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The Next British Invasion is Securities Crowdfunding: How Issuing Non-Registered Securities Through the Crowd Can Succeed in the United States

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THE NEXT BRITISH INVASION IS SECURITIES CROWDFUNDING: HOW ISSUING NON-REGISTERED SECURITIES THROUGH THE CROWD CAN SUCCEED IN THE UNITED STATES

ROBERT H. STEINHOFF*

Securities crowdfunding is the novel concept of using the power of the Internet to raise business capital through the “crowd.” British companies and investors have proven adept at using the relatively new medium of crowdfunding as a means of providing much needed capital to startups and other small businesses. This Comment examines securities crowdfunding in the United Kingdom in an effort to show how this means of capital formation might succeed in the United States once the SEC implements proposed rules exempting crowdfunded securities from registration. Other commentators have already provided ample criticism of the crowdfunding exemption in the JOBS Act, but none has yet to examine how this flawed legislation might add value to American entrepreneurial finance. This Comment asserts that securities crowdfunding stakeholders will likely overcome these regulatory hurdles to develop a robust market in the United States—particularly with regard to debt securities—that will be similar to the market in the United Kingdom.

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INTRODUCTION

Websites such as Kickstarter and Indiegogo have made the concept of crowdfunding popular among the American public, but outside the United States, entrepreneurs began using this fundraising model to sell unregistered securities in their businesses as far back as 2010.¹ Soon American entrepreneurs, particularly those that lack access to other types of capital formation, will have the same opportunity. On October 23, 2013, the Securities and Exchange Commission (SEC) released proposed rules that implement exemptions to current securities laws for crowdfunding under the Jumpstart Our Business Startups Act of 2012 (JOBS Act).² These new rules allow privately held businesses to raise capital by selling non-registered equity and debt securities to the general public.³ Soon, these businesses will likely have a more accessible alternative to bank loans, angel investors, and venture capitalists by way of the crowd.

This Comment seeks to determine how securities

1. *Kickstarter Basics*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter+basics?ref=help_nav (last visited Feb. 1, 2014), *archived at* <http://perma.cc/U5Y-U4XU>; *Indiegogo Basics*, INDIEGOGO, <http://www.indiegogo.com/indiegogo-faq> (last visited Feb. 1, 2014), *archived at* <http://perma.cc/5BVA-JRY4>.

2. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, 126 Stat. 306 (codified in scattered sections of 15 U.S.C.); *see also infra* Part II.B (examining the proposed SEC rules).

3. This Comment applies the definition of a “security” under American law, and attempts to maintain consistency of terms in accordance with this legal definition. 15 U.S.C. § 77b(a)(1) (2012) (defining “security”); *see also* Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 886 (2011) (defining 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 a promoter or a third party” (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 298–301 (1946))).

crowdfunding, as an alternative to bank lending and established forms of risk capital, might prove to be a successful means for startups and other small businesses to raise money. In doing so, this Comment concludes that securities crowdfunding will not serve as a substitute for traditional entrepreneurial finance, but rather will offer startups and other small businesses the ability to finance the funding gap between owners' equity and follow-on capital.⁴

A study of British securities crowdfunding supports the conclusion that securities crowdfunding markets act complementary to, and not in substitute of, traditional means of entrepreneurial finance. Critics in the United States should be assuaged by the use of crowdfunding to raise both debt and equity financing in the United Kingdom under a similar financial market structure and regulatory framework. The British securities crowdfunding market is growing exponentially under rules similar to those legislated by Congress, but largely developed through private ordering. The United Kingdom stands out globally as the country most successful in the development of this nascent industry, and with low incidences of fraud.⁵ The inferences drawn from the successful British experience demonstrate that securities crowdfunding in the United States has the potential to fund a wide range of startups and small businesses that lack alternative sources of capital within the context of American

4. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 100–04 (2012) [hereinafter Bradford, *Crowdfunding*] (arguing that Congress should relax securities laws to overcome the critical funding gap for startups between \$100,000 and \$5 million). Professor Bradford points to two causes for this funding gap: “informational inefficiency” and “unavailability of traditional sources of small business financing—bank lending, venture capitalists, and angel investors.” *Id.* at 101 (emphasis added); see also Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (2008) (explaining the funding gap in the context of lack of access to venture capital for many startups). See *infra* Part I.C for a discussion on how securities crowdfunding operates to bridge this funding gap.

5. A survey of securities crowdfunding globally is beyond the scope of this Comment. Work has begun in this area of scholarship however. See, e.g., TAX AND LEGAL WORK GROUP, EUROPEAN CROWDFUNDING NETWORK, REVIEW OF CROWDFUNDING REGULATION (Oliver Gajda, Tanja Aschenbeck-Florange, & Thomas Nagel eds., 2013), available at <http://www.europecrowdfunding.org/wp-content/blogs.dir/12/files/2013/12/ECN-Review-of-Crowdfunding-Regulation-2013.pdf>, archived at <http://perma.cc/F6VN-VZYW> (providing a summary of national laws in Europe and North America applicable to various forms of crowdfunding including for securities offerings).

securities law.

Many commentators have already provided a thorough critique of the JOBS Act policy decisions made by Congress and the SEC.⁶ With the policy train long out of the station, this Comment examines the development of the United Kingdom's functioning but still immature securities crowdfunding market. Empirical evidence provided here suggests that a dynamic securities crowdfunding market might yet emerge in the United States by showing how British crowdfunding evolved within an ever-changing regulatory environment. This should not imply that this Comment advocates for a wholesale adoption of British-style crowdfunding or for that nation's policies. Rather, the evidence presented here supports the argument that critics should not write off the emergence of a securities crowdfunding market in the United States.

The success of securities crowdfunding in the United States will not come easy. As explained in Part II, limitations on the amount of capital a business can raise through crowdfunding and other regulatory hurdles will likely deter many potential investors and entrepreneurs. Portal operators may struggle to offer a critical mass of companies that investors will be willing to support.⁷ Additionally, the small size of the British securities crowdfunding market relative to traditional forms of entrepreneurial finance in that country should mitigate expectations for explosive market growth in the United States.⁸ These concerns aside, securities crowdfunding in the United Kingdom demonstrates that the emerging regulatory framework in the United States should present American stakeholders the opportunity to develop a sustainable and profitable version of the industry.⁹

6. *E.g.*, Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1605–06 (2013) (arguing that the securities crowdfunding market in the United States will be hampered by a combination of heavy-handed regulation on crowdfunding and other JOBS Act provisions that will prove more appealing to most startups).

7. For means of achieving this critical mass, see *infra* Part IV.

8. See LIAM COLLINS, RICHARD SWART & BRYAN ZHANG, *THE RISE OF FUTURE FINANCE: THE U.K. ALTERNATIVE FINANCE BENCHMARKING REPORT 8* (2013) [hereinafter COLLINS, SWART & ZHANG, *ALTERNATIVE FINANCE BENCHMARKING REPORT*] (providing financial analysis of the British securities crowdfunding market).

9. See *infra* Part III (explaining securities crowdfunding in the United Kingdom). By stakeholders, this Comment refers primarily to investors,

The creation of a securities crowdfunding market in the United States begs the question of how stakeholders should measure success. While existing literature in this country has focused on the success of crowdfunding portal operators and securities brokers,¹⁰ these two types of financial intermediaries—whose primary function is to link businesses to capital¹¹—will likely develop scalable models to maximize their profitability in similar ways to their British counterparts.¹² This Comment suggests, alternatively, that success in securities crowdfunding should be measured in terms of placing capital in the hands of as many legitimate entrepreneurs as practicable while protecting investor interests primarily through fraud prevention.¹³

Critics of the JOBS Act and the SEC's proposed implementing rules accurately point out that the securities market created by Congress and the SEC is so tightly constrained by regulation that the securities crowdfunding industry could fail before it gets off the ground.¹⁴ This is certainly a risk, and one that is not unique to securities crowdfunding in the United States. Stakeholders in the United Kingdom also attempt to strike a balance between the often-

businesses seeking capital, financial intermediaries linking these parties, and regulators. Other stakeholders include legal practitioners, academics, and the American public in general whose benefits are less easily measured in terms of job creation and economic growth.

10. The term "portal operator" is a financial intermediary created by the JOBS Act, defined *infra* Part I.C.

11. Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517, 1519 (2013) (describing the important roles financial intermediaries play in financial transactions and detailing scholarship on the historic role of traditional financial intermediaries as gatekeepers to businesses' access to capital).

12. See *infra* Part III (describing securities crowdfunding portals in the United Kingdom); see also *infra* Part II (assessing the role of broker-dealers and funding portals within the JOBS Act framework).

13. In addition to the two measurements of success for securities crowdfunding explained here, a third measurement is the success rate of businesses funded through securities crowdfunding. Developing a testable model for this measurement will be predicated on the first two conditions relevant here: placing capital with businesses that they in turn use for legitimate purposes.

14. See, e.g., Thompson & Langevoort, *supra* note 6, at 1605 (providing an overall critique of crowdfunding and pointing out that regulatory costs under the JOBS Act will dissuade most entrepreneurs from choosing this means of finance); see also Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 196–97 (2013) (examining the myriad regulatory requirements placed on securities crowdfunding intermediaries through the JOBS Act).

conflicting goals of safeguarding investors and developing sources of entrepreneurial finance.¹⁵ Regulators in both countries point out that the risk for fraud against investors is heightened by the new exemptions from long-standing securities laws in the United States and the United Kingdom. Former SEC Chairwoman Mary Schapiro voiced these concerns when stating, “[t]oo often, investors are the target of fraudulent schemes disguised as investment opportunities.”¹⁶ As this Comment explains, many crowdfunding stakeholders agree with Ms. Schapiro. In response to the potential fraud, they expect their government to provide a well-defined regulatory environment, while simultaneously fostering development of a securities crowdfunding market. Karen Kerrigan, legal director of British equity crowdfunding portal Seedrs presented her company’s view that “the average retail investor should have the freedom to participate in [securities] crowdfunding, provided they are appropriately protected.”¹⁷

Part I of this Comment begins with a primer on how crowdfunding operates, and how it serves to bridge the funding gap between owners’ equity and traditional means of capital formation. Part II surveys the current state of securities crowdfunding in the United States at this early juncture, within the context of other recent changes to federal securities laws. Part III examines securities crowdfunding in the United Kingdom where a dynamic market continues to develop within an evolving regulatory regime. Additionally, Part III offers a vision of what this new means of finance might look like to American entrepreneurs and investors. Part IV extrapolates from the British securities crowdfunding experience that a similarly risk-prone yet viable market is possible in the United States, and in particular, for debt crowdfunding. This

15. See *infra* Part III (examining how the British regulator is working with industry stakeholders to develop sound policy protecting investors while encouraging investment).

16. David S. Hilzenrath, *JOBS Act Could Remove Investor Protections, SEC Chair Schapiro Warns*, WASH. POST (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html, archived at <http://perma.cc/6ERU-5LAR>; accord Jonathan Moules, *FCA Outlines Crowdfunding Rules*, FIN. TIMES (Mar. 6, 2014), <http://www.ft.com/intl/cms/s/0/1ee31f08-a51f-11e3-a7b4-00144fea b7de.html#axzz2vLI4H8fX>, archived at <http://perma.cc/6GA8-7FU4> (“We want to ensure that consumers are appropriately protected—but not prevented from investing.” (quoting Christopher Woolard, a British securities regulator)).

17. Moules, *supra* note 16.

Comment concludes with several predictions for the securities crowdfunding market in the United States based on the work presented here.

I. CROWDFUNDING BASICS

Prior to surveying securities crowdfunding in the United States and United Kingdom in Parts II and III, this Comment begins in section A with a foundational summary of crowdfunding to provide context for this new and dynamic means of capital formation.¹⁸ Section B then articulates how securities crowdfunding relates to other forms of early stage business financing. Section C concludes with how the crowdfunding model proposes to bridge the existing funding gap between an entrepreneur's personal sources of capital and traditional forms of financing.

A. *Defining Crowdfunding*

Professor Steven Bradford defines crowdfunding as raising money "through relatively small contributions from a large number of people," usually through the Internet by way of an online intermediary.¹⁹ For the "crowdfunder," raising money through this mechanism eliminates the need for a traditional financial intermediary, such as a bank, thus reducing transaction costs.²⁰ The Internet facilitates the conditions

18. Extensive scholarship exists that reviews and critiques securities crowdfunding, and crowdfunding in general. *See, e.g., generally* KEVIN LAWTON & DAN MAROM, *THE CROWDFUNDING REVOLUTION* (2013) (examining the relationship between online social interaction and crowdfunding, and how this paradigm could revolutionize entrepreneurial finance); Bradford, *Crowdfunding*, *supra* note 4 (providing a detailed taxonomy of crowdfunding).

19. Bradford, *Crowdfunding*, *supra* note 4, at 10 (This Comment applies Professor Bradford's definition of crowdfunding throughout); *see also* Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1459 (2013) (crowdfunding is where "the crowd is asked to contribute capital, as opposed to labor, to the project"). For scholarship on the composition of the crowd, *see* Enrique Estellés-Arolas & Fernando Gonzáles-Ladrón-de-Guevara, *Towards an Integrated Crowdsourcing Definition*, 38 J. INFO. SCI. 189 (2012) (presenting analytical study on the definition of the "crowd."). While used by these authors outside the context of crowdfunding, their extensive effort defining the online "crowd" as a group of individuals linked by the Internet remains relevant here.

20. Bradford, *Crowdfunding*, *supra* note 4, at 5; *see, e.g.,* Judge, *supra* note 11, at 1518 (defining transaction costs as they relate to financial intermediaries as "the costs two parties incur finding one another, overcoming information

permitting these relationships through websites referred to as “platforms” or “portals” and online social media.²¹ These intermediaries create an online marketplace by hosting the fundraising campaign and attracting potential funders from the “crowd.”²² The campaign typically consists of project or financial information provided by the fundraiser and a video pitch to prospective donors or investors. The fundraiser’s use of social media is critical to drawing attention to the campaign and mobilizing the crowd to back it.²³

Crowdfunding has evolved into four general models: donation, reward, debt, and equity.²⁴ These models are not mutually exclusive, and an entity may employ multiple types during its fundraising efforts.²⁵ This Comment focuses primarily on the application of equity and debt crowdfunding as an emerging means of entrepreneurial finance. In contrast, other scholars readily address the application of donation, reward, and individual-lending crowdfunding.²⁶ To summarize, donations crowdfunding is the earliest form of crowdfunding and operates through an online portal linking the fundraiser to donors who have no anticipation of receiving anything in return.²⁷ Reward crowdfunding changes the dynamic from

asymmetries, and negotiating the terms of a transaction”). According to Professor Judge, transaction costs “reduce net welfare gains, making it less likely that an otherwise value-creating transaction will occur.” *Id.*

21. Heminway & Hoffman, *supra* note 3, at 881 (“Crowdfunding involves using a web-based business enterprise to seek and obtain incremental venture funds from the public using a website.”).

22. KRISTOF DE BUYSERE ET AL., A FRAMEWORK FOR EUROPEAN CROWDFUNDING 9, 14 (2012), available at http://www.crowdfundingframework.eu/images/European_Crowdfunding_Framework_Oct_2012.zip, archived at <http://perma.cc/UB98-VEBM> (defining crowdfunding websites as “platforms” who post the crowdfunding campaign or fundraising effort on the website); cf. 15 U.S.C. § 78c(a)(80) (2012) (defining crowdfunding websites as “portals”).

23. See Heminway & Hoffman, *supra* note 3, at 881 (noting the importance of connecting parties through social media websites such as Facebook, Twitter, and LinkedIn).

24. DE BUYSERE ET AL., *supra* note 22, at 10.

25. *Id.* (“The biggest potential [lies] in the combination of different approaches that will allow funding the whole life-cycle of a project, product . . . or other business innovation.”).

26. For a thorough examination of donation and reward, see generally THOMAS ELLIOT YOUNG, THE EVERYTHING GUIDE TO CROWDFUNDING (2012) (providing a detailed account of donation and reward crowdfunding); see also DE BUYSERE ET AL., *supra* note 22, at 10 (summarizing the forms of crowdfunding).

27. See DE BUYSERE ET AL., *supra* note 22, at 10; see, e.g., Campaign for Local Power, INDIEGOGO, <http://www.indiegogo.com/projects/campaign-for-local-power> (last visited Mar. 12, 2014), archived at <http://perma.cc/VDS7-8339> (donation

charitable giving to a model based on funds in return for some nominal good similar or lower in value than the amount donated.²⁸

Entrepreneurs have increasingly relied on reward-based crowdfunding as a means of proving a market for their product while raising seed financing.²⁹ Angel investor networks and venture capital firms often look favorably on a startup that has proven demand for its product through reward crowdfunding.³⁰ For example, Boulder, Colorado-based Seamless Toy Company leveraged its ability to raise \$132,000 on Kickstarter as part of a successful effort to secure \$2.6 million in venture capital while using the funds to move closer to the mass-production of its programmable toys.³¹

B. Securities Crowdfunding Defined

The novel expansion of crowdfunding into the highly regulated world of securities transactions marks a substantial turning point in both the crowdfunding and securities industries. In 2010, securities crowdfunding evolved out of

crowdfunding campaign where a non-profit raised \$193,018 for an initiative in Boulder, Colorado to municipalize the city's utility service).

28. DE BUYSERE ET AL., *supra* note 22, at 10 (defining reward crowdfunding and explaining different types of rewards that crowdfunders typically offer).

29. *Id.* at 10 (using the term "pre-sales" crowdfunding to describe how an entrepreneur can use crowdfunding as an alternative means to measure demand); *see also* Schwartz, *supra* note 19, at 1460 (describing the breadth of the reward crowdfunding market as a \$1.5 billion industry). This Comment follows the path of other commentators, such as Professor Bradford, who combine these types of crowdfunding within the category of reward crowdfunding. Bradford, *Crowdfunding*, *supra* note 4, at 16–20.

30. *See* Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 1, 3 (2014) ("Crowdfunding has been used by founders to demonstrate demand for a proposed product, which can lead to funding from more traditional sources."); *see also* Connie Loizos, *Entrepreneurs Are Taking Kickstarter More Seriously; VCs Should, Too*, PEHUB (Sep. 6, 2012), <http://www.pehub.com/2012/09/entrepreneurs-taking-kickstarter-more-seriously-vc-should-too>, archived at <http://perma.cc/N2T6-GQ8V> (describing how several companies received outside equity investment after successful crowdfunding campaigns, but noting that this approach is not universally successful).

31. SEAMLESS TOY COMPANY, <http://myatoms.com/about> (last visited Feb. 1, 2014), archived at <http://perma.cc/4JYV-PNKE> (Boulder, Colorado-based maker of innovative toys); Michael Davidson, *Seamless Toy Introduces Atoms, the Latest Robotic Toy from Colorado*, XCONOMY (Nov. 25, 2013), <http://www.xconomy.com/boulder-denver/2013/11/25/seamless-toy-introduces-atoms-latest-robotic-toy-colorado>, archived at <http://perma.cc/KC9M-QMPV> (describing the venture capital investment).

reward crowdfunding as a unique and legal method of raising business capital in Europe.³² Professor Andrew Schwartz provides a useful definition of securities crowdfunding as “the sale of unregistered securities over the Internet to large numbers of retail investors, each of whom only invests a small dollar amount.”³³ Securities crowdfunding is further subdivided into equity crowdfunding and debt crowdfunding.³⁴ This section provides baseline definitions of debt and equity crowdfunding.

1. Equity Crowdfunding

In equity-based crowdfunding, a company raises financial capital from the crowd in exchange for an ownership stake, represented by share ownership.³⁵ Startups and other small businesses with high growth potential but lacking cash flows represent the most likely users of equity crowdfunding due to

32. DE BUYSERE ET AL., *supra* note 22, at 6; *see also* LIAM COLLINS & YANNIS PIERRAKIS, THE VENTURE CROWD CROWDFUNDING EQUITY INVESTMENT INTO BUSINESS 9 (July 2012) [hereinafter COLLINS & PIERRAKIS, VENTURE CROWD], available at http://www.nesta.org.uk/sites/default/files/the_venture_crowd.pdf, archived at <http://perma.cc/GL3Y-7CS9> (describing crowdfunding in the United Kingdom in particular). British firms Crowdcube (equity) and Funding Circle (debt) both began operating their current models in 2010. *Meet the Team*, CROWDCUBE, <http://www.crowdcube.com/pg/meettheteam-5> (last visited Sept. 7, 2014), archived at <http://perma.cc/R84N-AKYG>; FUNDING CIRCLE, <https://www.fundingcircle.com/homepage> (last visited Sept. 7, 2014), archived at <http://perma.cc/RP9B-VHQ7>. Until SEC rules described in *infra* Part II.A go into effect, equity and debt crowdfunding remain illegal in the United States.

33. Schwartz, *supra* note 19, at 1458 (this definition will apply throughout this Comment). Other experts refer to this model as “crowd investing,” but the term should be taken to mean the same as “securities crowdfunding” generally. DE BUYSERE ET AL., *supra* note 22, at 11. *See generally* Heminway & Hoffman, *supra* note 3, at 885–906 (concluding that many American crowdfunding portals operating in 2011 should have been concerned that they were illegally selling securities).

34. Professor Bradford offers a distinction between crowdfunded lending to individuals (“peer-to-peer” lending) and debt securities as a means of entrepreneurial finance. Bradford, *Crowdfunding*, *supra* note 4, at 20–23 (providing a thorough discussion of peer-to-peer lending). Collins and Pierrakis and De Buysere et al. both refer to “lending” where this Comment chooses to use “debt” in order to maintain consistency with regulators in the United States as further explained in Part II. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 4; DE BUYSERE ET AL., *supra* note 22, at 10 (neither group of European authors addresses how securities laws impact in their definition sections); *see also* Schwartz, *supra* note 19, at 1458–59 (describing the types of securities that could be issued through crowdfunding).

35. DE BUYSERE ET AL., *supra* note 22, at 11.

their lack of access to other forms of working capital.³⁶ These businesses remain privately held with a limited or non-existent secondary market for the widely-distributed, small equity stakes sold through crowdfunding.³⁷ However, the equity crowdfunding investor may not have any anticipation of a near-term return on the investment. On the contrary, it is more likely that “[t]he intrinsic motivation to become a part of an entrepreneurial venture or to support a particular individual or business, will play a significant part in many investors’ decisions to invest.”³⁸

2. Debt Crowdfunding

Debt crowdfunding occurs when a business borrows money from a large number of individuals providing small amounts of capital aggregated into a loan package by an online intermediary, whereby the business agrees contractually to repay the loan with interest.³⁹ Debt crowdfunding encompasses nebulous terminology as it relates to borrowing by businesses such as “lending-based” crowdfunding, “peer-to-peer lending,” and “peer-to-business lending.”⁴⁰ Generally, crowdfunded loans have a defined term and interest rate.⁴¹ This Comment uses the term “debt” because the offering companies solicit funds from a broad segment of the public.⁴²

36. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 17–19 (explaining the attributes of equity crowdfunding).

37. *Id.* at 30 (noting that “equity investors may have to wait five to ten years for a return”); *see also* Schwartz, *supra* note 19, at 1463 (emphasizing the limitations on equity crowdfunding due to illiquidity of such investments).

38. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 9.

39. DE BUYSERE ET AL., *supra* note 22, at 10–11 (defining debt crowdfunding in terms of “lending”); *see also* Schwartz, *supra* note 19, at 1482 (defining crowdfunded debt as “contractual obligations between the investor and the corporation,” and providing an explanation of the benefits of this type of securities crowdfunding).

40. DE BUYSERE ET AL., *supra* note 22, at 10; YANNIS PIERRAKIS & LIAM COLLINS, BANKING ON EACH OTHER: PEER-TO-PEER LENDING TO BUSINESS: EVIDENCE FROM FUNDING CIRCLE 11–12 (April 2013) [hereinafter PIERRAKIS & COLLINS, BANKING], available at <http://www.nesta.org.uk/publications/banking-each-other-rise-peer-peer-lending-businesses>, archived at <http://perma.cc/NMV2-2K6E>. These authors employ various phrases referring to securitized lending to businesses, where this Comment aggregates the terms into debt crowdfunding.

41. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 3–4.

42. *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES LAW HANDBOOK § 2:7 (2014) (describing when a promissory note is a security). A rebuttable presumption exists “that every note with a maturity in excess of nine

A number of commentators contend that debt crowdfunding could prove to be the most disruptive crowdfunding model to traditional means of small business capital formation. It potentially bridges the funding gap between an owner's equity and traditional financing while ensuring the management team retains control of the business.⁴³ First, an entrepreneur should prefer the sale of debt over equity because "the rights of a debtholder are a matter of contract between her and the corporation to which management is not a party."⁴⁴ Second, based on the terms of the debt contract, an entrepreneur may face a lower chance of personal liability and therefore may be more willing to proceed with the funding.⁴⁵ Finally, debt crowdfunding limits other expenses associated with equity shareholders, such as voting rights and shareholder communications.⁴⁶ Pierrakis and Collins' recent survey in the United Kingdom demonstrated the ability of debt crowdfunding to reduce borrowing transaction costs and thus interest rates, leading over three-fourths of the companies surveyed to state that they would choose this method of funding over bank lending for future capital needs.⁴⁷

Debt crowdfunding is not without its drawbacks, however. Unlike financing raised in equity crowdfunding, the company must pay the money back within the terms of the loan.⁴⁸ The need to service this debt could lead to a cash shortage that limits the company's ability to operate and causes the

months is a security." *Id.* at § 2:10 (citing *Reves v. Ernst & Young*, 494 U.S. 56 (1990)).

43. Schwartz, *supra* note 19, at 1488; *see also* PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 11–12 (describing debt crowdfunding in terms of "peer-to-peer" lending that is providing alternative business finance in the wake of the 2008 financial crisis); *see also infra* Part C (elaborating on crowdfunding's potential effects on the "funding gap").

44. Schwartz, *supra* note 19, at 1488.

45. *Id.* at 1483 (describing the entrepreneur's potential liability from shareholder derivative claims).

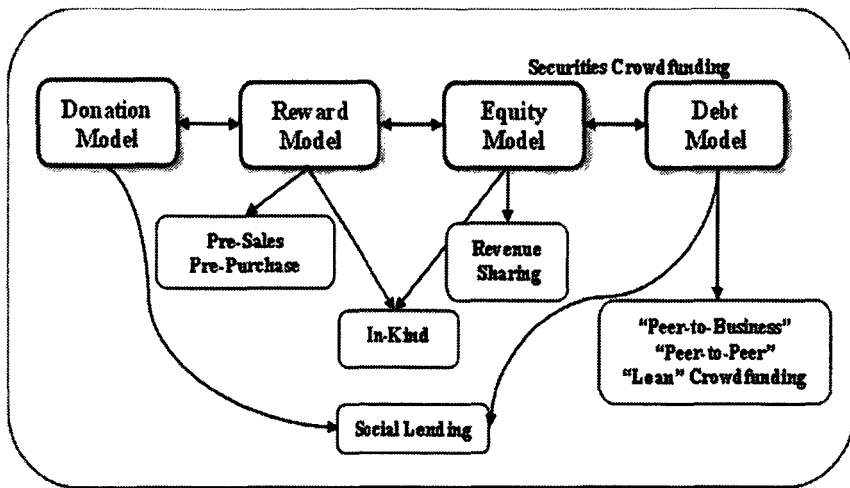
46. *Id.* at 1488; *see also id.* at 1487 (describing an entrepreneur's potential challenges dealing with shareholder voting rights); *id.* at 1484–86 (describing demands for books and records, and the imposition of shareholder resolutions); COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 4 (articulating the concern for entrepreneurs in managing a large diffuse group of shareholders).

47. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 37 (describing survey finding that seventy-seven percent of businesses that used British debt crowdfunding portal Funding Circle would consider debt crowdfunding again before seeking a bank loan).

48. Schwartz, *supra* note 19, at 1488.

management team to lose focus on growing their business.⁴⁹ In order to mitigate their risk, investors from the crowd may demand a history of cash flows or collateral from the company prior to lending, and funding portals may use a company's history as part of its screening criteria.⁵⁰ Such limitations could close off this means of crowdfunding to companies in the pre-revenue stage of development. Figure 1 below graphically depicts the four primary crowdfunding models and several variants that have emerged.⁵¹

Figure 1: The Four Crowdfunding Models and Their Variants



C. Securities Crowdfunding and the Funding Gap

Of relevance to entrepreneurs and other securities crowdfunding stakeholders in the United States is how this

49. *Id.* Professor Schwartz, however, suggests that artful drafting of debt agreements may serve to mitigate the entrepreneur's risk of default. *Id.* at 1489.

50. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 25 (noting that, of eighty-nine companies funded through debt crowdfunding in survey, the average time of incorporation was eleven years); see also *Loan Types and Criteria*, FUNDING CIRCLE, <https://www.fundingcircle.com/businesses/loan-types-and-criteria> (last visited Sept. 7, 2014), archived at <http://perma.cc/ZND8-CF6J> (explaining that the largest debt crowdfunding portal in the United Kingdom requires as part of its screening criteria that a company have been incorporated for a minimum of two years and have a minimum of £100,000 (\$168,000) in sales revenue).

51. DE BUYSERE ET AL., *supra* note 22, at 10–11.

funding mechanism acts as a bridge for funding gaps created by the lack of access to institutional and private equity capital for startups and small businesses. Some crowdfunding advocates see its application as a replacement for traditional means of entrepreneurial finance, such as bank lending and venture capital.⁵² European commentators most exposed to this new model of finance, however, view securities crowdfunding as complimentary to other sources of capital.⁵³ This Comment, adhering to the latter theory, asserts that securities crowdfunding provides a *potential* solution to entrepreneurial finance challenges. Securities crowdfunding cannot replace banks, angel investor networks, or venture capitalists, but it can fill gaps between owners' equity and these follow-on sources of finance.

Funding gaps develop when an entrepreneur exhausts one source of capital before meeting the criteria to acquire additional financing through new investors or bank lending.⁵⁴ Figure 2, below, temporally depicts the traditional forms of early stage finance for a startup.⁵⁵ A typical startup business begins with an initial investment by the founders, family, and friends.⁵⁶ The next step—or goal—for many startups is to pursue some form of equity investment through a combination of business angels,⁵⁷ an angel investor network,⁵⁸ and “super

52. LAWTON & MAROM, *supra* note 18, at 121–23.

53. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 17–18; *see also* DE BUYSERE ET AL., *supra* note 22, at 13 (discussing project owners who use crowdsourcing first before turning to traditional financing).

54. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 18.

55. *See* KAREN E. WILSON & FILIPE SILVA, ORG. ECON. COOPERATION & DEV., POLICIES FOR SEED AND EARLY STAGE FINANCE: FINDINGS FROM THE 2012 OECD FINANCING QUESTIONNAIRE 10–11 (2013) (refer to Figure 2 and Table 2 for a detailed account of the early stage investment cycle), *available at* http://www.oecd-ilibrary.org/science-and-technology/policies-for-seed-and-early-finance_5k3xqsf00j33-en, *archived at* <http://perma.cc/6N98-5GUJ>.

56. *See* Bradford, *Crowdfunding*, *supra* note 4, at 101 (explaining that family members are among the primary sources of initial business capital).

57. *See* COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 17 (describing the limitations of angel financing as angel investors move towards larger investments with greater returns); *see also* *Getting Started With Angel Investing*, ENTREPRENEUR, <http://www.entrepreneur.com/article/52742> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/37DV-ANRW> (defining angel investors as wealthy individuals willing to invest in a startup business in return for an equity stake and possibly other benefits such as a position on the company's board).

58. Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 742 (2010) (defining these networks as “angel investor groups” and

angels” in an effort to obtain funding prior to acquiring venture capital.⁵⁹ Unfortunately, “none of these alternatives has yet developed into a reliable bridge to venture capital,”⁶⁰ as these sophisticated investors have shifted their investments into more developed companies in search of higher returns and defined exit strategies.⁶¹ Securities crowdfunding proposes to bridge the gap between the owners’ initial equity and larger sources of growth capital, and do so within the limits imposed by securities laws on how much an entrepreneur might raise and who can invest.⁶²

noting that “Angels are increasingly abandoning informal operation in favor of organization into regional angel investor groups.”); *see, e.g.*, ANGELLIST, <https://angel.co/about> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/DBU2-2NV6> (example of an Internet-based angel investing platform based in the United States). Business angel networks, such as those assembled on AngelList, “play a match-making function between angel investors and entrepreneurs.” WILSON & SILVA, *supra* note 55, at 53.

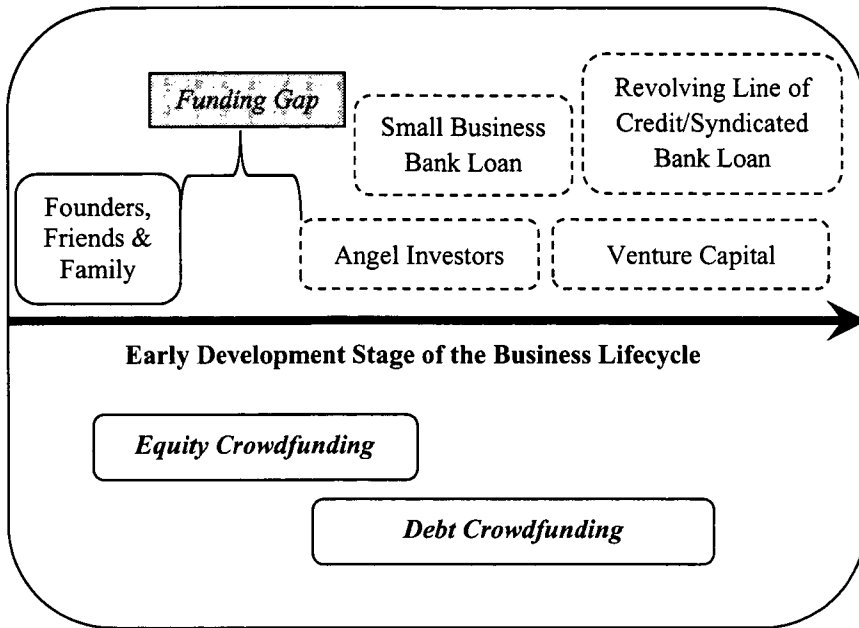
59. Abraham J.B. Cable, *Incubator Cities: Tomorrow’s Economy, Yesterday’s Start-Ups*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 195, 207 (2013) (citing Pui-Wing Tam & Spencer Ante, *Super-Angels Alight: No Longer Flying Solo, Big Investors Attract Others to Juice Start-Ups*, WALL ST. J. (Aug. 16, 2010), <http://online.wsj.com/article/SB10001424052748703321004575427840232755162.html>, *archived at* <http://perma.cc/N9RS-43T3>) (defining “super angels” as “involved investors who form small funds (generally less than \$50 million) to make seed investments in start-ups”).

60. *Id.* at 208.

61. *Id.* at 228 (arguing that the “ambitious exit goals” of venture capital funds contribute significantly to the funding gap); *see also* COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 17–18 (citing angel and venture capital research in the United Kingdom).

62. *See infra* Part II and Part III (describing limitations on securities crowdfunding by regulators in the United States and United Kingdom, respectively); *see also infra* Part III (providing evidence of how British securities crowdfunding bridges the funding gap).

Figure 2: Early Stage Financing—Securities Crowdfunding Filling the Funding Gap⁶³



Recent data suggests that, unless startups and small businesses fit a well-defined profile, venture capital firms may not invest in them.⁶⁴ The average venture capital seed stage round of financing increased from \$2.8 million in 2012 to \$4.3 million in 2013, with the number of deals at its lowest since 2003. This indicates that venture capital firms devoted larger sums to fewer small companies.⁶⁵ This data also points to regional and industry biases for venture capital. Silicon Valley captured 41 percent of all deals, with the software industry leading all others at 37 percent.⁶⁶ Additionally, bank loans in both the United States⁶⁷ and the United Kingdom⁶⁸ remain

63. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 17–18.

64. PRICEWATERHOUSECOOPERS & NAT'L VENTURE CAPITAL ASS'N, MONEYTREE REPORT—Q4 2013/ FULL-YEAR 2013 (2014), available at http://www.pwc.com/en_US/us/technology/assets/pwc-moneytree-q4-and-full-year-2013-summary-report.pdf, archived at <http://perma.cc/S84Y-9FP4>.

65. *Id.* at 5 (showing that companies at later stages of growth experienced increases in funding and decreases in the number of deals as well).

66. *Id.* at 3, 9 (graphically portraying data by industry and region respectfully).

67. ROBERT JAY DILGER, CONG. RESEARCH SERV., R40985, SMALL BUSINESS:

difficult for small businesses to obtain, further exacerbating small business owners' struggle to access capital beyond their friends and family.

For technology and other startups with the potential for high initial revenue growth but little initial cash flow, securities crowdfunding has gravitated towards equity investments by building on the established reward model in several ways.⁶⁹ First, the startup may incorporate the reward model into initial rounds of equity crowdfunding in order to prove that its market exists and to define its potential customer base.⁷⁰ Angel investors and venture capital firms may be more likely to engage a startup that has demonstrated a market for its product and the ability to raise money from a diverse group of potential consumers through the crowd, as suggested by Seamless Toy Company addressed in Part I.A.⁷¹ British crowdfunding demonstrates that larger equity investors, such as angels, use crowdfunding portals as an initial means of identifying target investments, and the portals may facilitate the development of relationships between the entrepreneur and investors.⁷²

ACCESS TO CAPITAL AND JOB CREATION 3–12 (2014), available at <http://fas.org/sgp/crs/misc/R40985.pdf>, archived at <http://perma.cc/Y5SZ-8PAB> (providing federal data suggesting small business lending is not meeting demand). “[M]any, including the [Small Business Administration], view the decline in small business outstanding debt as a signal that small businesses might be experiencing difficulties in accessing sufficient capital to enable them to lead job growth during the current recovery.” *Id.* at 6 (noting the difficulty in extrapolating conclusions regarding the availability of credit to small businesses through the use of proxy data).

68. PIERRAKIS & COLLINS, BANKING, *supra* note 40, at 7–8 (providing statistics on the decrease of bank lending to British small businesses).

69. *See supra* notes 28–31 and accompanying text (describing reward crowdfunding).

70. DE BUYSERE ET AL., *supra* note 22, at 13; *see, e.g., Frequently Asked Questions*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-faq-20> (last visited Sept. 7, 2014), archived at <http://perma.cc/Z446-BPAD> (example of securities crowdfunding portal encouraging issuers to use a reward program and providing a mechanism of advertising the reward through the portal's website); *see also infra* Part III.B (providing additional examples in context of securities crowdfunding in the United Kingdom).

71. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 19; *see supra* Part I.A (describing how Seamless leveraged its successful reward crowdfunding to raise venture capital). Currently, reward crowdfunding serves as the best proxy available in the United States for how securities crowdfunding might contribute to later funding rounds for startups. *See id.*

72. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 19 (“Equity crowdfunding may have the potential to offer an alternative or, in some cases,

Conversely, many small businesses are too small and lack the growth trajectory to warrant investment by angel investors or venture capital firms.⁷³ These firms, furthermore, may lack the financial history or positive cash flow required for debt financing at economically feasible rates. However, these companies are integral to their communities as job creators and key players in the local social fabric.⁷⁴ Securities crowdfunding may have its most profound effect on this segment of small businesses. As evidence from the United Kingdom suggests, the success of equity crowdfunding in local small businesses appears to develop out of the desire for members of the community to have an ownership stake in their local economy while benefiting from discounts and other investor benefits.⁷⁵

A common fear among crowdfunding advocates is regulation that “obstruct[s] access to assets where users want to fund value creation . . . for both[] financial and non-financial reasons,” thus precluding a large segment of the population from investing in small business.⁷⁶ Securities crowdfunding experts acknowledge that keeping this funding model open to the majority of the public is not a foregone conclusion. Unforeseen costs, such as those potentially imposed by portals, and policy-makers’ concerns with fraud prevention, could limit long-term access to many investors.⁷⁷

complementary source of finance for businesses in this space, offering risk capital for early-growth or new product development.”).

73. PETER BAECK ET AL., CROWDING IN: HOW THE UK’S BUSINESSES, CHARITIES, GOVERNMENT, AND FINANCIAL SYSTEM CAN MAKE THE MOST OF CROWDFUNDING 11 (2012) [hereinafter BAECK ET AL., CROWDING IN], available at http://www.nesta.org.uk/about_us/assets/features/crowding_in, archived at <http://perma.cc/D4DZ-Y92V>.

74. GAYLE CHRISTIANSEN ET AL., STRENGTHENING LOCAL ECONOMIES AND CIVIC LIFE: THE UNTAPPED POWER OF SMALL BUSINESSES 6 (2010), available at http://web.mit.edu/colab/pdf/papers/Strengthening_Local_Economies_and_Civic_Life.pdf, archived at <http://perma.cc/X4QQ-ZWHK>.

75. See *infra* Part III.B.2; see, e.g., BAECK ET AL., CROWDING IN, *supra* note 73, at 7–8 (providing evidence of the intrinsic motivations of investors to support small businesses in their community).

76. DE BUYSERE ET AL., *supra* note 22, at 28. Mr. Baeck of Nesta specifically echoed these concerns during his conversation with the Author. Skype Interview with Peter Baeck, Principal Researcher & Liam Collins, Policy Advisor, Nesta (Oct. 29, 2013).

77. Interview with Pater Baeck & Liam Collins, *supra* note 76. Nesta is a United Kingdom-based research organization focused on social and economic innovation issues. *What We Want to Achieve*, NESTA, <http://www.nesta.org.uk/about-us/what-we-want-achieve> (last visited Sept. 7, 2014), archived at <http://perma.cc/2229-N6CY>. Mr. Baeck and Mr. Collins are Nesta researchers and

II. SECURITIES CROWDFUNDING IN THE UNITED STATES

This Part briefly discusses the post-JOBS Act regulatory environment for securities crowdfunding in the United States and its alternatives.⁷⁸ After establishing a frame of reference for the American approach to securities crowdfunding regulation, Part III will examine the securities crowdfunding market and regulatory regime in the United Kingdom. Part IV then suggests that securities crowdfunding in the United States should succeed in ways similar to those in the United Kingdom, in spite of the JOBS Act limitations described in this Part.

A. Securities Laws in the United States and the JOBS Act

Describing securities crowdfunding regulation in the United States requires a summary of the country's evolving securities laws, the effect of regulation on crowdfunding stakeholders, and the perceived risk of fraud to the public. The SEC states that the primary goal of securities regulation in the United States is to protect investors by "prohibit[ing] deceit, misrepresentations, and other fraud in the sale of securities."⁷⁹ In an effort to achieve this goal, the SEC, as directed by the Securities Act of 1933 (Securities Act),⁸⁰ requires companies to comply with an expensive and time-consuming registration

experts in crowdfunding. Peter Baeck, NESTA, <http://www.nesta.org.uk/users/peter-baeck> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/D73K-6RGL>; Liam Collins, NESTA, <http://www.nesta.org.uk/users/liam-collins> (last visited Feb. 1, 2014), *archived at* <http://perma.cc/HR8B-Z3JY> (listing biographies and contact information).

78. A thorough examination and critique of the JOBS Act and its effects on securities crowdfunding in the United States is beyond the scope of this Comment. A significant body of scholarship exists in this field. *See, e.g.*, Thompson & Langevoort, *supra* note 6 (examining JOBS Act changes to securities laws in the United States and reviewing previous scholarship on this subject); *see also* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L. J. 195 (2012) [hereinafter Bradford, *Promise Unfulfilled*], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2066088, *archived at* <http://perma.cc/WT6S-J6F3>.

79. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/laws.shtml>, (last visited Nov. 15, 2013), *archived at* <http://perma.cc/A6HE-9XPS> [hereinafter *Laws*].

80. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)).

process prior to selling securities to the public.⁸¹ Established exemptions for an entrepreneur's friends and family and for accredited investors do permit raising capital without registration.⁸² Section 4(a)(2) of the Securities Act permits these exemptions as "private offerings" or "private placements."⁸³ Section 4(a)(2) private placements are complicated endeavors with considerable risk to the issuer of mistakenly running afoul of the exemption requirements.⁸⁴ The SEC therefore provides certain safe harbors by rule. The most prominent of these safe harbors occur under Regulation D, and are Rules 504, 505, and 506.⁸⁵ These registration exemptions, however, significantly limit an entrepreneur's ability to raise capital without the help of angel investor networks and venture capital funds. Table 1 below provides a summary of registration exemptions.

81. See 15 U.S.C. §§ 77f-g (registration requirements); see also *Laws, supra* note 79 (summarizing registration requirements and the SEC's purpose for registration). These registered public offerings often cost the issuing company over \$1 million. CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, *THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW* 173 (4th ed. 2012).

82. 15 U.S.C. § 77d; see *infra* Table 1 (summarizing important registration exemptions).

83. Securities Act of 1933 § 4(a)(2) (formerly § 4(2) and amended by the JOBS Act).

84. See BAGLEY & DAUCHY, *supra* note 81, at 174.

85. See *id.* at 175; see also Regulation D, Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.500-508 (2014).

*Table 1: Primary Registration Exemptions and the New Crowdfunding Exemption*⁸⁶

Exemption	Aggregate Offering Limitations	Number of Investors	Investor Qualifications	Limits on Manner of Offering
Section 4(a)(2)	No limit	Limited number of offerees	Offerees and purchasers have knowledge of the business and are sophisticated investors	Can only offer to a limited number of offerees who understand the particular risk
Regulation D exemptions from registration				
Rule 504	\$1 million over 12 month period	Unlimited accredited investors ⁸⁷	None required	No general solicitation; does not preempt state regulation
Rule 505	\$5 million over 12 months	Unlimited accredited investors; 35 unaccredited	No requirements for unaccredited investors	No general solicitation; preempts state regulation
Rule 506	No limit	Unlimited accredited investors	Issuer must take reasonable steps to verify investor is accredited	Permits general solicitation of accredited investors; preempts state regulation

[Table Continued on Next Page.]

86. BAGLEY & DAUCHY, *supra* note 81, at 183 tbl. 7.1.

87. Definitions and Terms Used in Regulation D, 17 C.F.R. § 230.501(a) (2014) (defining “accredited investor”). Accredited investors include various types of institutional investors and individuals with assets of at least \$1 million at the time of purchasing the security or income of at least \$200,000 in the previous two years. *Id.*; see also *Accredited Investors*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/accred.htm> (last visited Sept. 7, 2014), archived at <http://perma.cc/X2KP-89QQ>.

Exemption	Aggregate Offering Limitations	Number of Investors	Investor Qualifications	Limits on Manner of Offering
Crowdfunding Exemption (to be implemented)				
Section 4(a)(6)	\$1 million over 12 month period preceding date of transaction	Unlimited	Aggregate amount sold under any exemption limited to: Investor income / net worth < \$100,000, then limited to the greater of \$2,000 or 5% of income or net worth; Investor income / net worth > \$100,000, then limited to 10% of annual income or net worth	General solicitation to all potential investors permitted; preempts state regulation

Rule 506 provides significant advantages over other existing registration exemptions, making it the clear favorite among issuers and intermediaries for private placements.⁸⁸ Pursuant to Title II of the JOBS Act, the SEC added paragraph (c) to Rule 506. This amendment removes monetary limits on issuing securities under Rule 506 and permits issuers to solicit accredited investors.⁸⁹ Exemption from most state regulation is

88. See BAGLEY & DAUCHY, *supra* note 81, at 178 (discussing venture capital financiers' use of Rule 506); see also Thompson & Langevoort, *supra* note 6, at 1604 (asserting the advantages of Rule 506 over other registration exemptions). Part IV, *infra*, contrasts Rule 506 and the new crowdfunding exemptions under section 4(a)(6) in an effort to demonstrate that businesses may use these exemptions at different stages of growth.

89. *Eliminating the Prohibition Against General Solicitation and General*

an additional benefit not available through many other safe harbor provisions.⁹⁰ The advantages of Rule 506 over other exemptions bear out in its use, as demonstrated by a recent SEC study showing that issuers used the rule in 94 percent of all private placement offerings between 2009 and 2012.⁹¹ While Rule 506 will likely continue to be the main conduit for private placement capital, it remains limited to accredited investors. This limitation sets the conditions for the creation of a securities crowdfunding market where accreditation is not a requirement.⁹²

Despite the benefits inherent in registration exemptions such as Rule 506, a lack of access to capital remains, particularly for startups and other small businesses that do not fit the high-growth models sought by most institutional and angel equity investors.⁹³ While angel investors may be willing to take an early stake in a high-risk company with minimal cash flows in exchange for potentially exponential revenue growth later, these types of companies must fit the specific profile desired by investors.⁹⁴ Entrepreneurs may think to turn to bank loans in the absence of outside equity financing. However, bank lending to small businesses has decreased dramatically since the financial crisis of 2008, and has yet to recover to pre-crisis levels.⁹⁵ Where available, bank lending often requires several years' history of cash flows and is subject

Advertising in Rule 506 and Rule 144A Offerings, U.S. SEC. & EXCH. COMM'N (Sept. 20, 2013), <http://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm>, archived at <http://perma.cc/VM77-UDFC>; see *supra* note 87 (describing accredited investors).

90. BAGLEY & DAUCHY, *supra* note 81, at 178.

91. VLADIMIR IVANOV & SCOTT BAUGUESS, SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012, at 7 (2013), available at <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf>, archived at <http://perma.cc/4GML-AGTW>. This study predates the JOBS Act's changes to Rule 506. Additionally, the study points out the insignificant amount of funding issued under other Regulation D exemptions as compared to Rule 506. *Id.*; see also *infra* Part IV (arguing that advantages within the crowdfunding exemption should complement the still dominant Rule 506).

92. See Thompson & Langevoort, *supra* note 6, at 1604 (pointing to the clear advantages of Rule 506 over other registration exemptions). Professors Thompson and Langevoort proceed to describe in detail the Rule 506 exemption as revised by the JOBS Act. *Id.* at 1615–19.

93. See Cable, *supra* note 59, and accompanying text.

94. *Id.*

95. See Dilger, *supra* note 67, at 10–11 (discussing the dramatic fall in small business lending since the financial crisis and its tepid recovery).

to potentially high interest rates depending on the form of collateral provided by the business.⁹⁶

B. The Securities Crowdfunding Registration Exemption

Congress reacted in 2012 to the difficulty small businesses faced in accessing capital by passing the JOBS Act.⁹⁷ Among its provisions, the Act grants a registration exemption for securities offered and sold to the general public through crowdfunding portals.⁹⁸ In addition to permitting general solicitation, the new JOBS Act crowdfunding provisions preempt most state securities registration requirements, or “blue sky” laws,⁹⁹ although the offeror must still inform the state regulator of an offering.¹⁰⁰

Despite these developments, the JOBS Act does not provide entrepreneurs the ability to raise money *carte blanche*.

96. See, e.g., Natale Goriel, *6 Step Guide—How to Get a Business Loan*, SMALL BUS. ADMIN., <http://www.sba.gov/community/blogs/6-step-guide-how-get-business-loan> (last visited Sept. 1, 2014), archived at <http://perma.cc/9H77-VUC4> (advising small business owners on requirements for obtaining a bank loan).

97. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) §§ 301–05 (codified in scattered sections of 15 U.S.C. and amending the Securities Act by adding section 4(a)(6)); see also Press Release, Sec. & Exch. Comm’n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Uol4Zvmsgk0>, archived at <http://perma.cc/D5H-BJW6> (describing the exemption); Bradford, *Promise Unfulfilled*, *supra* note 78, at 198–99 (providing a legislative history of the section 4(a)(6) crowdfunding exemption). The JOBS Act requires that the SEC implement new rules establishing a regulatory framework before the crowdfunding exemption can go into effect. The SEC offered its proposed rules in November 2013 and expects to issue final rules in October 2014. Crowdfunding, 78 Fed. Reg. 66,427 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249), available at <https://www.federalregister.gov/articles/2013/11/05/2013-25355/crowdfunding>, archived at <http://perma.cc/QS2V-MNQE>.

98. See 15 U.S.C. § 78c(a)(80) (2012) (defining “funding portal”); see also *id.* § 77d(a)(6)(C) (exempting transactions conducted through a “portal”); Schwartz, *supra* note 19, at 1462–64 (summarizing the funding portal statutory definition and the portal’s role as an intermediary).

99. 15 U.S.C. § 77r(b)(4)(C) (including crowdfunded securities defined under section 77d(a)(6) as covered securities). Covered securities, as defined by the National Securities Markets Improvement Act of 1996, are exempt from state registration or qualification. Pub. L. No. 104-290, §§ 101-102, 110 Stat. 3417 (codified at 15 U.S.C. § 77r). “Blue sky” laws refer to state securities regulations. See *Blue Sky Laws*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/bluesky.htm> (last visited Sept. 7, 2014), archived at <http://perma.cc/8LRA-BYWA>.

100. 15 U.S.C. § 77d-1(d).

The exemptions the Act created within section 4(a)(6) of the Securities Act have specific limitations and impose significant requirements on crowdfunding intermediaries, as summarized in Table 1 above.¹⁰¹ The many critics of the section 4(a)(6) crowdfunding exemption point to sections where the law does not do enough to protect investors and other places where its limitations will stifle market growth.¹⁰² Among the exemption's specific limitations, Congress limited how much individuals may invest based on an income-to-net-worth test. Investors with a net worth or annual income less than \$100,000 are limited to investing "the greater of \$2,000 or 5 percent of the[ir] annual income or net worth," within a twelve-month period.¹⁰³ This rule allows most Americans to invest a sizeable amount of their income in very high-risk investments.¹⁰⁴ The JOBS Act permits investors with a net worth or income over \$100,000 to invest up to 10 percent of their annual income or net worth, with a \$100,000 investment cap over a twelve-month period.¹⁰⁵ Congress established these limits to protect unsophisticated investors from catastrophic loss, but the law still permits investors to invest (and potentially lose) up to 10 percent of their income each year on high-risk investments.¹⁰⁶

The statute imposes a myriad of additional rules and limitations on the crowdfunding registration exemption. The statutory \$1 million cap on crowdfunded securities issued in any twelve-month period provides one such significant limitation.¹⁰⁷ The widespread application of securities

101. 15 U.S.C. § 77d-1(a) (requirements on intermediaries); see also Heminway, *supra* note 14, at 190–91 (describing the funding portal intermediary within Title III of the JOBS Act); see also *supra* Table 1.

102. Bradford, *Promise Unfulfilled*, *supra* note 78, at 218 (arguing that parts of the exemption are too strict or too lenient); Thompson & Langevoort, *supra* note 6, at 1605 (explaining that issuers will not choose this means of finance because the exemption's many restrictions make it prohibitively expensive). A thorough critique of the crowdfunding exemption and the JOBS Act is beyond the scope of this Comment.

103. 15 U.S.C. § 77r(b)(4)(C); 15 U.S.C. § 77d(a)(6)(B)(i).

104. Table 690: *Money Income of Households—Percent Distribution by Income Level, Race, and Hispanic Origin, in Constant (2009) Dollars: 1990 to 2009*, U.S. CENSUS BUREAU, <http://www.census.gov/compendia/statab/2012/tables/12s0690.pdf> (last visited Sept. 2, 2014), archived at <http://perma.cc/8GGU-2MQM>.

105. 15 U.S.C. § 77d(6).

106. Bradford, *Promise Unfulfilled*, *supra* note 78, at 218. Professor Bradford provides a strong critique of the investor limitation language of the statute in that it adds to the ambiguity of these investor limits. *Id.* at 201–02.

107. 15 U.S.C. § 77d(a)(6)(A) (\$1 million limit); see *supra* Table 2. See also

crowdfunding could be undermined by the speed at which a growing startup might burn through \$1 million and the costs associated with issuing securities under the crowdfunding exemption.¹⁰⁸ Additionally, the JOBS Act imposes disclosure requirements on issuers that increase significantly with the amount of financing.¹⁰⁹ Table 2 below summarizes these disclosure requirements. Within the \$1 million cap, the portal and issuer must establish a predetermined amount of capital to raise within a specific offering period.¹¹⁰ Congress also applied the all-or-nothing approach commonly used in reward-based crowdfunding.¹¹¹ This requires the portal to return investors' money if the issuer fails to reach the agreed funding goal.¹¹² Less onerous, but still time consuming, are requirements that the issuer disclose other information that relates to the funding, the issuing company's structure, and business operations.¹¹³

Bradford, *Promise Unfulfilled*, *supra* note 78, at 197–98 (providing a concise summary and critique of the JOBS Act amendments to the Securities Act).

108. See Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1438 (2012) (critiquing the complexity and poorly drafted language of the statute as it pertains to the \$1 million limit).

109. 15 U.S.C. § 77d-1(b)(1).

110. *Id.* § 77d-1(b)(1)(F) (requiring the issuer to disclose the agreed offering amount and date required to reach this amount).

111. *Id.* § 77d-1(a)(7); see also Kate Taylor, *6 Top Crowdfunding Websites: Which One Is Right For Your Project?*, FORBES (Aug. 6, 2013), <http://www.forbes.com/sites/katetaylor/2013/08/06/6-top-crowdfunding-websites-which-one-is-right-for-your-project/>, archived at <http://perma.cc/U5R8-6JCE> (distinguishing different aspects of crowdfunding websites available in the United States).

112. 15 U.S.C. § 77d-1(a).

113. *Id.* § 77d-1(b).

Table 2: Disclosure Requirements for Securities Funded Under the JOBS Act¹¹⁴

Size of Offer	Disclosure Requirements
\$100,000 or less	- Previous year income tax returns - Unaudited financial statements
\$100,000 up to \$500,000	- Independent public accountant must review the financial statements
Over \$500,000 (up to the maximum \$1,000,000)	- Audited financial statements

The issuer, additionally, cannot advertise its offer for crowdfunded securities.¹¹⁵ The JOBS Act limits the issuer's advertisements to directing potential investors to the crowdfunding portal.¹¹⁶ Based on this restriction, entrepreneurs and portals cannot advertise specific securities offerings or the details of such offerings. Entrepreneurs must take great care in how they spread word of their offerings through social media, but at least this remains a viable option. As securities crowdfunding in the United Kingdom demonstrates, achieving the funding goal often requires a great deal of social networking on behalf of the startup and its founders.¹¹⁷

Unsurprisingly, crowdfunding portals are the most regulated players in this new regime. Entrepreneurs and companies cannot issue crowdfunded securities to the public on their own.¹¹⁸ They must do so through a registered broker-dealer or funding portal.¹¹⁹ This allows broker-dealers registered with the SEC to sell crowdfunded securities.¹²⁰ The

114. See *id.* § 77d-1(b)(1)(D) (providing data for Table 2).

115. *Id.* § 77d-1(b)(2).

116. See *id.* (advertising can only direct potential investors to the portal's website).

117. DE BUYSERE ET AL., *supra* note 22, at 14; see *infra* Part III.A (securities crowdfunding in the United Kingdom).

118. 15 U.S.C. § 77d(a)(6)(C).

119. *Id.* § 78c(a)(4)–(5) (defining broker-dealer); *id.* § 78c(a)(80) (defining funding portal).

120. *Id.* § 78c(a)(4)–(5). An examination of the ability of securities broker-dealers to use the section 4(a)(6) securities crowdfunding exemption is beyond the scope of this Comment as the focus here is on how small businesses will use the exemption to acquire capital, and not on the type of intermediary they use. See Cohn, *supra* note 108, at 1439–41 (critiquing JOBS Act requirements on broker-

JOBS Act additionally creates a new type of intermediary called a funding portal.¹²¹ Essentially, the portal acts as a matchmaker between the issuing company and investors.¹²² As British securities crowdfunding demonstrates, the portals may play a significant gatekeeper role by screening potential issuers before the portal operator posts the offering, also known as a pitch, on its website.¹²³

These portals are, however, severely limited in their interaction with investors and will be highly regulated by the SEC.¹²⁴ Perhaps most importantly, the portal can neither offer advice to potential investors nor advertise their offerings to the public aside from directing potential investors to the portal's website.¹²⁵ Portals will be required to obtain disclosure statements from potential investors certifying that they reviewed "investor-education information," understand their risk of loss, and possess sufficient investor aptitude as required by the SEC.¹²⁶ Additional restrictions on portals require investor funds to be handled by a third party and prohibit portals from paying commissions on sales of securities.¹²⁷ Finally, the law requires portals to prevent fraud by various

dealers and speculating that few of these intermediaries will use the crowdfunding provisions because of potential liability). *But see* Bradford, *Promise Unfulfilled*, *supra* note 78, at 205 (arguing that the JOBS Act provides broker-dealers a competitive advantage over funding portals).

121. 15 U.S.C. § 78c(a)(80); *see also* *Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, SEC. & EXCH. COMM'N (May 7, 2012), <http://www.sec.gov/divisions/marketreg/tmjjobsact-crowdfundingintermediariesfaq.htm>, *archived at* <http://perma.cc/839T-PZ8T> (describing the funding portal and its role). *See generally* Heminway, *supra* note 14, at 177 (providing a detailed account of the new role of the funding portal within American securities law).

122. *See* Schwartz, *supra* note 19, at 1462 (describing the funding portal).

123. *See infra* Part III.A (describing securities crowdfunding regulation in the United Kingdom); Cohn, *supra* note 108, at 1439 (noting that the imposition of an intermediary by Congress was primarily motivated as a fraud deterrent).

124. 15 U.S.C. § 78c(a)(80) (regulating portal operators); *see generally* Bradford, *Promise Unfulfilled*, *supra* note 78, at 205–08 (describing regulations Congress imposed on portals under the JOBS Act crowdfunding exemption; these include requirements to enforce the issuer's mandatory reporting, conduct due diligence, and prohibit the intermediary's principals from investing in the issuer, just to list a few).

125. 15 U.S.C. § 78c(a)(80)(A)–(B) (prohibiting investment advice and solicitation respectfully).

126. *Id.* § 77d-1(a)(3)–(4). The SEC has yet to establish a standard for education and appears willing to allow portals to develop this aspect on their own.

127. *Id.* § 78c(a)(80) (defining a "funding portal" for purposes of the Securities Act).

means, including background checks, as established by SEC rulemaking.¹²⁸ Unfortunately, these requirements placed on the crowdfunding portals may significantly impair an issuer's ability to spread word of their crowdfunding efforts to a mass audience.

While not a comprehensive review of the JOBS Act amendments to the Securities Act, this Part presented a brief account of the emerging regulatory field for securities crowdfunding in the United States and its alternatives. This Comment next examines securities crowdfunding in the United Kingdom through the lens of regulation in the United States. Part IV then makes the case that securities crowdfunding in the United States may yet succeed, despite the regulatory hurdles facing the industry discussed here.

III. SECURITIES CROWDFUNDING IN ACTION: HOW THE UNITED KINGDOM IS LEVERAGING SECURITIES CROWDFUNDING TO SPUR BUSINESS DEVELOPMENT

American entrepreneurs, their legal and financial advisors, and other stakeholders should closely examine the United Kingdom's securities crowdfunding market as the SEC's implementation of the crowdfunding exemption draws near.¹²⁹ The United Kingdom provides a robust example of both equity and debt crowdfunding markets. As this Part explains, the United Kingdom and United States also share similar regulatory and capital market structures. The British equity and debt crowdfunding examples provided here should serve as guides for American crowdfunding stakeholders as they contemplate what a successful securities crowdfunding market might look like.

Section A begins by introducing the regulatory and commercial environments in which British securities crowdfunding operate. Sections B and C then provide detailed examinations of equity and debt crowdfunding, respectively, as they operate in the United Kingdom. With the stage set, Part IV then offers American crowdfunding stakeholders conclusions about how a securities crowdfunding industry

128. *Id.* § 77d-1(a)(5) (requiring crowdfunding intermediaries to take measures to prevent fraud, as promulgated by the SEC).

129. *See supra* Part II.A.

might succeed in the United States based on the British experience.

A. *The Securities Crowdfunding Environment in the United Kingdom*

1. Regulations Affecting Securities Crowdfunding

The United Kingdom presents a unique regulatory environment, although it remains similar enough to the United States to draw conclusions about what securities crowdfunding could look like in the American market. As with securities crowdfunding in the United States, regulation of this new financing model is quickly evolving in the United Kingdom. This section additionally points to an emerging convergence between British and American regulation of securities crowdfunding focused on investor protection. The United Kingdom's securities regulator, the Financial Conduct Authority (FCA), published new rules in March 2014 that provide structured regulation of securities crowdfunding in the form of Policy Statement PS 14/4.¹³⁰

The FCA is the regulator of the British financial services industry. While accountable to the British Treasury, the FCA is an independent organization funded exclusively by the fees it charges regulated firms.¹³¹ It is also a relatively new organization, created under the Financial Services Act of 2012, which provides the FCA with significantly more responsibility

130. *Policy Statement PS14/4—The FCA's Regulatory Approach to Crowdfunding Over the Internet, and the Promotion of Non-readily Realizable Securities by Other Media*, FIN. CONDUCT AUTH. (Mar. 2014), <http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-04>, archived at <http://perma.cc/EZV-5WDL>; see also *Consultation Paper CP13/13—The FCA's Regulatory Approach to Crowdfunding (and Similar Activities)*, FIN. CONDUCT AUTH. (Oct. 2013), <http://www.fca.org.uk/news/cp13-13-regulatory-approach-to-crowdfunding>, archived at <http://perma.cc/US66-CNEM> (proposing rules and opening public comment period prior to new rules issued March 2014). The FCA is an independent statutory organization with a board appointed by the British Treasury, but financed by the financial industry. *How We Are Governed*, FIN. CONDUCT AUTH., <http://www.fca.org.uk/about/governance> (last visited Sept. 6, 2014), archived at <http://perma.cc/3YAP-ZU6B>.

131. *About Us*, FIN. CONDUCT AUTH., <http://www.fca.org.uk/about> (last visited Sept. 6, 2014), archived at <http://perma.cc/6N4N-HBKL> (providing information on the FCA's mission, governance, funding, and structure). A board of directors appointed by the Treasury governs the FCA. *How We Are Governed*, *supra* note 130.

than its predecessor agencies.¹³² The FCA's primary objectives, as required by statute, are consumer protection, market integrity, and fair competition in the financial markets.¹³³

Prior to the FCA's March 2014 Policy Statement, disparate regulators had limited oversight over securities crowdfunding. The industry developed within the context of existing securities and consumer protection laws that permitted this new means of business capital formation, but with inefficient regulatory oversight.¹³⁴ The Policy Statement articulates for the first time the FCA's stated goal regarding securities crowdfunding: to mitigate "the liquidity risk investors face when investing in the equity or debt securities of small and medium enterprises which are difficult to price and for which there is no, or only a limited, secondary market."¹³⁵ The FCA, through its Policy Statement, requires that, prior to an offering, securities crowdfunding intermediaries comply with its pre-existing rules regarding risk warnings, disclosures, and due diligence requirements for "non-readily realizable investments."¹³⁶

The Policy Statement additionally places new limits on investors in crowdfunded securities.¹³⁷ The FCA requires intermediaries to determine, prior to promotion of the security, whether a potential investor is "high net worth," "sophisticated," or is a "restricted investor,"¹³⁸ and requires

132. Financial Services Act, 2012, c. 21, § 6 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted>, archived at <http://perma.cc/6EHX-2E37>.

133. *Id.* § 6(1B)(3). The FCA is the agency most closely resembling the U.S.'s SEC with regard to oversight responsibility and enforcement power, as explained in *supra* note 79 and accompanying text.

134. See *supra* note 132 and accompanying text.

135. *Policy Statement*, *supra* note 130, at 37.

136. *Id.* at 41; see also *id.* at 58 (defining "non-readily realizable security" as an investment not readily liquidated for cash). The FCA's Policy Statement amended its online handbook, including this glossary term. *Financial Conduct Authority Handbook*, FIN. CONDUCT AUTH., <http://fshandbook.info/FS/html/FCA> (last visited Sept. 6, 2014), archived at <http://perma.cc/ZLJ4-DDGF> [hereinafter *Handbook*].

137. David Prosser, *Why UK Crowdfunders Are Holding Their Breath on Regulation*, FORBES (Mar. 7, 2014), <http://www.forbes.com/sites/davidprosser/2014/03/07/why-uk-crowdfunders-are-holding-their-breath-on-regulation>, archived at <http://perma.cc/P383-GCP7> (providing a concise summary of FCA rules regarding investor categories and investor disclosure requirements).

138. FIN. CONDUCT AUTH., RELEASE 156, CONDUCT OF BUSINESS SOURCEBOOK (2014), available at <http://media.fshandbook.info/content/FCA/COBS.pdf>, archived at <http://perma.cc/3UJK-K56H> [hereinafter COBS] (defining the types of investors that may receive offers or "promotions" of crowdfunded securities, including "restricted investor[s]"). The COBS document codifies the FCA's Policy

that securities crowdfunding intermediaries adhere to the FCA's "appropriateness test."¹³⁹ Although the FCA caps the amount that restricted investors may invest, the agency does not limit the amount that both high net worth and sophisticated investors may invest in crowdfunded securities.¹⁴⁰ The FCA defines high net worth and sophisticated investors under preexisting rules,¹⁴¹ and requires that securities crowdfunding intermediaries maintain current statements by investors stating that they are either high net worth or sophisticated.¹⁴²

If an investor is not high net worth or sophisticated according to FCA rules, then the investor is restricted to investing no more than 10 percent of net assets in non-readily realizable investments, including crowdfunded securities.¹⁴³

Statement and is part of the "Business Standards" section of the FCA's online *Handbook*. *Handbook*, *supra* note 136.

139. COBS, *supra* note 138, §§ 10.1–10.7 (Appropriateness Test rules). COBS articulates the Appropriateness Test as a subjective assessment that the investor "has the necessary experience and knowledge in order to understand the risks involved in relation to the product or service offered or demanded." *Id.* § 10.2.1(2)(a). Securities crowdfunding portals must generally comply with the Appropriateness Test when a potential investor signs up for a user account on their website. See *FCA Tackles Crowdfunding*, TAYLOR WESSIG LLP, <http://www.taylorwessing.com/fileadmin/files/docs/FCA-tackles-crowdfunding.pdf> (last visited Sept. 6, 2014), archived at <http://perma.cc/RRV-3WVB> (recommending securities crowdfunding portals obtain information from users about their investment experience and level of understanding, and provide a warning to users if the portal is not satisfied of the appropriateness); see, e.g., CROWDCUBE, <https://www.crowdcube.com> (last visited Sept. 6, 2014), archived at <https://perma.cc/74FM-L3ZC> (requiring an Appropriateness Test to use this popular equity crowdfunding portal).

140. COBS, *supra* note 138, § 4.7.7(2) (requiring the potential investor meet one of the specified categories).

141. *Id.* §§ 4.12.6–4.12.8. The FCA defines a high net worth investor as someone with annual income of at least £100,000 (\$168,000) or net assets of at least £250,000 (\$419,000). *Id.* § 4.12.6. The FCA permits an investor to certify as sophisticated in one of two ways. First, an investor may receive certification by a qualified firm that has assessed the investor to be "sufficiently knowledgeable to understand the risks associated with engaging in investment activity in . . . [non-readily realizable] investments." *Id.* § 4.12.7. Second, an investor may self-certify by providing the intermediary a signed "Self-Certified Sophisticated Investor" statement. *Id.* § 4.12.8. This statement requires that the investor affirm that he or she is a member of a business angel network, has invested in an unlisted company in the previous two years, has worked in the business finance sector over the previous two years, or served as a director of a company with revenues of at least £1 million (\$1.68 million). *Id.*

142. *Id.* § 4.7.9.

143. *Id.* § 4.7.10 (defining investing limits for restricted investors); cf. *supra* notes 97–98 and accompanying text (explaining similar limitations on how much

Securities crowdfunding intermediaries must retain a “Restricted Investor Statement” signed by all potential investors registered with the intermediary, stating that the investor has not invested over the 10 percent limit during the previous twelve months and commits to not doing so through the twelve months from the date of signature.¹⁴⁴

The new rules uniquely affect debt crowdfunding in several ways. The Policy Statement transfers debt crowdfunding from regulation under a separate agency, and gives the FCA regulatory authority over all securities crowdfunding.¹⁴⁵ In an effort to protect parties on both sides of debt crowdfunding transactions, the FCA rules impose minimum capital requirements for portal operators and require alternative servicing arrangements should the portal fail.¹⁴⁶ Additional requirements imposed on debt crowdfunding portals include disclosure of the portal’s business model, defining “secured” debt, and explanations of tax obligations.¹⁴⁷ The FCA’s new rules, however, do not place any additional limits on the amount of capital that a business might raise through securities crowdfunding.¹⁴⁸ This means the only practical legal limitation to a securities issuance is the European Union requirement that a firm produce a prospectus on offers at or

an investor can invest under the Securities Act § 4(a)(6) crowdfunding exemption).

144. *Policy Statement*, *supra* note 130, at 43; *see also* COBS, *supra* note 138, § 4.7.10. Similar to the SEC concerns, the FCA’s limitation on individual investment arises from its objective to mitigate small investors’ over-exposure to illiquid, high-risk investments. *Policy Statement*, *supra* note 130, at 43; *see also supra* Part II.B (describing individual investment limits in the United States).

145. *Policy Statement*, *supra* note 130, at 5 (referring to debt crowdfunding as “loan-based crowdfunding”). The FCA assumed duties as regulator over debt crowdfunding as it applies to businesses from the Office of Fair Trading, effective April 1, 2014. *The FCA Sets Out in Detail How it Will Regulate Consumer Credit, Including Payday Lending, When it Takes Over Responsibility in April 2014*, FIN. CONDUCT AUTH. (Oct. 3, 2013), <http://www.fca.org.uk/news/firms/consumer-credit-detail>, archived at <http://perma.cc/APW4-P5DX>.

146. *Policy Statement*, *supra* note 130, at 18; *see also* FIN. CONDUCT AUTH. INTERIM PRUDENTIAL SOURCEBOOK FOR INVESTMENT BUSINESSES, §§ 12.1–12.2.10 (Apr. 2014), available at http://media.fshandbook.info/Handbook/IPRU-INV_FCA_20140401_2015_1230.pdf, archived at <http://perma.cc/EAN8-9Z23> (codifying the FCA rules).

147. COBS, *supra* note 138, § 14.3.7A.

148. *Policy Statement*, *supra* note 130, at 40–41 n.15; *see also* Council Directive 2010/73, 2010 O.J. (L 327) (EU) (amending 2003/71/EC Art. 1, ¶ 2(h) by requiring a prospectus for securities offerings at or above €5 million). For a comparison of SEC registration to EU prospectus requirements, see Roberta S. Karmel, *The EU Challenge to the SEC*, 31 FORDHAM INT’L L.J. 1692 (2007).

above the equivalent of €5 million.¹⁴⁹

Despite the significant regulation recently imposed on the United Kingdom's nascent securities crowdfunding industry, the positive response from various stakeholders to the new rules stands in contrast to the JOBS Act commentary in the United States.¹⁵⁰ According to debt crowdfunding innovator James Meekings, "[t]he FCA has shown foresight in striking the balance between enabling the industry to continue to flourish while ensuring the protection of investors and borrowers."¹⁵¹ Securities crowdfunding legal expert David Blair, head of financial regulation at the law firm Osborne Clarke, commented that "[t]he regulatory environment in the U.K. is being developed sensibly with industry and consumer groups each having a fair say in the consultation, so that the regime looks well balanced to enable the industry to thrive."¹⁵² The FCA's director of policy, Christopher Woolard, and other crowdfunding industry leaders echoed this sentiment of striking a balance between industry needs and investor protection.¹⁵³ The following sections demonstrate how regulation built around consensus has contributed to securities crowdfunding's success in the United Kingdom.

2. Government Incentives and Securities Crowdfunding

Beyond regulation, the British government has provided

149. *Policy Statement*, *supra* note 130, at 40–41 n.15. This Comment identifies, *infra* Parts III.B and C, other factors limiting the average size of offerings to well below the €5 million limit on prospectus exemption.

150. *Compare* Moules, *supra* note 16 (quoting several British crowdfunding stakeholders on their positive view of the new FCA rules), *with* Thompson & Langevoort, *supra* note 6, at 1604–09 (articulating and citing overwhelming criticism of JOBS Act crowdfunding provisions).

151. Moules, *supra* note 16. James Meekings is co-founder of debt crowdfunding portal Funding Circle. *Id.*; *see also* *Meet the Team*, *supra* note 32.

152. Email from David Blair, Partner, Osborne Clarke, London, to author (Dec. 4, 2013) (on file with author). Mr. Blair is a leading crowdfunding legal expert in the United Kingdom. *David Blair Biography*, Osborne Clarke, <http://www.osborneclarke.com/lawyers/davidblair/> (last visited Nov. 30, 2014), *archived at* <http://perma.cc/7K2B-XUHS>.

153. Moules, *supra* note 16 (quoting Woolard and Karen Kerrigan, legal director of equity crowdfunding portal Seedrs); *see also* Liat Clark, *The FCA is About to Shake up Crowdfunding*, WIRED.CO.UK (Mar. 7, 2014), <http://www.wired.co.uk/news/archive/2014-03/07/crowdfunding-fca>, *archived at* <http://perma.cc/6STV-2RXJ> (articulating overwhelming industry support for new regulation).

incentives for both debt and equity crowdfunding. For example, debt crowdfunding and other “non-traditional” lenders received £85 million (\$143 million)¹⁵⁴ in direct lending to businesses through the Business Finance Partnership (BFP).¹⁵⁵

Not to be outdone, equity crowdfunders receive significant tax incentives for investing in small businesses.¹⁵⁶ Two overlapping incentive programs exist for small business investors. The original program, the Enterprise Investment Scheme (EIS), provides a tax deduction of 30 percent of the cost of shares purchased in qualifying private companies with a maximum tax benefit of £300,000 (\$503,000).¹⁵⁷ The Seed Enterprise Investment Scheme (SEIS) is a follow-up program introduced in April 2012 that provides additional incentives.¹⁵⁸ This program opens tax-incentivized investment in early stage companies to company insiders, and permits a tax deduction for share purchases of 50 percent on investments up to £100,000 (\$142,600).¹⁵⁹ Additionally, SEIS shares are exempt from capital gains tax.¹⁶⁰ Companies are limited to raising

154. *Foreign Exchange Rates*, FED. RES., http://www.federalreserve.gov/releases/h10/hist/dat00_uk.htm (last visited Sept. 28, 2014), archived at <http://perma.cc/MP93-WR JW>. At the time this Comment was written, the Federal Reserve’s most recent data was for August 8, 2014, when £1 equaled \$1.6778. *Id.* This Comment applies this exchange rate throughout.

155. *Making It Easier to Set Up and Grow a Business*, DEP’T. FOR BUS., INNOVATION & SKILLS, <https://www.gov.uk/government/policies/making-it-easier-to-set-up-and-grow-a-business—6/supporting-pages/encouraging-private-sector-investment> (last updated Feb. 3, 2014), archived at <http://perma.cc/P488-U6CQ>. Funding Circle borrowers may receive direct loans from the BFP as if it were an individual crowdfunder. *Government General FAQs*, FUNDING CIRCLE, <https://support.fundingcircle.com/forums/21594611-Government-General-FAQs> (last visited Sept. 7, 2014), archived at <http://perma.cc/N3XV-JTDA>.

156. The capital gains tax laws in the United Kingdom differ greatly from the United States. The specifics of these programs are offered here only as an example of policymakers partnering with industry to encourage investment in small business. This Comment takes no position regarding the need for American policymakers to change tax policy in support of crowdfunding.

157. *Enterprise Investment Scheme*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/eis> (last visited Sept. 7, 2014), archived at <http://perma.cc/HC5Z-DREP>. HMRC is the United Kingdom’s taxing authority. See *HM Revenue & Customs*, GOV.UK, <https://www.gov.uk/government/organisations/hm-revenue-customs> (last visited Sept. 7, 2014), archived at <https://perma.cc/ZJD3-XCKB> (describing scope and mission of the agency).

158. *Seed Enterprise Investment Scheme*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/seedeis> (last visited Sept. 7, 2014), archived at <http://perma.cc/S546-2BTW>.

159. *Id.*

160. *Id.*

£150,000 (\$252,000) in SEIS shares.¹⁶¹ Qualifying for EIS and SEIS shares provides equity issuers an important marketing tool in offering their shares.¹⁶²

3. Securities Crowdfunding Portal Operations: The Portal as Gatekeeper

Despite the more hands-off regulatory approach taken by the FCA as compared to Congress and the SEC, portal operators in the United Kingdom have developed several measures to police themselves for the sake of legal protection and to protect their brand images.¹⁶³ Even before the FCA's recent rule changes, all British-based platforms performed some level of gatekeeping through applicant screening for fraud, and many portals used their broad discretion to vet proposals for potential appeal to investors.¹⁶⁴ This is perhaps

161. *Seed Enterprise Investment Scheme Background*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/seedeis/background.htm> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/ZMJ3-U225>. These government incentives appear to have a correlated impact on portal behavior, as £150,000 is the maximum issuance sought by equity crowdfunding sites such as Seedrs and Crowdcube. *Is There a Maximum Amount of Seed Capital I Can Raise Through Seedrs?*, SEEDRS, http://www.seedrs.com/faq/items/42_is_there_a_maximum_amount_of_seed_capital_i_can_raise_through_seedrs (last visited Sept. 7, 2014), *archived at* <http://perma.cc/ACX5-RH5G> (limiting issuers to £150,000 unless the portal believes investor demand would permit a higher figure); *Frequently Asked Questions*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-faq-20> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/Z4BE-NMWW> (explaining that the portal's "maximum . . . [t]arget amount" issued is £100,000 to £150,000, otherwise the issuer must present a "compelling proposition" to convince Crowdcube to list the issuer).

162. *E.g., Investment Opportunities*, CROWDCUBE, <http://www.crowdcube.com/investments> (last visited Nov. 8, 2014), *archived at* <http://perma.cc/CH5V-VGYQ> (as of Nov. 8, 2014, all of the listed offerings qualify for either EIS or SEIS).

163. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 24. These measures are similar to those prescribed by the JOBS Act in the United States. *See supra* Part II.B. The FCA does not place significant responsibility on the portals to screen potential issuers, and this is a major difference with the American approach. *See supra* Part III.A. *But see* Bradford, *Promise Unfulfilled*, *supra* note 78, at 205–08 (describing the many regulations Congress imposed on portals under the JOBS Act crowdfunding exemption; these include requirements to enforce the issuer's mandatory reporting, conduct due diligence, and prohibit the intermediary's principals from investing in the issuer).

164. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 24. Collins and Pierrakis assert funding sites will tailor this screening function as a means of competing for the best investors and companies. *Id.* For scholarship on the role of financial intermediaries (which includes securities crowdfunding portals) as gatekeepers, see Judge, *supra* note 11, at 1519.

why the FCA chose not to establish minimum due diligence requirements in its recently promulgated rules.¹⁶⁵ In response to comments on its proposed rules, the regulator replied, “[a]t present, it is for firms to determine the risks present in their business models and to develop appropriate processes to deal with them.”¹⁶⁶ The important takeaway here for securities crowdfunding stakeholders is that a dynamic market has evolved in the United Kingdom within a private ordering framework where the portals conduct due diligence on potential offerors.

The screening process begins with an application submitted by the company seeking funding from the portal.¹⁶⁷ An application, known as a pitch, generally includes background information on the company, its founders, management team, and primary financial backers, along with a fixed amount of money that the company seeks to raise in the campaign.¹⁶⁸ The portal then exerts significant discretion on whether or not to proceed with launching the campaign.¹⁶⁹ Additionally, all securities crowdfunding portals in the United Kingdom examined in this Comment apply the “all-or-nothing”

165. *Policy Statement*, *supra* note 130, at 15.

166. *Id.* The FCA left open the possibility that it would consider emplacing due diligence requirements “depending on how the market evolves.” *Id.* at 16.

167. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 4; *see also* PIERRAKIS & COLLINS, BANKING, *supra* note 40, at 9 (describing application process for debt crowdfunding portal Funding Circle).

168. *See, e.g., Getting Your Pitch on Crowdcube*, CROWDCUBE, <http://www.crowdcube.com/pg/getting-your-pitch-on-crowdcube-1374> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/3D9K-23WS> (describing a securities crowdfunding portal’s process for hosting an offering on its website); *see* CROWDING IN, *supra* note 73, at 5 (providing a graphical representation of the crowdfunding process); *see also* DE BUYSERE ET AL., *supra* note 22, at 14 (describing crowdfunding portal operations from pitch to funding the campaign); *cf. Create a Campaign*, INDIEGOGO, <http://support.indiegogo.com/hc/en-us/articles/526556-Create-a-Campaign> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/U2ZM-C7FC> (providing an example of a United States-based crowdfunding site’s description of how to set up a reward or donation campaign in terms similar to British securities crowdfunding models).

169. *See* COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 4, 11 (listing relevant factors often considered in the vetting process). *Compare Getting Your Pitch on Crowdcube*, *supra* note 168 (explaining how after company submitting for funding meets initial threshold criteria, a decision to launch campaign is premised heavily on subjective assessment of its pitch), *with How Borrowing Works*, FUNDING CIRCLE, <https://www.fundingcircle.com/businesses/how-borrowing-works> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/Q3MM-GEBQ> (vetting loan applicants primarily on quantitative risk data rather than on subjective elements of a business pitch).

model, whereby the issuing company only receives the money it raised if it hits the minimum target established at the outset of the campaign.¹⁷⁰ The all-or-nothing model presupposes that potentially negative information about a company will diffuse throughout the crowd of potential investors, ensuring that only legitimate and financially viable ventures receive funding.¹⁷¹

B. Equity Crowdfunding in the United Kingdom

A 2013 study estimates the value of the British equity crowdfunding market at £29.5 million (\$49.6 million).¹⁷² Although this represents a sliver of the British private equity market, the same study reports 371 percent growth in the amount funded since 2011.¹⁷³ Such data suggests equity crowdfunding has established a market position among other means of risk capital formation in the United Kingdom. First, this section looks at common strategies employed by equity crowdfunding portals, investors, and entrepreneurs in the United Kingdom. Next, it turns to conclusions and common concerns among stakeholders.¹⁷⁴

1. British Equity Crowdfunding in Action

Equity crowdfunding in the United Kingdom begins with a

170. See COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 24 (describing the “all-or-nothing” model); see, e.g., *Customer Support*, FUNDING CIRCLE, <https://support.fundingcircle.com/entries/22555211-What-happens-if-my-loan-does-not-become-fully-funded-> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/55FH-BK4U> (applying all-or-nothing approach in that “borrowers cannot receive partially funded loan requests”). The JOBS Act similarly requires that securities crowdfunding portals in the United States apply the all-or-nothing model. See 15 U.S.C. § 77d(a)(7) (2012) (discussed *supra* Part II.B).

171. COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 24 (citing the proliferation of social media as a means of measuring an entrepreneur’s creditworthiness and trustworthiness).

172. COLLINS, SWART & ZHANG, *ALTERNATIVE FINANCE BENCHMARKING REPORT*, *supra* note 8, at 8 (figure based on market data collected by authors and combines “Equity-based Crowdfunding” and “Revenue/Profit Sharing Crowdfunding”).

173. *Id.*; see also U.K. CROWDFUNDING ASS’N, <http://www.ukcfa.org.uk/members> (last visited Oct. 10, 2014), *archived at* <http://perma.cc/AKN7-DW5F> (listing 38 member portals operating in the UK).

174. Appendix A, *infra*, provides additional information on securities crowdfunding in the United Kingdom through a case study of the equity portal Crowdcube.

pitch submitted by the offering company to the portal website. In addition to the financial and background information discussed in Part III.A.3, the pitch contains aspects of an online marketing tool for the company to appeal to investors.¹⁷⁵ This often includes a promotional video and customer testimonials as well as required information such as the percent of equity the company offers and the total amount it seeks to raise. While pitch requirements may be fairly uniform, differentiation among portals arises at the selection stage. As stated in Part III.A, the FCA chose not to implement universal due diligence standards. This leaves the portals to select companies based on a wide array of criteria that ranges from their financial disclosures to the marketability of their proposed campaign.¹⁷⁶ When a company is chosen, the company and portal then contract for a funding goal, start date, and deadline to raise the funds.¹⁷⁷ Under this contract arrangement, the portal receives a fixed percentage of the amount raised, but only if the offering company reaches its goal.¹⁷⁸

Once a pitch is accepted, the portal presents it to the public on its website as a campaign where interested investors can view the entrepreneur's pitch, and communicate directly with the offering company to ask questions.¹⁷⁹ Additionally, the portals encourage entrepreneurs to rely on their social networks, particularly online social media such as Facebook, to generate excitement about their campaign.¹⁸⁰ British law

175. See, e.g., *The Crowdcube Crowdfunding Process*, CROWDCUBE, <http://www.crowdcube.com/pg/the-crowdcube-crowdfunding-process-1371> (last visited Sept. 6, 2014), archived at <http://perma.cc/3EPP-X6FK> (offering an eleven-step roadmap for developing a pitch and selling shares).

176. *Policy Statement*, *supra* note 130, at 15–16.

177. BAECK ET AL., *CROWDING IN*, *supra* note 73, at 5.

178. See, e.g., *What Fees Do Crowdcube Charge?*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-faq-20> (last visited Sept. 6, 2014), archived at <http://perma.cc/Z446-BPAD> (assessing a five percent fee on the amount raised plus additional charges); cf. *What Are the Fees?*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter+basics#faq_41854 (last visited Sept. 6, 2014), archived at <http://perma.cc/QP99-CGGK> (United States-based reward crowdfunding portal with similar five percent fee structure on the amount raised).

179. See, e.g., *Am I Able to Ask the Entrepreneur Questions About Their Business?*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-faq-20> (last visited Sept. 6, 2014), archived at <http://perma.cc/Z446-BPAD> (directing investors to the “Forum” section of a pitch).

180. See, e.g., *Creating a Successful Pitch*, CROWDCUBE, <http://www.crowdcube.com/pg/creating-a-successful-pitch-1373> (last visited Sept. 6, 2014), archived at

restricts funding portals from advertising securities crowdfunding campaigns beyond the pitches posted to their website, leaving the challenge of generating buzz about a campaign to the entrepreneur.¹⁸¹ Applying the all-or-nothing approach discussed in Part III.A.3, if the company fails to reach its funding goal then the portal refunds investors their money (or allows them to save it in escrow for another investment) and the company receives nothing.¹⁸² If the company meets its funding goal then it receives the money it raised after the portal takes any necessary legal steps and consolidates the funds from investors for distribution to the company.¹⁸³ In return, the new investors receive their shares in the company as agreed to in the terms of the offering and their investment contract with the portal.¹⁸⁴ The securities purchased may have privileges that vary from voting rights for the board of directors to naming a product, or, at the discretion of the issuer, the securities may include no rights at all.¹⁸⁵

<http://perma.cc/BY2D-RZZJ> (offering a step-by-step approach to creating and promoting a successful pitch).

181. See COBS, *supra* note 138, § 4.7.7(2) (requiring that retail clients receiving the direct-offer financial promotion be investors certified as “high net worth,” “sophisticated,” or “restricted”). The JOBS Act imposes a similar requirement on securities crowdfunding in the United States as well. See *supra* Part II.B.

182. See BAECK ET AL., CROWDING IN, *supra* note 73, at 4–5; cf. 15 U.S.C. § 77d(a)(7) (2012) (describing a similar requirement for securities crowdfunding in the United States); see also *supra* note 111 and accompanying text (describing all-or-nothing approach in American crowdfunding regulation).

183. See, e.g., *The Crowdcube Crowdfunding Process*, CROWDCUBE, http://www.crowdcube.com/pg/the-crowdcube-crowdfunding-process-1371#Pitch_Funded (last visited Sept. 6, 2014), archived at <http://perma.cc/3EPP-X6FK> (proving potential issuers with steps in how this portal executes the funding process).

184. *Id. Contra Seedrs and Crowdfunding FAQs*, SEEDRS, http://www.seedrs.com/faq/items/83_what_am_i_buying_with_my_investment_am_i_buying_shares_in_the_startup_or_something_else (last visited Sept. 6, 2014), archived at <http://perma.cc/SLY7-5JMP> (describing how the portal holds shares as a “nominee”). Additionally, Paragraph 7.2 of the company’s Membership Agreement further explains that the shareholder is a beneficial owner of the shares and not the legal owner. *Membership Agreement*, SEEDRS (on file with the author) (also available by signing up for a Seedrs account at <https://www.seedrs.com/join>). Seedrs is an equity crowdfunding portal offering a unique business model focused on businesses at the “seed” stage of early development. See *About Us*, SEEDRS, http://www.seedrs.com/about_us/philosophy (last visited Sept. 6, 2014), archived at <http://perma.cc/YVX7-VX8K>.

185. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 15–16 (refer to Box 2, “Post-investment,” where the authors describe potential investor rights among several crowdfunding portals); see, e.g., *infra* Appendix A (describing how a British brewer, Little Brew, combined rewards, voting rights, and other benefits

For potential investors, investing in a company through an equity crowdfunding portal requires little effort. While all portals in the United Kingdom require a potential investor to establish a user account prior to investing,¹⁸⁶ due diligence is often limited to a user name, password, contact information, and determining the type of investor.¹⁸⁷ The investor does not provide financial information until he or she is ready to invest. Once an investor becomes a shareholder, portals typically offer additional value by helping these new equity owners keep in contact with the companies they have invested in.¹⁸⁸ This may help the investor take advantage of any perks associated with their stock ownership and keep them informed of additional investment opportunities.¹⁸⁹ The focus for most portals appears to be on the retention of investors as a stable source of revenue, and not on the post-issue companies. Perhaps the portals operate under the assumption that focusing too much time on the funded companies is not in their economic interest because these companies are unlikely to conduct future rounds of financing through crowdfunding.¹⁹⁰

While all portals in the United Kingdom possess some common traits regarding campaign management and signing up investors, the portals typically distinguish themselves on customer service and targeted companies. On one hand, the early market entrant Crowdcube presents investors with many different types of filters for selecting a diverse range of possible investments.¹⁹¹ The site also provides ample historical data.¹⁹² However, its information pages and interaction between

of stock ownership in its offering). *Little Brew*, CROWDCUBE, <http://www.crowdcube.com/investment/little-brew-13197> (last visited Sept. 6, 2014), archived at <http://perma.cc/8EPU-UMYU>.

186. COBS, *supra* note 138, § 4.7.7 (requiring the creation a user account by regulation prior to investing).

187. See COBS, *supra* note 138, §§ 4.7.7–4.7.10. The type of investor refers to high net worth, sophisticated, or restricted. *Supra* Part III.A.

188. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 27 (discussing examples of post-investment support provided by portals).

189. These investor benefits may include voting or other substantial rights, or be as simple as receiving the company's product or service in the same way as reward crowdfunding discussed *supra* Part I.A.

190. A further question, beyond the scope of this Comment, is how many of the funded companies return to equity crowdfunding for additional rounds of finance rather than moving on to more traditional forms once crowdfunding has achieved its ends.

191. *Investment Opportunities*, CROWDCUBE, *supra* note 162.

192. *Id.*

investors and entrepreneurs is minimal, perhaps in an effort to target investors with more experience. On the other hand, Seedrs only targets companies in their startup phase and investors willing to bear the risk of investing in these types of companies.¹⁹³ This portal advertises its ability to link novice entrepreneurs with experienced mentors through its network and the crowd.¹⁹⁴

2. The Positive Side of Equity Crowdfunding in the United Kingdom

British crowdfunding experts predict that the equity crowdfunding market should continue to grow exponentially based on a foundation of small businesses that do not appeal to traditional suppliers of equity capital. “The traditional sources of risk capital, business angels and venture capitalists, have increasingly been moving their investment activity upstream in recent years, making bigger investments into more developed companies,” in an effort to generate higher returns.¹⁹⁵ Many have moved out of the market for seed financing, creating a funding gap as discussed in Part I.¹⁹⁶ Equity crowdfunding proponents believe this scalable funding model can create long-term value by expanding access to capital for small businesses.¹⁹⁷

As the British equity-crowdfunding model develops, intrinsic motivations behind investor decisions emerge. Initial research indicates that crowdfunding investors often choose to

193. See *About Us*, SEEDRS, http://www.seedrs.com/about_us/what_is_seedrs (last visited Sept. 6, 2014), archived at <http://perma.cc/4HQS-5MD4>.

194. *Seedrs and Crowdfunding FAQs*, SEEDRS, http://www.seedrs.com/faq/items/68_in_addition_to_capital_i_need_mentorship_and_support_for_my_startup_does_seedrs_provide_this (last visited Sept. 6, 2014), archived at <http://perma.cc/TS6B-ABPJ>. This Comment does not seek to provide a comprehensive market study of British portals, but the two examples here are relevant to potential application in the United States.

195. COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 17; see also BAECK ET AL., *CROWDING IN*, *supra* note 73, at 11 (discussing the potential scalability of securities crowdfunding and the social problems resulting from a lack of funding it potentially helps solve); cf. CHRISTIANSEN ET AL., *supra* note 74 and accompanying text (providing recent data suggesting similar trends in the United States).

196. See COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 17.

197. See BAECK ET AL., *CROWDING IN*, *supra* note 73, at 9 (juxtaposing “the current state of play” of traditional capital opportunities with “how crowdfunding can add value” through investors acting as “a platform, not as a principal”).

invest at least as much out of an emotional attachment to the company as they do for eventual return on their equity.¹⁹⁸ Many British crowdfunding investors express a desire to invest at least some of their excess capital in businesses within their community, and particularly in those that provide social benefits.¹⁹⁹

Evidence suggests equity crowdfunding may prove most successful for consumer-oriented businesses.²⁰⁰ These businesses can appeal to a much larger group of potential investors who are consumers themselves.²⁰¹ Food and beverage producers, for example, have used equity crowdfunding as a means of validating their business model to obtain other means of private equity later, while developing relationships with their customers.²⁰² Consumer-product and service companies stand in contrast to complicated high-technology startups. High-technology firms have largely shunned crowdfunding over other means of raising equity.²⁰³ This happens for two reasons.

198. See COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 9. This research indicates a strong market for what its authors describe as “socially focused ventures,” where profitability of the enterprise may be secondary to some other social goal. See *id.* at 20 (providing case study of the WakaWaka light); see also *infra* Part IV (discussing a similar opportunity for equity crowdfunding in the United States).

199. COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 20; see, e.g., David Prosser, *BrewDog Smashes U.K. Crowdfunding Records*, *FORBES* (Dec. 23, 2013), <http://www.forbes.com/sites/davidprosser/2013/12/23/brewdog-smashes-uk-crowdfunding-records>, archived at <http://perma.cc/8GXD-2DSW> (discussing how the largest independent brewer in Scotland has used equity crowdfunding to raise capital while developing a closer relationship with its customers through a mix of equity and reward perks for investors).

200. See COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 19 (hypothesizing “consumer-facing businesses” may be more suited to equity crowdfunding because potential investors are also potential consumers); see also *infra* Appendix A (Crowdcube case study). Well over half of Crowdcube’s successfully funded companies have been consumer-oriented. See *Crowdcube Infographic*, CROWDCUBE, <http://www.crowdcube.com/infographic> (last visited Nov. 8, 2014), archived at <http://perma.cc/V7TJ-HWS9>.

201. COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 19; see, e.g., *Crowdcube: Taking the Equity Crowdfunding Model and Going Global*, *GROWTHBUSINESS* (Nov. 25, 2013), <http://www.growthbusiness.co.uk/growing-a-business/business-finance/2440137/crowdcube-taking-the-equity-crowdfunding-model-and-going-global.shtml>, archived at <http://perma.cc/LGE8-B2UR> (quoting Crowdcube founder Luke Lang that approximately one third of total investment has been to food and drink companies).

202. E.g., COLLINS & PIERRAKIS, *VENTURE CROWD*, *supra* note 32, at 19.

203. *Id.* Crowdcube, for example, admits that only four “IT and Telecommunications” firms have successfully raised capital through its site. See *Crowdcube Infographic*, CROWDCUBE, *supra* note 200.

First, these types of companies still appeal to angels and venture capital because of their high growth potential and scalability.²⁰⁴ Second, equity crowdfunding inherently requires a great deal of disclosure to the public of the firm's business model so that potential investors may determine if the founders' valuation is accurate.²⁰⁵ This may explain why technology startups, with complex and potentially valuable intellectual property, have not rushed into crowdfunding.²⁰⁶

3. The Pitfalls of Equity Crowdfunding in the United Kingdom and How Stakeholders Are Attempting to Mitigate Them

An inherent problem with equity crowdfunding is establishing a valuation for private firms that often lack a history of sales revenue or profits.²⁰⁷ Entrepreneurs must determine valuation on their own or, at best, receive minimal assistance from the crowdfunding portal.²⁰⁸ Unfortunately, the significant uncertainty that surrounds future cash flows makes determination of the firm's present value difficult for even experienced financial consultants.²⁰⁹ To mitigate this

204. See Scott Shane, *Why Equity Crowdfunding Isn't a Threat to Venture Capital*, ENTREPRENEUR (Oct. 7, 2013), <http://www.entrepreneur.com/article/228738>, archived at <http://perma.cc/TKW7-CC7M> ("Equity crowdfunding will provide businesses in other industries—restaurants and retail establishments, for instance—and companies with lesser growth potential with a new way to raise money.").

205. See Shireen Smith, *Using Crowdfunding Sites Could Destroy Your Nascent Business Idea*, GUARDIAN (June 27, 2013), <http://www.theguardian.com/media-network/media-network-blog/2013/jun/27/crowdfunding-sites-destroy-business-idea>, archived at <http://perma.cc/6P4T-QRD7> (advising entrepreneurs to secure intellectual property rights prior to launching crowdfunding campaigns).

206. See Nicholas Wells, *The Risks of Crowdfunding*, RISK MGMT. (Mar. 4, 2013), <http://www.rmmagazine.com/2013/03/04/the-risks-of-crowdfunding>, archived at <http://perma.cc/3C5A-VYLQ> (describing the intellectual-property hazards posed under patent laws for crowdfunding users, particularly those in high-technology industries).

207. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 23.

208. *E.g.*, *Getting Your Pitch on Crowdcube*, CROWDCUBE, <http://www.crowdcube.com/pg/pitch-support-services-1372> (last visited Sept. 7, 2014), archived at <http://perma.cc/55A8-RBUR> (offering very limited assistance with valuation without additional fees).

209. JANET KIHOLM SMITH & RICHARD L. SMITH, ENTREPRENEURIAL FINANCE 287 (2004) [hereinafter SMITH & SMITH] (discussing valuation from the entrepreneur's perspective); see also Ross B. Emmett, *Frank H. Knight on the "Entrepreneur Function" in Modern Enterprise*, 34 SEATTLE U. L. REV. 1139, 1141 (2011) (describing Knightian uncertainty in the context of the modern

uncertainty, sophisticated investors in entrepreneurial finance, such as venture capitalists and angel investors, often play an active role in assisting their target firms with valuation, in addition to providing other financial and management expertise.²¹⁰ The crowd, unfortunately, fails to fulfill this role of the initial valuation expert, at least at the present stage of crowdfunding.²¹¹ Some equity crowdfunding proponents offer only cursory rhetoric in this regard or ignore the entrepreneur's valuation dilemma entirely.²¹² With such limited resources for valuation, it is little wonder that high-tech entrepreneurs and other startups with difficult-to-value intellectual property may find equity crowdfunding to be against their interests.

Most British equity portals, however, do allow some valuation flexibility when posting a company's campaign.²¹³ This permits the company to increase the amount of equity if it overvalued the offering at the onset of the campaign.²¹⁴ Generally, this takes retroactive effect for investors who already committed.²¹⁵ Equity crowdfunders in the United Kingdom have also faced the challenge of what rights to provide their shareholders. Companies that choose not to provide their crowdfunding investors with voting rights subject the investors to possible inequities. This can lead to lower-quality investors who are unwilling to risk much, and result in

entrepreneur). Smith and Smith additionally provide several models and simulations to aid in determining the present value of a startup firm. SMITH & SMITH, *supra*, at 288–330.

210. SMITH & SMITH, *supra* note 209, at 481–88 (addressing how VCs add value including valuation, negotiating future financing rounds, and management strategy).

211. *See supra* Part I.B.1 (explaining that equity crowdfunding platforms require *ex ante* valuation to launch the crowdfunding campaign); *see also supra* Part III.B.3 (ex ante valuation and its drawbacks in the United Kingdom).

212. LAWTON & MAROM, *supra* note 18, at 85 (“Public valuations have been crowdsourced since mankind has traded goods, and certainly in capital markets”). *Contra* DE BUYSERE ET AL., *supra* note 22, at 15 (addressing the concern of ex ante valuation “as there are often parts of the business, such as intellectual property or estimations on market size and scale that are difficult to estimate or quantify”).

213. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 23; *see, e.g., Frequently Asked Questions*, CROWDCUBE, *supra* note 70.

214. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 23. In theory this could apply in the opposite direction, and the amount of equity offered could be reduced if the company was undervalued. *See id.*

215. *Id.*

the issuer falling short of its contracted funding target. Sophisticated investors realize that a lack of voting rights means having no voice in future rounds of fundraising or the firm's exit strategy, thus risking significant dilution and potentially very little return on their investment.²¹⁶

Alternatively, selling a few shares to many crowdfunding investors creates potentially time-consuming problems for a company's management team, due to the large number of new shareholders they must now keep happy.²¹⁷ Small companies that use equity crowdfunding have thus struggled with managing a multitude of shareholders with voting rights.²¹⁸ Portals have handled this dilemma in different ways. Crowdcube is an example of a portal that encourages the offering company to set a threshold investment level that, if met, would enable investors to obtain voting shares.²¹⁹ However, Crowdcube does not manage investor relations for the funded company.²²⁰ Startup-focused Seedrs provides an alternative model using what it calls a "nominee" structure, where it manages corporate governance for the funded company and crowdfunding shareholders.²²¹ Shareholders may maintain certain rights, such as voting power, as specified in an investment agreement.²²²

216. *Id.* at 27.

217. *See id.* (noting that British portals have not taken a uniform approach in facilitating post-issue investor relations); *see also* Schwartz, *supra* at note 19, at 1476–87 (describing the potential problems for issuers with their new shareholders including hostile takeovers, proxy contests, shareholder derivative actions, demand for books and records, and shareholder resolutions). “[T]he very same tools that a crowdfunded issuer used to finance itself in the first place—such as social media campaigns—can be expected to be used against the issuer by dissatisfied shareholders.” *Id.* at 1487.

218. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 27.

219. *See How Does Investing Actually Work?*, CROWDCUBE, http://www.crowdcube.com/pg/crowdcube-faq-20?search_term=voting+rights (last visited Sept. 7, 2014), *archived at* <http://perma.cc/Z4BE-NMWW> (warning investors that the majority of shares issued on its sight are class B stock with no voting rights, but this option is left to the issuer).

220. *See The Investor Relations Portal—Part 1: Entrepreneurs*, CROWDCUBE, <http://www.crowdcube.com/blog/2014/02/14/investor-relations-portal-part-1-entrepreneurs/> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/5NRN-YTNT> (providing instructions for using Crowdcube's Investor Relations Portal created as a media for issuers to conduct investor relations).

221. *Seedrs and Crowdfunding FAQs*, SEEDRS, *supra* note 184.

222. *Id.*

C. Debt Crowdfunding in the United Kingdom

Small businesses' use of crowdfunding to raise debt capital in the United Kingdom has quietly realized exponential growth in contrast to the considerable attention given to equity crowdfunding by British media and crowdfunding stakeholders.²²³ Collins et al. report that the total British debt crowdfunding market stood at nearly £200 million (\$337 million) at the end of 2013.²²⁴ This figure represents a 200 percent increase since 2011, and dwarfs equity crowdfunding.²²⁵ The study's authors concluded that, "[t]he peer-to-business lending sector is more than doubling each year and the United Kingdom is the undisputable world leader of this alternative financing model."²²⁶

Debt crowdfunding could become a significant source of finance for American small businesses based on the British experience surveyed in this section. This Comment offers the additional observation that debt crowdfunding does not compete directly with equity crowdfunding for potential issuers, as it addresses the capital needs for a different segment of small businesses. This section identifies debt crowdfunders as established small businesses with a history of cash flow beyond the stage of development where most owners would seek new equity investors.

223. See *supra*, Part III.B (equity crowdfunding in the United Kingdom). Debt crowdfunding is this Comment's term for the model as explained *supra* Part I. British crowdfunders refer to peer-to-peer lending to businesses as something different from crowdfunding, but typically the lender is acquiring a security interest in the company, and therefore, "debt crowdfunding" is an appropriate term. See PIERRAKIS & COLLINS, BANKING, *supra* note 40, at 11.

224. COLLINS, SWART & ZHANG, ALTERNATIVE FINANCE BENCHMARKING REPORT, *supra* note 8, at 8 (as compared to equity crowdfunding in the United Kingdom, at £29.5 million). This figure represents what the study authors define as "peer to business lending" and "Debt-based Securities." *Id.* One debt crowdfunding portal, Funding Circle, currently reports over £287 million in outstanding loans. *Marketplace Performance*, FUNDING CIRCLE, <https://www.fundingcircle.com/statistics> (last visited Sept. 7, 2014), archived at <http://perma.cc/V28P-G4GZ>.

225. COLLINS, SWART & ZHANG, ALTERNATIVE FINANCE BENCHMARKING REPORT, *supra* note 8, at 9.

226. *Id.* at 10.

1. A Survey of Debt Crowdfunding in the United Kingdom

The British debt crowdfunding portals examined for this Comment exhibit considerable divergence in the operating models of their equity cousins. As with equity crowdfunding, the issuer first applies to offer securities with the portal.²²⁷ The company and portal then agree to terms of how much money to raise within a specific time under the all-or-nothing model.²²⁸ The critical difference from equity crowdfunding is in the interaction between the individual lenders and the issuer throughout the funding process. In addition to deciding on an amount to loan, the lender “bids” on an interest rate.²²⁹ The issuing company then chooses either to accept the funds and the bidder’s interest rate or decline the offer.²³⁰ Only if the company meets its funding goal does the portal then collect the funds from lenders for distribution to the issuer.²³¹ Through a financial intermediary, usually a bank, the company then repays its lenders in monthly installments plus interest according to a pre-established time limit of months or years.²³²

Pierrakis and Collins suggest that there are several advantages of debt crowdfunding over traditional business lending. Their study reported that issuing companies were able to receive financing faster through debt crowdfunding than with traditional bank lending.²³³ Many of the companies surveyed considered debt crowdfunding less expensive than bank lending.²³⁴ Due to the efficiency of debt crowdfunding,²³⁵

227. See, e.g., *Applying for a Loan*, FUNDING CIRCLE, <https://support.fundingcircle.com/forums/21573817-Applying-for-a-loan> (last visited Sept. 7, 2014), archived at <http://perma.cc/9WDK-TT3S> (providing information to businesses on how to apply to this debt crowdfunding portal).

228. *Id.*

229. See, e.g., *How Borrowing Works*, FUNDING CIRCLE, <https://www.fundingcircle.com/businesses/how-borrowing-works> (last visited Sept. 7, 2014), archived at <http://perma.cc/Q3MM-GEBQ> (describing how Funding Circle’s loan auction operates).

230. *Id.*

231. *Id.*

232. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 10–11 (explaining that neither the debtor company nor the portal repays each individual lender, but instead relies on the financial institution to accomplish this function).

233. *Id.* at 4, 8–9; see *supra* Part I.B.2 (examining debt crowdfunding generally and introducing Pierrakis and Collins’ study using data from debt crowdfunding portal Funding Circle).

234. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 34.

77 percent of these borrowers reported a high likelihood of choosing it again even if traditional bank lending were available.²³⁶

2. Debt Crowdfunding in Action: How Companies Like Funding Circle Are Changing Small Business Lending in the United Kingdom

Funding Circle, the largest British debt portal, offers American crowdfunding stakeholders a powerful example of how debt crowdfunding in the United States might function.²³⁷ Funding Circle's pre-lending due diligence process is far less subjective than that of equity crowdfunding portals explored in Part III.B. This early entrant into the debt crowdfunding market takes a more analytical approach to approving borrowers.²³⁸ The portal typically requires at least £100,000 (\$168,000) in annual revenue and financial statements for the previous two years.²³⁹ While the borrower must provide a short description of their business and the purpose of the loan, the application process focuses on the financial soundness of the company that includes an analysis of other outstanding debts and background checks of the principals.²⁴⁰ Funding Circle uses this information to establish a "risk band" for the borrowing company to help investors assess risk.²⁴¹ The portal

235. *Id.* at 35.

236. *Id.* at 37.

237. Funding Circle advertises that it alone has facilitated over £355 million in debt crowdfunding since its inception in 2010. FUNDING CIRCLE, <https://www.fundingcircle.com/homepage> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/RP9B-VHQ7>. This is considerably more than the £100 million cited by Pierrakis and Collins in April 2013. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 3.

238. *Loan Types and Criteria*, FUNDING CIRCLE, <https://www.fundingcircle.com/businesses/loan-types-and-criteria> (last visited Mar. 15, 2014), *archived at* <http://perma.cc/L4N6-Z7GR>.

239. *A Step-by-Step Guide to Borrowing*, FUNDING CIRCLE 2, <https://www.fundingcircle.com/information-packs/business-information.pdf>, *archived at* <http://perma.cc/5QYE-L35L> (downloadable document from the company website providing information on the application process to include specific financial statement requirements).

240. *Id.* at 4.

241. *How is the Risk Band of My Business Determined?*, FUNDING CIRCLE, <https://support.fundingcircle.com/entries/22572457-How-is-the-risk-band-of-my-business-determined-> (last visited Mar. 15, 2014), *archived at* <http://perma.cc/XSN3-XR25> (explaining that risk bands, similar to a credit ratings, score borrowers from A+ through C-).

creates the risk band based on a company's credit rating—if available—and a number of other factors, including financial records and the credit-worthiness of its principals.²⁴²

Once Funding Circle approves a company for a loan and assigns a risk band, the portal posts the company's offering on its website.²⁴³ For current loans, Funding Circle reports an average interest rate of 8.3 percent to top-rated businesses ("A+" risk band), and up to an average of 12.8 percent on its lowest-rated debt ("C-" risk band).²⁴⁴ The company offers an average 6.4 percent return to investors after fees and bad debt, taking into account 6,096 loans currently worth over £287 million (\$482 million).²⁴⁵ Figure 3 below offers additional loan data compiled from Funding Circle's current offerings.

242. *Id.* (stating that Funding Circle considers more than 1,500 factors when assigning a risk band).

243. *Marketplace*, FUNDING CIRCLE, <https://www.fundingcircle.com/lend/loan-requests> (last visited Mar. 15, 2014), *archived at* <http://perma.cc/DLM8-895F> (listing available businesses, risk band, amount the business is attempting to borrow, term of loan, and the average rate of bidders to date).

244. *Marketplace Performance*, FUNDING CIRCLE, *supra* note 224 (access to this data requires toggling to the "last 100 loans"). The United Kingdom Federation of Small Business offers some interest rate comparison data from its most recent quarterly survey, finding that over half of companies approved for bank loans received a rate under six percent. FSB VOICE OF SMALL BUSINESS INDEX, FED'N SMALL BUS. 15 (1st Quarter 2014), *available at* http://www.fsb.org.uk/frontpage/assets/q1%202014_cabr%20index%20_final.pdf, *archived at* <http://perma.cc/52BR-CEGH>. Of the companies that applied for loans, forty-two percent faced rejection. *Id.*; *see also* TRENDS IN LENDING, BANK ENG. 10 (Jan. 2014), <http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary14.pdf>, *archived at* <http://perma.cc/EF7C-RGKM> (citing the FSB study and noting, "credit was offered at higher rates to a larger proportion [of applicants] than in the previous quarter").

245. *Id.* (as of Nov. 8, 2014 according to company data). Funding Circle estimates its bad debt at 4.4 percent of outstanding loans, and provides advice to investors on how to apply this calculation into their lending decision.

Figure 3. *Funding Circle: Current Offering Averages (as of March 15, 2014)*²⁴⁶

Average Risk Band (A+ to C-)	Average Amount of Loan	Average Term of Loan	Average Interest Rate
B	£61,719 (\$103,553) ²⁴⁷	54 months ²⁴⁸	11.2%

Pierrakis and Collins' study, as well as Funding Circle's website, demonstrate several market positioning differences between the debt and equity models. Debt crowdfunding appears to target businesses with at least some financial history and current cash flow, as opposed to most equity portals.²⁴⁹ Pierrakis and Collins link Funding Circle's demand to the observation that debt crowdfunding investors consider financial return to be considerably more important than other intrinsic factors, such as emotional fulfillment, common to equity crowdfunding.²⁵⁰ Intuitively, this makes sense as the debt investors are not purchasing a stake in the company, and lack many of the other features of emotional engagement that equity crowdfunding offers, such as rewards and continued

246. Data set based on Funding Circle posted offerings as of November 8, 2014. *Marketplace Performance*, FUNDING CIRCLE, *supra* note 224. Data set comprises seventy-eight companies (on file with author). Author's note: Funding Circle provides very little public information without becoming a member—a process requiring British residence.

247. *Foreign Exchange Rates*, FED. RESERVE, *supra* note 154.

248. Funding Circle offers loan terms of six, twelve, twenty-four, thirty-six, forty-eight, and sixty months. *Marketplace Performance*, FUNDING CIRCLE, *supra* note 224.

249. *Compare a Step-by-Step Guide to Borrowing*, FUNDING CIRCLE, *supra* note 239, at 4–5 (requiring business records and history of cash flows), *with, e.g., Should I Raise Debt or Equity Seed Capital*, SEEDRS, http://www.seedrs.com/faq/items/25_should_i_raise_debt_or_equity_seed_capital, archived at <http://perma.cc/RB7L-WXU2> (explaining this portal's focus on startup companies that may not have a history of cash flow or even a product at time of issuance). The purpose for the capital may also play a role in the issuer's decision between debt or equity crowdfunding. Where an early stage startup may welcome raising the equity capital necessary to launching their product or service, the Pierrakis and Collins study found that over one-third of debt crowdfunding went towards business expansion and a similar amount towards working capital for the business. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 26.

250. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 23 (examining data from Funding Circle case study).

contact post-investment.²⁵¹ For businesses that qualify for debt crowdfunding, however, there appears to be a symbiotic relationship between lenders and borrowers based on their financial motivation. 75 percent of lenders in the survey stated they would increase their debt crowdfunding and 77 percent of borrowers stated they were either “very likely” or “likely” to return to Funding Circle if they require additional financing.²⁵²

IV. TAKEAWAYS FOR CROWDFUNDING STAKEHOLDERS IN THE UNITED STATES

The preceding Part explained how securities crowdfunding has evolved in the United Kingdom into a significant market force for small business capital formation. The following sections take these observations a step further and offer several conclusions of how a successful securities crowdfunding industry should develop in the United States, despite its many critics in this country. Sections A and B address some of the major concerns of other commentators, including the impact of JOBS Act regulation on issuers and portals, and the role of the crowdfunding exemption under section 4(a)(6) in relation to the Rule 506 exemption.²⁵³ This Part concludes with the assertion that, based on evidence from the United Kingdom, debt crowdfunding will likely develop into the dominant application of the section 4(a)(6) exemption and will serve as a powerful alternative to bank lending for small businesses.

A. *Why Securities Crowdfunding Likely Succeeds Despite the JOBS Act Regulation*

While both the funding limits and disclosure requirements of section 4(a)(6) appear excessive,²⁵⁴ the British crowdfunding experience indicates that some criticism may be overdone.²⁵⁵

251. Compare generally *supra* Part III.B (equity crowdfunding as it operates in the United Kingdom), with *supra* Part III.C (debt crowdfunding in the United Kingdom).

252. PIERRAKIS & COLLINS, *BANKING*, *supra* note 40, at 20, 37.

253. See *supra* Part II discussing the various critiques of the securities crowdfunding exemption.

254. See Bradford, *Promise Unfulfilled*, *supra* note 78, at 217 (suggesting that the Act is ambiguous and potentially too costly for many small businesses to comply).

255. See, e.g., Cohn, *supra* note 108, at 1444 (asserting that “[i]t is difficult to

This section draws from Part III to suggest that portals and issuers will likely overcome these regulatory obstacles due to the scalability of portal business models and the market-driven support for securities offerings well under \$500,000.

Both equity and debt crowdfunding portals in the United Kingdom have proven their scalability. For example, Funding Circle currently maintains 6,096 loans valued at over £287 million (\$482 million).²⁵⁶ That company's analytics-driven approval process for debt issuers demonstrates a high level of efficiency that should readily adapt to regulatory requirements in the United States by issuing a large number of relatively small loans at low cost.²⁵⁷ Indeed, the company's recent expansion into the United States took place through a merger with Endurance Lending Network and corresponded with an additional \$37 million in venture capital financing, thus paving the way for potential development of its debt crowdfunding model in this country.²⁵⁸ Additionally, equity portal Crowdcube currently operates in eight countries using a joint venture approach as a means of adapting to national securities laws.²⁵⁹ While equity portals in the United Kingdom exhibit a strong degree of subjective analysis in approving offerings, the use of modern modeling techniques and big data likely permit companies such as Crowdcube to develop cost-effective

imagine that for offerings under \$250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities.”).

256. *Marketplace*, FUNDING CIRCLE, <https://www.fundingcircle.com/lend/loan-requests> (last visited Mar. 15, 2014), *archived at* <http://perma.cc/DLM8-895F>.

257. *See infra* Part III.C.2 (describing Funding Circle's decision-making process for business lending applications).

258. *About Us*, FUNDING CIRCLE, <https://www.fundingcircle.com/us/about>, *archived at* <http://perma.cc/9TM9-KL56> (stating that, as of Nov. 16, 2013, loans made in the United States must originate from accredited investors); Kylie MacLellan, *UK Peer-to-Peer Lender Funding Circle Expands with U.S. Deal*, REUTERS (Oct. 23, 2013, 7:02 PM), <http://news.yahoo.com/uk-peer-peer-lender-funding-circle-expands-u-230224844—sector.html>, *archived at* <http://perma.cc/4TRM-S2D5>.

259. *Crowdcube Continues Global Expansion*, CROWDCUBE, <http://www.crowdcube.com/blog/2013/11/22/crowdcube-launch-italy-signing-seventh-global-joint-venture-agreement> (last visited Sept. 7, 2014), *archived at* <http://perma.cc/5BZW-SVNZ> (in addition to the United Kingdom, Crowdcube currently operates in Sweden, Italy, Spain, Poland, Dubai, Brazil, and New Zealand); *see also* Kylie MacLellan, *UK Start-Up Investment Website Plans Global Expansion*, FORBES (July 3, 2013), <http://www.reuters.com/article/2013/07/03/us-britain-crowdfunding-crowdcube-idUSBRE9620UC20130703>, *archived at* <http://perma.cc/4UUX-9ZV8> (reporting that Crowdcube is exploring partnerships in the United States and Canada as well).

selection methods in their gatekeeping role.²⁶⁰ Companies such as Crowdcube and Seedrs may combine their existing experience with new analytical tools in an effort to expand into the United States. Conversely, this Comment avers that American firms, such as Indigogo and Kickstarter, will leverage their own similar capabilities to enter the funding portal market as a logical expansion of their current business models.²⁶¹

Empirical evidence provided in this Comment suggests that the second factor that contributes to the successful application of securities crowdfunding in the United States is the demonstration of a need for financing well under the \$1 million JOBS Act limit. As depicted in Table 3 below, British companies using equity portal Crowdcube had an average offering of £173,919 (\$291,802) while those borrowing through debt portal Funding Circle raised an average of £61,719 (\$103,553). The Table then demonstrates the disclosure requirements for these issuing amounts if they had taken place in the United States under the section 4(a)(6) exemption.

260. See Schumpeter, *Building with Big Data*, *ECONOMIST* (May 26, 2011), available at <http://www.economist.com/node/18741392>, archived at <http://perma.cc/AG58-AAZR> (describing big data as “the next frontier for innovation, competition and productivity,” where companies can assemble ever increasing detailed pictures of their customers by collecting massive amounts of data, storing it, and analyzing it at low cost). See generally VIKTOR MAYER-SCHONBERGER & KENNETH KUKIER, *BIG DATA: A REVOLUTION THAT WILL TRANSFORM HOW WE LIVE, WORK, AND THINK* 6–7 (2013) (offering a definition of big data as the ability to use information on an unprecedented scale).

261. See *supra* Part I (introducing these American reward and donation-based crowdfunding portals).

Table 3: British Securities Crowdfunding Portal Data Applied to JOBS Act Disclosures

Portal Example	Average Amount Offered	JOBS Act Disclosure Implications (assuming similar issuing amounts in the U.S.)
Crowdcube—Equity	£173,919 (\$291,802) ²⁶²	Independent public accountant must review financial statements.
Funding Circle—Debt	£61,719 (\$103,553) ²⁶³	Independent public accountant must review financial statements. (If under \$100,000, then only previous year income tax returns and unaudited financial statements required.)

Most issuers, if inferring similar results from Table 3 in the United States, would qualify for the less onerous independent public accountant review requirement rather than the audited financial statements required for issuances over \$500,000.²⁶⁴ Legal and accounting costs will remain, but securities crowdfunding portals should develop business models that are able to succeed within the JOBS Act regulatory environment.²⁶⁵ This is due to the lower transaction costs associated with the limited size of average issues studied here combined with the apparent scalability of crowdfunding portals demonstrated by the British experience.

262. This figure represents the average of twenty-six startup and early-stage active offerings posted on Crowdcube's website on November 8, 2014. *Investment Opportunities*, CROWDCUBE, *supra* note 162. Additional data of note is that the average offering had fifty-four investors who had committed an average of £1,831 (\$3,072). *Id.*; see *Foreign Exchange Rates*, FED. RES., *supra* note 154 (currency conversion). Data set on file with the author.

263. See Figure 3, *supra* note 246 (showing that, although the mean issuance is over the \$100,000 limit for simplified disclosure, the median amount converts to \$83,413). Forty-two percent of the companies in the Funding Circle data set borrowed \$100,000 or less and would qualify for the lowest level of disclosure. *Id.*; see *Foreign Exchange Rates*, FED. RES., *supra* note 154 (currency conversion).

264. See *supra* Part II (describing disclosure requirements under the JOBS Act).

265. Bradford, *Promise Unfulfilled*, *supra* note 78, at 217.

B. The Role of the Crowdfunding Exemption in Relation to Rule 506

This section examines how securities crowdfunding potentially bridges the funding gap discussed in Parts I and II between owners' equity and traditional means of follow-on equity capital such as that acquired under Rule 506. The funding gap discussed in Part I likely persists, despite the JOBS Act revisions to Rule 506, because of the motivations for higher and more definite returns for those investors who qualify under the Rule. This in turn leads to a potential role for securities crowdfunding in capitalizing businesses that would otherwise present sound investment opportunities but operate against the evolved biases of angel investors and venture capital firms.²⁶⁶

Key benefits of the crowdfunding exemption discussed in Part II include an exemption from state regulation and the ability to issue securities to an unlimited number of unaccredited investors.²⁶⁷ The examination of securities crowdfunding in Part III demonstrated the importance of this latter provision. While section 4(a)(6) prohibits portals from promoting securities offerings, other than the information displayed on their websites,²⁶⁸ British crowdfunders demonstrate the effectiveness of such activity in the form of the "pitch."²⁶⁹ Additionally, securities crowdfunding's critics apparently fail to note the power of social media in the crowdfunding context.²⁷⁰ British securities rules likewise prohibit specific advertisements of offerings beyond a portal's website,²⁷¹ yet issuers have adeptly used social media to direct

266. See Cable, *supra* note 59 and accompanying text.

267. Thompson & Langevoort, *supra* note 6, at 1604–05; see also *supra* Part III.B.2 (providing evidence of the extrinsic motivations of British equity crowdfunding investors).

268. See *supra* Part II.A.

269. See *supra* Part III.B.1 (discussing composition of the issuing company's pitch); see, e.g., *Creating a Successful Pitch*, CROWDCUBE, *supra* note 180 (providing steps on pitch creation and offering technical assistance in pitch production).

270. See Cohn, *supra* note 108, at 1433 (pointing to the advertising restriction as another means of discouraging issuers from using securities crowdfunding); see also Thompson & Langevoort, *supra* note 6, at 1605 (“[I]t is difficult for us to see why a rational start-up entrepreneur would find it appealing to use the new 4(a)(6) exemption at all.”).

271. See *supra* note 140 and accompanying text.

potential investors to their funding pitches hosted by the portal.²⁷²

Securities crowdfunding in the United States, therefore, is likely to develop a symbiotic relationship with Rule 506 by permitting companies to raise capital in anticipation of capturing the attention of accredited investors.²⁷³ Alternatively, the new exemption provides businesses with a means of raising capital from smaller investors in their local community.²⁷⁴ This financing alternative is particularly important for companies that do not meet the profile desired by most accredited investors looking for high-growth startups.²⁷⁵

C. *The Future for Debt Crowdfunding in the United States*

Few critics of securities crowdfunding in the United States mention the potential for using this new medium for raising business debt.²⁷⁶ This Comment, however, presents the first empirical evidence to support the theory that debt crowdfunding under section 4(a)(6) should evolve into a robust means of capital formation for American small businesses and could become the primary application for the crowdfunding exemption. Debt crowdfunding in the United Kingdom, as discussed in Part III.C, succeeded through a combination of protections for both investors and debt issuers; a scalable, analytics-driven risk allocation model; and competitive interest rates. This Comment asserts that these factors are replicable in the United States once the SEC implements rules permitting debt crowdfunding. Actions such as Funding Circle's establishment of an American subsidiary add further support to this theory.

272. *What Is Crowdfunding*, U.K. CROWDFUNDING ASS'N, <http://www.ukcfa.org.uk/what-is-crowdfunding>, archived at <http://perma.cc/X9VP-JFS4>.

273. See *supra* Part I.C (describing securities crowdfunding's position relative to other means of entrepreneurial finance).

274. See *supra* Part III.B–C (describing how securities crowdfunding operates in the United Kingdom as an alternative source of small business finance).

275. See *supra* Part I.C (describing how securities crowdfunding addresses the funding gap for companies that do not fit the investing profile of large equity investors).

276. *But see* Schwartz, *supra* note 19, at 1488 (discussing the potential preference for debt over equity crowdfunding).

CONCLUSION

While many experts in the United States fear securities crowdfunding will emerge as either a flop or a platform for bilking uneducated investors out of their money,²⁷⁷ the British experience supports an opposite conclusion. The experts interviewed for this Comment and recent research point to negligible instances of fraud.²⁷⁸ This phenomenon is likely due in part to both the highly evolved regulatory environment in the United Kingdom and the private ordering that developed along with the British securities crowdfunding model. American crowdfunding stakeholders have many reasons to feel optimistic that securities crowdfunding will develop to be relatively fraud-resistant. The new rules in the United States correspond to the all-or-nothing model used by the portals surveyed here.²⁷⁹ This approach encourages issuers to produce a convincing business model for evaluation by the crowd before investors will commit their funds.²⁸⁰ The British application of the all-or-nothing funding requirement has proven to be a powerful anti-fraud measure in the crowdfunding market because it requires companies to commit to broad disclosure in order to attract sufficient financing. This approach enables potential investors to use social media as a conduit for conducting due diligence and spreading the word of possible fraudsters.

Securities crowdfunding in the United Kingdom demonstrates the potential for a vibrant alternative source of entrepreneurial finance that, given the appropriate opportunity, should similarly succeed in the United States. This funding model exhibits inherent fraud-preventative measures. It is scalable and designed to work within today's social-media-addicted economy. Finally, securities crowdfunding has successfully adapted to a changing

277. See 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, 1763 (2012) (arguing for a narrowly defined crowdfunding exception due to the potential for investor fraud).

278. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 24; see also *Policy Statement*, *supra* note 130, at 15 (basing FCA decision not to impose more regulation on the market, based on the lack of bad conduct to date).

279. See *infra* Part III; see also 15 U.S.C. § 77d-1(a)(7) (2012).

280. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 24.

regulatory landscape, as evidenced by British stakeholders' general acceptance of rules similar to those legislated in the United States. For these reasons, this Comment concludes that securities crowdfunding (and particularly debt crowdfunding) will likely develop into a robust market for entrepreneurial finance despite the American government's best efforts to marginalize it.

APPENDIX: A CASE STUDY IN EQUITY CROWDFUNDING:
CROWDCUBE²⁸¹

Part IV surveyed the similarities between the existing securities crowdfunding regulatory environment in the United Kingdom and the one emerging in the United States. A closer examination of a leading British equity crowdfunding portal provides additional insight into how British crowdfunding operates in practice and what this might look like in the United States. As this Comment indicates, however, the British legal regime that governs securities crowdfunding is not perfectly analogous to its American counterpart. This Appendix, therefore, presents a case study of the basic mechanics of how a portal interacts with its two primary constituencies: offering companies and investors.

Founded in 2010, Crowdcube was the first equity portal in the United Kingdom.²⁸² The company offers securities crowdfunding stakeholders in the United States an idea of how an early entrant into this market might operate. According to Crowdcube, the site has successfully funded 158 businesses for a total of over £42 million (\$70 million) of equity raised.²⁸³ Companies have raised an average of £230,990 (\$387,555), with the highest at £1 million (\$1.68 million), and the lowest at £12,000 (\$20,100).²⁸⁴ The firm used its own site to raise over £1.8 million (\$3 million) in two separate rounds.²⁸⁵ Eleven companies have returned for additional rounds of financing.²⁸⁶ Research data indicates that British equity crowdfunding portals reject approximately 75 percent of all pitches.²⁸⁷

Crowdcube discloses a significant amount of investor data. The average investment is £2,500 (\$4,200) and the largest

281. This Comment relies primarily on information the company provides to the public at CROWDCUBE, <http://www.crowdcube.com/> (data as of Nov. 8, 2014), archived at <http://perma.cc/FWE3-SKRQ>.

282. *About Crowdcube*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-inc-about-us-1>, (last visited Nov. 8, 2014), archived at <http://perma.cc/7K4F-ZWUN>.

283. *Crowdcube Infographic*, CROWDCUBE, *supra* note 200; see *Foreign Exchange Rates*, FED. RES., *supra* note 154 (currency conversion).

284. *Id.*

285. *Investment Opportunities*, CROWDCUBE, *supra* note 162.

286. *Crowdcube Infographic*, CROWDCUBE, *supra* note 200.

287. COLLINS & PIERRAKIS, VENTURE CROWD, *supra* note 32, at 11. This figure correlates to Crowdcube's published seventy-six percent rejection rate. *Crowdcube Infographic*, CROWDCUBE, *supra* note 200.

single investment was £250,000 (\$419,000), even though the site requires a minimum investment of only £10 (\$17).²⁸⁸ Successful funding rounds have averaged 104 investors, and 24 percent of investors have committed funds to more than one company.²⁸⁹

Furthermore, Crowdcube generates its revenue from the companies it successfully funds, and not investors. The portal charges 5.5 percent of total funds raised when the company successfully reaches its target.²⁹⁰ This includes a “success fee” and payment processing.²⁹¹ The portal charges an additional £1,750 (\$2,936) in legal fees.²⁹² Neither investors nor companies seeking funding pay a signup fee to register with Crowdcube, and the portal only charges the company a fee once the funding round succeeds.²⁹³ The entrepreneur has a maximum of sixty days to reach the funding target, and the average length of time for successful offerings is forty-five days.²⁹⁴

In contrast to funding a business through Crowdcube, signing up as an investor is relatively easy and has no cost. British regulations only require Crowdcube investors either to sign a disclaimer that they are educated in the risks of investing in small businesses or to “self-certify” as high net worth individuals or sophisticated investors.²⁹⁵ Potential investors may view all offerings prior to signing up on the site.²⁹⁶ Crowdcube only charges investors once the funded company reaches its target and completes all legal documentation for the issuance of shares.²⁹⁷ The investor or offering company may cancel the investment at any time prior

288. *Crowdcube Infographic*, CROWDCUBE, *supra* note 200.

289. *Id.*

290. *Crowdcube Fees*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-fees-34> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/KQ7Z-S9TT>.

291. *Id.*

292. *Id.*

293. *Id.*

294. *Frequently Asked Questions*, CROWDCUBE, *supra* note 70 (maximum sixty days); *Raising Finance*, CROWDCUBE, <http://www.crowdcube.com/pg/businessfinance-3> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/V68R-MMY3> (average forty-five days).

295. *Frequently Asked Questions*, CROWDCUBE, *supra* note 70 (“Who can invest?”).

296. *Investment Opportunities*, CROWDCUBE, *supra* note 162.

297. *Frequently Asked Questions*, CROWDCUBE, *supra* note 70 (“How does investing actually work?”).

to this point.²⁹⁸

To get an offering posted on Crowdcube requires considerable effort by the issuing company. It must provide Crowdcube (and potential investors) three years of financial forecasts, a business plan, and a video pitch.²⁹⁹ The portal provides links to third-party service providers to complete these requirements.³⁰⁰ The offering company then gets to decide how much money it wants to raise in exchange for an equity percent. Crowdcube requires companies to set a minimum goal of £10,000 (\$16,700) and there is no maximum under British law.³⁰¹ However, the portal expressly discloses that offerings over £150,000 (\$252,000) will require a considerably strong pitch.³⁰²

Crowdcube takes the following steps once an offering company receives at least its targeted amount of funding. First, Crowdcube places the offering company in contact with the portal's outside attorneys, who draft new articles of incorporation that permit the issuance of additional shares.³⁰³ The portal advertises that it uses a standard form for the articles as a means of investor protection and fraud prevention.³⁰⁴ Once this documentation is completed, Crowdcube instructs a third-party financial institution to withdraw investors' funds and transfer the money, less Crowdcube's fees, to the issuer's bank account.³⁰⁵ Crowdcube then issues stock certificates to investors on the issuer's behalf.³⁰⁶

Crowdcube permits the company making the offer to decide what rights shareholders will have and how to manage new

298. *Id.* ("Can I cancel my investment?").

299. *Become Investment Ready*, CROWDCUBE, <http://www.crowdcube.com/pg/investmentready-35> (last visited Sept. 6, 2014), *archived at* <http://perma.cc/45UU-PKKD>.

300. *Id.*

301. The effective maximum amount a crowdfunder could raise is €5 million above which point British and EU securities laws require the production of a prohibitively expensive prospectus. *See supra* Part III.A.

302. *Frequently Asked Questions*, CROWDCUBE, *supra* note 70 ("Is there a maximum or minimum Target Amount?").

303. *Id.* ("What happens once the Target Amount is raised?") (last visited Oct. 12, 2014).

304. *Id.*

305. *Id.*

306. *The Crowdcube Crowdfunding Process*, CROWDCUBE, <http://www.crowdcube.com/pg/the-crowdcube-crowdfunding-process-1371> (last visited Oct. 12, 2014), *archived at* <http://perma.cc/8SU6-VMGR>.

shareholders.³⁰⁷ Additionally, Crowdcube links equity with reward crowdfunding.³⁰⁸ For example, the brewer Little Brew raised £110,510 (\$185,400) in exchange for 28 percent equity to 167 investors.³⁰⁹ Additionally, the company provided rewards depending on the amount invested.³¹⁰ Investors received a case of beer and 10 percent off online orders for investing £100 (\$168).³¹¹ For £20,000 (\$33,600), the investor received a case of beer every three months for three years, the opportunity to develop a permanent beer, and the ability to host an annual party at the brewery.³¹² As discussed above, the reward feature serves to help entrepreneurs validate their market while getting potential investors excited about owning a stake in the company.³¹³

307. *Frequently Asked Questions*, CROWDCUBE, <http://www.crowdcube.com/pg/crowdcube-faq-20> (last visited Sept. 6, 2014), archived at <http://perma.cc/Z446-BPAD> (“How does investing actually work?”).

308. *Id.*

309. *Little Brew*, CROWDCUBE, *supra* note 185.

310. *Id.*

311. *Id.*

312. *Id.*

313. *Id.*; see *supra* Part III.B.2 (describing the use of equity crowdfunding to validate the market for a consumer product).