C.F.R. §230.506.


advantages – no limits on the amount of money that can be raised in total or from an individual investor, significantly lower risk of liability for issuers, no disclosure requirements, and a substantial compliance rule – mean that issuers that can use accredited crowdfunding likely will. As Thompson and Langevoort have concluded, “[I]t is difficult for us to see why a rational start-up entrepreneur would find it appealing to use the new 4(6) exemption at all.”207

Only those start-ups that cannot attract the more sophisticated investors involved in accredited crowdfunding are likely to turn to the retail version. The most promising companies – that small percentage of start-up companies that account for the bulk of angel investors’ gains – will seek their financing far from the costly crowd.208 Without those companies to boost their returns, without negotiated protections from dilution, and without the ability to pursue business angels’ successful strategies – such as investing in industries with which the investors have deep experience, spending significant time on due diligence, and participating in the company’s operation – retail crowdfunders are virtually certain to lose their money.

V. Conclusion: What Should the SEC Do?

Congress authorized equity crowdfunding hoping to unleash an avalanche of capital that would energize small businesses and solve our unemployment problems while opening up lucrative investment opportunities to the middle class. Unfortunately, the investment possibilities that equity crowdfunding will furnish are likely to prove deeply disappointing. Eventually, investors will realize that money invested in crowdfunding enterprises will nearly always be money lost. When that understanding does percolate through the community of potential crowdfunders, the investment pool will dry up – taking with it the stimulus to small businesses and the jobs they create.

That process, though, will likely take considerable time. Successful angel investments sometimes require a decade to mature, and even those that fail typically flounder about for three or four years before collapsing.209 Issuers will be required to provide some annual disclosure, so investors may have a sense that these businesses are running in the

208 As John Torren has stated, “If angel investors have passed them by, there’s probably a good reason.” See Dave Lavinsky and John Torrens, Should Equity-Based Crowd Funding Be Legal?, WALL ST. J. (March 18, 2012), available at http://online.wsj.com/article/SB10001424052970203370604577265512766009938.htm l.
209 See Wiltbank & Boeker, supra note 127, at 4 (average holding period in survey was 3.5 years but ten-year periods were not unusual).
But shareholders are likely to rationalize early losses as a normal part of the development of a small business (which, to be fair, they very often are) and to remain optimistic until their companies enter bankruptcy.

During the years it will likely take for the middle class to see equity crowdfunding for the alluring trap that it is, investors are going to lose a lot of money. And these are not people who can afford the losses. Households earning $75,000 a year that somehow manage to put $2,000 a year into equity crowdfunding will not simultaneously be maxing out their retirement accounts and putting plenty of cash into their children’s college savings. Money sunk into equity crowdfunding is going to come at the expense of safer savings alternatives (and worse, perhaps even as an alternative to paying down credit card debt). These households (and even households considerably more affluent) all too often are only one paycheck away from disaster at the best of times. They should not be enticed to stress their finances further with the false promise of easy riches.

Helping small businesses is a worthy goal, and so is boosting employment. But con games are wrong even if some of the proceeds go to worthwhile charities. And even if everyone involved has the very best of intentions, equity crowdfunding is effectively going to be a con game.

Some experts who have expressed concern about the potential for intentional fraud in equity crowdfunding have proposed expanding the disclosure requirements. Others worried about dilution have advocated for anti-dilution protections either through standard form contracts or mandatory regulations. Unfortunately, both sets of solutions would make matters worse.

Enhanced disclosure would be unlikely to put a dent in investors’ initial enthusiasm for equity crowdfunding. Politicians and experts alike have been trumpeting the potential for large investment gains, and our culture is suffused with stories of those who made fortunes by getting in on the ground floor of phenomenal successes like Apple, Microsoft, Google and Facebook. The JOBS Act already calls for investor education and even testing to ensure participants acknowledge the riskiness of buying stock in start-ups.

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211 See Hazen, supra note 64; North American Securities Administrators Association, supra note 104; Summers, supra note 104.
212 See Wroldsen, supra note 10, at 37-48.
213 See, e.g., 158 CONG. REC. S1,830 (daily ed. Mar. 20, 2012) (Senator Mary Landrieu applauding the “exciting investments in the entrepreneurial spirit of America” the JOBS Act would open up to crowdfunders); Lavinsky & Torrens, supra note 208 (Lavinsky argues that crowdfunding lets investors participate in angel investments, which have outperformed most other investments over the past ten years); Obama, supra note 31; Edward Wyatt, Senate Passes Start-Ups Bill, With Amendments, N.Y. TIMES (March 22, 2012), available at http://www.nytimes.com/2012/03/23/business/senate-passes-start-ups-bill-with-amendments.html?_r=0 (quoting Steve Case lauding crowdfunding for democratizing access to investments).
But these warnings will be like whispers in a hurricane. People tend to be overly optimistic about their own abilities. Studies have shown that we act as though we can control purely random events like lotteries and dice rolls when there is a veneer – no matter how thin – of individual action involved.214

Plus, we think more highly of results we have achieved ourselves, regardless of our incompetence. For example, subjects who built IKEA furniture valued it more highly than identical furniture put together by professionals, although the professionally built items were objectively superior.215

Crowdfunders who pick out companies for investment are likely to overestimate greatly their ability to find the few likely winners in the vast sea of duds the portals will offer. Then cognitive dissonance will help them sustain their faith in their own judgment during the years companies will take to founder.216

Worse, boosting disclosure requirements will make retail crowdfunding less desirable to issuers as compared to alternative exemptions such as Rule 506. As it is, companies that can persuade enough sophisticated investors to back them are likely to choose accredited crowdfunding over the retail version.217 Adding more burdensome disclosure requirements will only drive more of the higher quality issuers away from the retail crowdfunding portals, further impoverishing the choices crowdfunders will have.

Mandating particular contract terms – and even requiring standard form contracts – would have a similar effect. The more costs the regulations impose on issuers using retail crowdfunding, the less likely issuers will be to choose this method of financing their businesses. Having fewer quality prospects to choose from will only increase the already high odds that crowdfunders will lose their investments.

Unfortunately, there is no way to rescue retail crowdfunding. The problem is not with how Congress set up the system or how the SEC will eventually implement it. The problem is that this was always a terrible idea.

Start-ups are hugely risky and the bulk of them fail. Those that do succeed sometimes do so extraordinarily well that they can make up for those that go bust, making angel investing a potentially lucrative enterprise for those with the resources and sophistication to take enormous risks. But the majority of wealthy, sophisticated angels with a


216 Cognitive dissonance occurs when a person’s beliefs and behavior do not match. Often people respond to the resulting discomfort by changing their beliefs to match their behavior. See Leon Festinger, A Theory of Cognitive Dissonance (1957).

217 See supra, notes 184-207 and associated text.
wide universe of companies to choose from still lose money. Only a small percentage do really well at this game, and those depend on strategies that are inherently unavailable to crowdfunders.

Granted, Congress made matters worse by opening up accredited crowdfunding. But even without that option, the best issuers would still have preferred financing from angels that comes free of the host of regulatory requirements equity crowdfunding imposes. Reducing these burdens is not a realistic option. Critics are right to worry that if there is too little regulation, fraud will run rampant (as it did when Rule 504 permitted general solicitations).\(^{218}\) Having adequate regulations to deter fraud, though, will also deter quality issuers from participating. And even quality issuers (as judged by angels’ willingness to invest) fail more often than they succeed.\(^{219}\)

At this point, the SEC’s best option is to kill retail crowdfunding with excessive regulation. Congress is not going to amend the JOBS Act so soon after passage, and it certainly will not eliminate the Act’s most highly publicized provision.\(^{220}\) The Act gave the SEC considerable discretion in a number of areas, however, and the SEC could use that freedom to impose the most onerous regulations possible.\(^{221}\) For example, the SEC could require portals to confirm investors’ statements about their eligibility to invest by contacting other portals to ensure each investor has not exceeded her or his annual investment limits.\(^{222}\) Portals could also be required to verify investors’ statements about their income.\(^{223}\) The SEC should require extensive investor education and mandate a difficult test investors must pass before being allowed to invest.\(^{224}\) And by no means should the SEC pass a substantial compliance rule for issuers, protecting them from losing the exemption so long as their errors were minor and unintentional.\(^{225}\) If the SEC uses tools like these to make it too expensive for portals to operate and for issuers to use this exemption, retail crowdfunding may never see the light of day. That seems the only remaining path to protect investors.

\(^{218}\) See Hazen, supra note 64, at 1763-64.

\(^{219}\) See Wiltbank & Boeker, supra note 127, at 1, 3; Wiltbank, supra note 133 at 14.

\(^{220}\) In President Obama’s speech accompanying his signing of the JOBS Act, for example, three paragraphs described what the Act did. Of these, two were devoted to retail crowdfunding. See Obama, supra note 31.

\(^{221}\) This is, of course, precisely the opposite of the recommendation made by those who want to invigorate retail crowdfunding. See Parsont, supra note 61, at 62; Schwartz, supra note 104.


\(^{223}\) Id.
