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I. INTRODUCTION

On April 05, 2012 President Obama signed into law the Jumpstart Our Business Startups (JOBS) Act.[1] The JOBS Act was met with a great deal of fanfare, due mostly to passing with bipartisan support and because it was intended to encourage funding of small businesses and allow everyday investors to participate in startup investing. The goal of the JOBS Act was to ease securities regulations that had long been deemed as onerous for small businesses seeking to raise capital. While Title II and Title IV of the Act received attention, it was Title III, colloquially known at Regulation Crowdfunding, which received the lions' share of coverage.

Regulation Crowdfunding was a great attempt at opening up the capital markets both to business raising capital and investors desiring to invest in small businesses and startups who traditionally were preventing from doing so. That said, Regulation Crowdfunding is flawed and will not generate the activity once believed for a variety of reasons. In the wake of discussions around these flaws a new act, the Fix Crowdfunding Act,[2] is currently in the legislature, hopefully rendering moot the points of this article. That said, it is important to examine Regulation Crowdfunding for what it is.

The reality is that there are a number of flaws in Regulation Crowdfunding, but the four largest, as discussed by expert Anthony Zeoli,[3] are the low caps for entrepreneurs, the inability to use Special Purpose Vehicles ("SPVs"), low investor caps, and the burden placed upon crowdfunding portals. Even with the flaws there has been some success with the new rules, and the excitement level around the rules has not changed. Unfortunately the excitement found when the rules were passed has not been matched.

II. CURRENT SITUATION

Regulation Crowdfunding, which is actually Title III of the JOBS Act, went live on May 16, 2016. This was more than four years

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[1] H.R. 3606, 122th Cong. (2012).
[2] H.R. 4855, 112th Cong. (2012).
[3] Anthony Zeoli, *Will Title III Crowdfunding Be a Reality or a Pipe-dream?* CROWDFUNDINGLEGALHUB (July 29, 2016, 10:45 PM), https://crowdfundinglegalhub.com/2016/02/11/will-title-iii-crowdfunding-be-a-reality-or-a-pipedream/.

after the signing of the JOBS Act, and well after the deadline set for promulgating rules. The Securities and Exchange Commission ("SEC") took its time, releasing a 685-page[4] rule that was a difficult slog to get through even for the most ardent supports of crowdfunding. The end result was a set of rules that met the requirements of the JOBS Act but did not live up to the intent of the legislature. Many commentators agreed that the rules would disappoint entrepreneurs.[5]

There has been some activity. Within the first month of Regulation Crowdfunding going live there were forty-three offerings, with California being the most active state for offerings.[6] Many had minimum and maximum offerings, and there was a total of $5,660,465.90 offered with a maximum of $25,395, $241.00.[7] The average offering size ranged from $131,638.74 to a maximum of $604,648.60.[8] Most commonly the offerings were for common stock, but there were debt and preferred stock offerings as well, and many other options.[9] Nearly $65,000 a day was being invested this way, or over $2,000,000 by June 13.[10]

While there is a great deal of room for growth in Regulation Crowdfunding and, in general, lower crowdfunding activity than expected, certain platforms have been doing very well, such as WeFunder and StartEngine, and a number of other portals have registered to work with these types of offerings. In other words the news is positive, just tempered from what was expected at the time the JOBS Act was passed. And campaigns built around food and beverage companies seem to be doing quite well in a variety of states.

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[4] Crowdfunding, 80 Fed. Reg. 71388 (Nov. 16, 2015)(codified in 17 CFR Parts 200, 227, 232, 239, 240, 249, 269, and 274).

[5] Chance Barnet, *Why Title III of the JOBS Act Will Disappoint Entrepreneurs*, FORBES (May 13, 2016), *available at* http://www.forbes.com/sites/chancebarnett/2016/05/13/why-title-iii-of-the-jobs-act-will-disappoint-entrepreneurs/#351b5777192a.

[6] Amy Wan, *Progress Report: Data from 30 Days of Title III Equity Crowdfunding*, CROWDFUND INSIDER (June 23, 2016, 8:37 PM), http://www.crowdfundinsider.com/2016/06/87201-progress-report-data-30-days-title-iii-equity-crowdfunding/.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

III. MAJOR FLAWS

As previously mentioned, the biggest flaws are the caps on the amount an entrepreneur can raise, the inability of investors to use SPVs, investor caps, and the burdens placed upon portals. Much of the information used in this section comes directly from the SEC Fact Sheet on Regulation Crowdfunding[11] that summarizes things more concisely than reading through the entire rules.

A. Caps on the Raise Amount

Companies using Regulation Crowdfunding would be limited to raising $1,000,000 in a 12-month period. This is an aggregate amount, and so could be deemed to be integrated in the case that another type of offering is issued. In general, this amount is actually not that low, especially for early stage startups or lifestyle businesses that may be best suited to use this type of crowdfunding. The real issue is the cost of doing this type of offering, which may reach as much as $250,000 for an offering that reaches the maximum limit.

In addition to the cost of doing the raise, suddenly a company will be bound by disclosure requirements that will be costly and difficult for a small-to-medium enterprise ("SME") to put together without the aid of third parties, such as accountants and lawyers. Although this is advisable anyways, all companies raising between $500,000 and $1,000,000 will be required to provide reviewed financial statements to the SEC, investors, and intermediaries, meaning they will have no choice but to work with an independent accountant.[12] Each company will also have to file an annual report with the SEC and provide this report to all investors, which can be costly and time consuming.[13]

In general, the disclosure requirements and the use of third party professionals is good, especially to protect investors who may be less sophisticated. However, it is hard to imagine a pizza shop in a small city in Michigan providing a sophisticated annual report. Many startup businesses will have little to no financial statements, especially an early stage tech company that has yet to raise capital for its operations, but

[11] *SEC Adopts Rules to Permit Crowdfunding*, (2015), http://www.sec.gov/news/pressrelease/2015-249.html (Last visited July 19, 2016).
[12] *Id.*
[13] *Id.*

needs to do so. Forcing an SME that needs to raise capital to have to professionally reviewed financial statements may be an undue burden.

B. Inability to use SPVs

In many other types of capital raising, especially Title II crowdfunding under the JOBS Act and traditional startup crowdfunding, entrepreneurs and investors use SPVs. Essentially SPVs are LLC's created solely for aggregating the investors into a company. This reduces administrative headaches and allows a company to maintain a clean cap table, which may be a necessity if it intends to raise future rounds of capital. Most companies that reach exit, either by acquisition or IPO, will have seven-to-ten funding rounds, and thus a clean cap table is important.

Under Regulation Crowdfunding, SPVs are prohibited. That means if a hundred investors invest in your company you will have to list all a hundred on your books, deal individually with all a hundred investors, and they will have statutory access to your books and records. This is a huge burden on a company trying to grow. With an SPV the entrepreneur would have one person to deal with, the manager of the SPV, and will not have to prepare a hundred separate reports, but rather one. More importantly, if they do decide to take additional rounds of funding or sell, they will not have to directly contact a hundred investors.

C. Investor Caps

The JOBS Act has also limited the amount investors can contribute to crowdfunding campaigns. Interestingly, the caps are not a single campaign, but aggregate on all campaigns. The caps are split based upon income levels, divided by those with income below $100,000 and those with income of $100,000 or more. The former group can invest $2000 or 5% of their income or net worth, whichever is lower. The latter can invest 10% of the lessor of their net worth or income, with a final cap of $100,000. These are aggregates over all offerings in a twelve month period. There is also a restriction on the ability to resell the shares for twelve months.

First, this can actually be bad for the entrepreneurs, because very wealthy investors, even someone like Warren Buffet, are capped at $100,000. Mr. Buffett can invest far more than that with other accredited investors, should he choose to do so, but under Regulation Crowdfunding even he would be severely limited. It would almost not be worth it for him to invest. This means that a large swath of capital that is theoretically accessible is actually lopped off and will remain in other types of investments for the accredited investor only class.

Second, the investment cap burdens the sophisticated but low-earning investor. Imagine a debt-free college professor of Finance earning $95,000 a year. This professor may be one of the people best suited to invest in Regulation Crowdfunding, considering he is likely not an accredited investor but may well have the training to best perform due diligence on a startup company. That does not matter, because he is limited based upon is income. Who will track how much the investor has in fact contributed towards crowdfunding campaigns and what is the effect of passing the threshold? Would the issuer, the portal or the investor bear the burden?

D. Portal Burdens

One last major flaw is the burden placed upon the portals that will be conducting the offerings. First, those conducting offerings must provide educational materials to investors explaining a laundry list of things, including their investment process, the types of securities being offering, and what information a company is required to provide, as well as informing investors of resale restrictions and investment limits. They must then perform due diligence on companies to a ‘reasonable’ basis to ensure that they are not committing fraud, as well as similar due diligence on investors that they are qualified and compliant with investment limitations, but only after they create an account on the portal.

On top of those requirements, which are generally meant to protect against fraud, the portal must provide communication channels, provide notices to investors, comply with cancellation of any investment, and provide the companies’ disclosures to investors twenty-one days before an offering. Basically they have to monitor offerings and investors and assist with transparency, including disclosing how much they charge. Again, not all bad, but they are onerous for the portal. Portals cannot pay for investor leads, and so they have to spend money on the technology to run a portal, to market their portal, and have to open at any time to be inspected by the Financial Industry Regulatory Authority (“FINRA”) and the SEC, who regulate them.

Simply put, these burdens will make it tough for most portals to survive, and will probably greatly limit the number of portals that go into business and succeed. The difficulty with that, of course, is that investors and issuers will have to choose their portal wisely or face the potential of having the portal go out of business, killing their momentum, and forcing them to start over.

IV. Other Issues

For the sake of brevity this article has focused on the largest issues, as seen by many in the industry, and has left out some of the underlying issues. Other problems include the movement of money via the payments industry, what types of payment will be accepted, where to escrow funds efficiently and at a low cost, and setting baseline standards that make Regulation Crowdfunding more accessible for entrepreneurs and investors. Ultimately, most entrepreneurs will find that other methods of raising funds are easier and cost less, but it is still a difficult process and SMEs are actually more frustrated now attempting to find capital then they were four years ago when the JOBS Act was passed.

V. Hope For The Future

A major source of hope for the future is the Fix Crowdfunding Act. This new bill, which has already passed the House, will increase caps to $5,000,000, allow the use of SPVs, and other provisions that will make crowdfunding easier. There is hope, and crowdfunding appears to be here to stay regardless of the flaws currently present. It is an exciting time for SME's hoping to raise funds, and for investors who have long been prevented from gaining wealth via startup investing.